

PAPER

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



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

(Set up by an Act of Parliament)



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Basic draft of this publication was prepared by CA. Vandana D Nagpal

Edition	:	April, 2023
Committee/Department	:	Board of Studies (Academic)
E-mail	:	bosnoida@icai.in
Website	:	www.icai.org
Price	:	₹ /- (For All Modules)
ISBN No.	:	978-81-19472-10-9
Published by	:	The Publication & CDS Directorate on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi 110 002 (India)
Printed by	:	

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IND AS PUZZLERS: TEST YOUR ACCOUNTING ACUMEN (1)-(4)

INDIAN ACCOUNTING STANDARD 103: BUSINESS COMBINATIONS

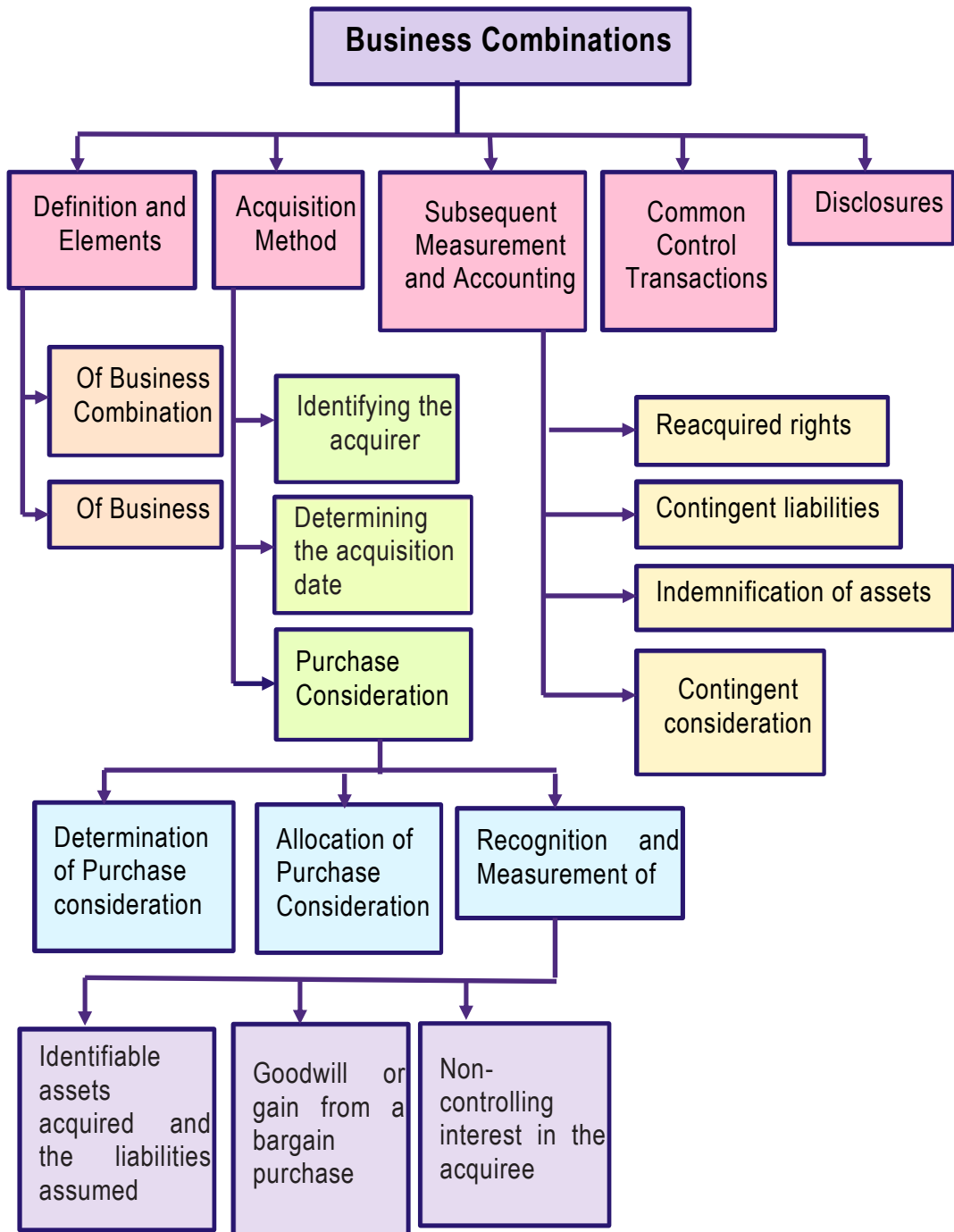


LEARNING OUTCOMES

After studying this chapter, you would be able to:

- ☐ Explain various terms used in Ind AS 103 “Business Combinations”
- ☐ Examine the key differences between Ind AS 103 and Accounting Standard 14
- ☐ Identify the acquiring enterprise
- ☐ Determine the acquisition date, purchase consideration under various situations and contingent consideration
- ☐ Allocate the purchase price
- ☐ Recognize the assets and liabilities of the acquired entity
- ☐ Examine the measurement principles
- ☐ Calculate goodwill or bargain purchase
- ☐ Evaluate contingent payments to employee shareholders and acquirer share-based payment awards exchanged for awards held by the acquiree’s employees
- ☐ Integrate subsequent measurement and accounting principles for reacquired rights, contingent liabilities, indemnification assets and contingent consideration
- ☐ Appraise the disclosure requirements in case of Business Combination
- ☐ Account for distribution of non-cash assets to owners as dividend in accordance with Appendix A Distribution of Non-Cash Assets to Owners of Ind AS 10 Events after the Reporting Period.

CHAPTER OVERVIEW





1. INTRODUCTION

The necessity of a standard on Business Combination in India assumes importance considering the fact that Indian companies are increasingly stretching their business in foreign countries for best-fit business combinations. Presently in India, Accounting Standard (AS) 14 'Accounting for Amalgamation' lays out specific treatment for Amalgamation and AS 21, 'Consolidated Financial Statements' are applied for consolidation. However, it is not matching the global financial reporting standards requirements.

After convergence of IFRS as Ind AS, Ind AS 103 which is in line with IFRS 3 takes care of the global requirements in case of business combinations worldwide.

A **business combination** is a transaction in which the acquirer obtains control of another business (the acquiree).

The term '**business**' is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing **goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.**

Business combinations are most common form of business transactions through which companies grow in size rather than organic activities.

Business combination or acquisition is different from asset acquisition. The following are the key differences in accounting of an asset acquisition and a business combination:

Particulars	Business Combination	Acquisition of group of assets under Ind AS
Intangible assets, including goodwill	Intangible assets are recognised at fair value, if they are separately identifiable. Goodwill is recognised as a separate asset.	Intangible assets acquired as part of a group of assets would be recognised and measured based on an allocation of the overall cost of the transaction with reference to their relative fair values. No goodwill would be recognised.
Transaction Costs	In a business combination, acquisition-related costs (including stamp duty) are expensed in the period in which	Transaction costs are capitalised as a component of the cost of the assets acquired.

	such costs are incurred and are not included as part of the consideration transferred.	
Deferred Tax Accounting	Deferred taxes are recorded on temporary differences of assets acquired (other than goodwill) and liabilities assumed in a business combination.	Ind AS prohibits recognition of deferred taxes for temporary differences that arise upon initial recognition of an asset or liability in a transaction which (i) is not a business combination and (ii) at the time of the transaction, affects neither accounting nor taxable income. [Ind AS 12 paragraph 15]. Accordingly, no deferred taxes are recognised for temporary differences on asset acquisitions (on initial recognition).
Situations where the fair value of the assets acquired and liabilities assumed exceeds the fair value of consideration Transferred (referred to as gain on bargain purchases)	If the fair value of the assets acquired and liabilities assumed exceeds the fair value of the consideration transferred (plus the amount of non-controlling interest and the fair value of the acquirer's previously held equity interests in the acquiree), a gain is recognised by the acquirer in other comprehensive income and accumulate the same in equity as capital reserve.	The assets acquired and liabilities assumed are measured using an allocation of the fair value of consideration transferred based upon relative fair values. As a result, no gain is recognised for a bargain purchase.
Contingent liabilities assumed	To be recognised if represents present obligation that arises from past events and its fair value can be measured reliably with subsequent changes to profit or loss.	Not recognised, subject to Ind AS 37.

Illustration 1: Asset acquisition

An entity acquires an equipment and a patent in exchange for ₹ 1,000 crore cash and land. The fair value of the land is ₹ 400 crore and its carrying value is ₹ 100 crore. Fair values of the equipment and patent are estimated to be ₹ 500 crore and ₹ 1,000 crore, respectively. The equipment and patent relate to a product that has just recently been commercialised. The market for this product is still developing.

Assume the entity incurred no transaction costs. For ease of convenience, the tax consequences on the gain have been ignored.

State how should the transaction be accounted for.

Solution

As per paragraph 2(b) of Ind AS 103, the standard does not apply to “the acquisition of an asset or a group of assets that does not constitute a business. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in Ind AS 38, Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill”. In the given case, the acquisition of equipment and patent does not represent acquisition of a business as equipment and patent relate to a product that has just recently been commercialised.

The cost of the asset acquisition is determined based on the fair value of the assets given, unless the fair value of the assets received is more reliably determinable. In the given case, the fair value measurement of the land appears more reliable than the fair value estimate of the equipment and patent. Thus, the entity should record the acquisition of the equipment and patent as ₹ 1,400 crore (the total fair value of the consideration transferred).

Thus, the fair value of the consideration given, i.e., ₹ 1,400 crore is allocated to the individual assets acquired based on their relative estimated fair values. The entity should record a gain of ₹ 300 crore for the difference between the fair value and carrying value of the land.

The equipment is recorded at its relative fair value ($(₹ 500 / ₹ 1,500) \times ₹ 1,400 = ₹ 467$ crore).

The patent is recorded at its relative fair value ($(₹ 1,000 / ₹ 1,500) \times ₹ 1,400 = ₹ 933$ Crore).



2. SCOPE UNDER IND AS 103

This Indian Accounting Standard applies to a transaction or other event that meets the definition of a business combination. This Indian Accounting Standard does not apply to:

- (a) the formation of a joint arrangement.
- (b) the acquisition of an asset or a group of assets that does not constitute a business i.e. it is an asset acquisition.



3. DEFINITION OF BUSINESS COMBINATION

Under Ind AS 103, Business combination occurs when an entity obtains **control** of a **business** by acquiring net assets or acquiring its significant equity interest. An entity can obtain control of a business by contract only in which case the acquirer would neither have acquired net assets nor equity interest. In such a case, while preparing balance sheet, controlling interest would be zero and non-controlling interest will be 100%.

- As such, two elements are required for a transaction to be a business combination under Ind AS 103:
 - the acquirer obtains control of an acquiree ("control" as defined in Ind AS 110); and
 - the acquiree is a business
- An acquirer might obtain control of an acquiree in a variety of ways, for example:
 - by transferring cash, cash equivalents or other assets (including net assets that constitute a business);
 - by incurring liabilities;
 - by issuing equity interests;
 - by providing more than one type of consideration; or
 - without transferring consideration, including by contract alone.
- A business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:
 - one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;

- one combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners;
- all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or
- a group of former owners of one of the combining entities obtains control of the combined entity.



4. DEFINITION AND ELEMENTS OF BUSINESS

4.1 Definition of Business

As per paragraph B7 of the application guidance of Ind AS 103, a business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business.

Analysis: Ind AS 103 defines business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

For a transaction to meet the definition of a business combination (and for the acquisition method of accounting to apply), the entity must gain control of an integrated set of assets and activities that is more than a collection of assets or a combination of assets and liabilities. It will be straightforward in most cases to determine whether a business has been acquired. A business would normally be carrying out a continuing trade with identifiable revenue. This means that the assets or combination of assets and liabilities of the acquired entity interact with each other and, importantly, with the people who operate the assets as a business. However, determining whether a business has been acquired may not be easy and in some cases will require judgement.

4.2 Elements of Business

The three elements of a business are defined as follows:

- (a) **Input:** Any economic resource that creates outputs or has the ability to contribute to the creation of outputs, when one or more processes are applied to it.

Example:

Non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

- (b) **Process:** Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates output or has the ability to contribute to the creations of outputs.

Example:

Strategic management processes, operational processes and resource management processes.

These processes typically are documented, but the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

- (c) **Output:** The result of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities.

4.3 Further Assessment

To be capable of being conducted and managed for the purpose identified in the definition of a business, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs.

Therefore, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output.

Substantive Process:

To determine whether acquired process is substantive, following has to be considered:

- (1) **If a set of activities and assets does not have output at the acquisition date, an acquired process (or group of processes) shall be considered substantive only if-**
- (a) It is critical to the ability to develop or convert an acquired input or inputs into outputs; and
 - (b) The inputs acquired include both an organised workforce that has the necessary skills, knowledge, or experience to perform that process (or group of processes) and other inputs that the organised workforce could develop or convert into outputs.

Those other inputs could include-

- (i) Intellectual property that could be used to develop a good or service;
- (ii) Other economic resources that could be developed to create outputs; or
- (iii) Rights to obtain access to necessary materials or rights that enable the creation of future Outputs.

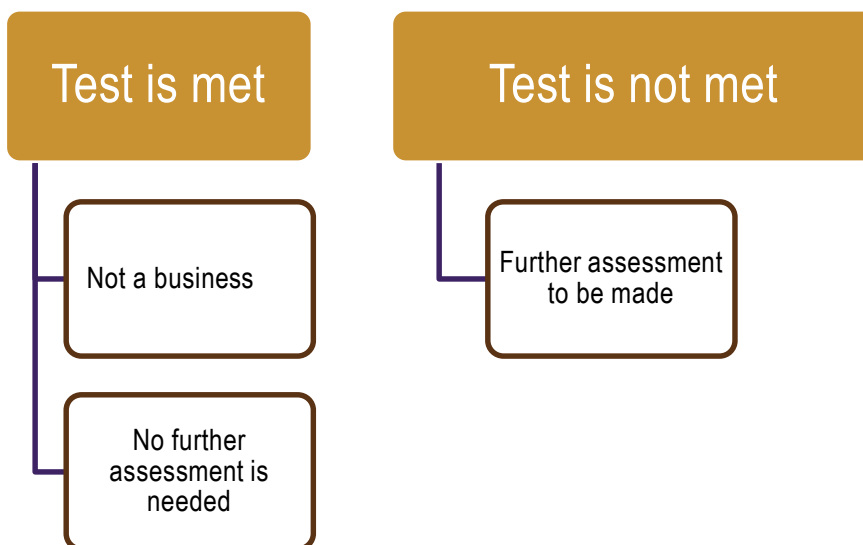
(2) If a set of activities and assets has outputs at the acquisition date, an acquired process (or group of processes) shall be considered substantive if, when applied to an acquired input or inputs, it-

- (a) is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce with the necessary skills, knowledge, or experience to perform that process (or group of processes); or
- (b) significantly contributes to the ability to continue producing outputs and-
 - (i) is considered unique or scarce; or
 - (ii) cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

4.4 Concentration Test

As per paragraph B7A of the application guidance of Ind AS 103, an optional test (the concentration test) has been introduced to permit a simplified assessment of whether an acquired set of activities and assets is not a business.

On the basis of the above test, following will be the consequences:



Following conditions should be present to meet concentration test:

As per paragraph B7A of the application guidance of Ind AS 103, the concentration test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. For the concentration test:

- (a) gross assets acquired shall exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities;
- (b) the fair value of the gross assets acquired shall include any consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) in excess of the fair value of net identifiable assets acquired.
- (c) a single identifiable asset shall include any asset or group of assets that would be recognized and measured as a single identifiable asset in a business combination;
- (d) if a tangible asset is attached to, and cannot be physically removed and used separately from, another tangible asset (or from an underlying asset subject to a lease, as defined in Ind AS 116, Leases), without incurring significant cost, or significant diminution in utility or fair value to either asset (for example, land and buildings), those assets shall be considered a single identifiable asset;
- (e) when assessing whether assets are similar, an entity shall consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics);
- (f) the following shall not be considered similar assets:
 - (i) a tangible asset and an intangible asset;
 - (ii) tangible assets in different classes unless they are considered a single identifiable asset in accordance with the criterion in subparagraph (d);
 - (iii) identifiable intangible assets in different classes
 - (iv) a financial asset and a non-financial asset;
 - (v) financial assets in different classes; and
 - (vi) identifiable assets that are within the same class of asset but have significantly different risk characteristics.

Notes:

- 1) Concentration test is optional test and the decision to apply is made on a transaction to transaction basis.
- 2) Does not prohibit an entity from performing a detailed test assessment using definition of business given in this standard.
- 3) 3 Step process for concentration test:
 - a) Measure the Fair Value of Gross Assets acquired.
 - b) Identify the single identifiable assets or group of similar identifiable asset.

- c) Determine if substantially all of the value determined in point (a) is concentrated in the value determined in point (b) then it is an asset acquisition otherwise needs to assess business definition as per Ind AS 103.

Fair value of gross assets shall be determined as follows (I + ii – iii):

- i) Fair value of consideration transferred (including fair value of non-controlling interest and fair value of previously interest held)
- ii) Fair value of liabilities assumed.
- iii) Cash and cash equivalent and deferred tax assets and goodwill resulting from DTL's.

Example 1: On Concentration test

Entity A holds 20% interest in Entity B. Subsequently Entity A, further acquires 50% share in Entity B by paying ₹ 300 Crores.

The fair value of assets acquired and Liabilities assumed are as follows:

Building	- ₹ 1000 Crores
Cash and Cash Equivalent	- ₹ 200 Crores
Financial Liabilities	- ₹ 800 Crores
DTL	- ₹ 150 crores

Fair value of Entity B is ₹ 400 Crores and Fair value of NCI is ₹ 120 Crores (400 x 30%)

Fair value of Entity A's previously held interest is ₹ 80 Crores (400 x 20%)

Entity A needs to determine whether acquisition is an asset acquisition as per concentration test.

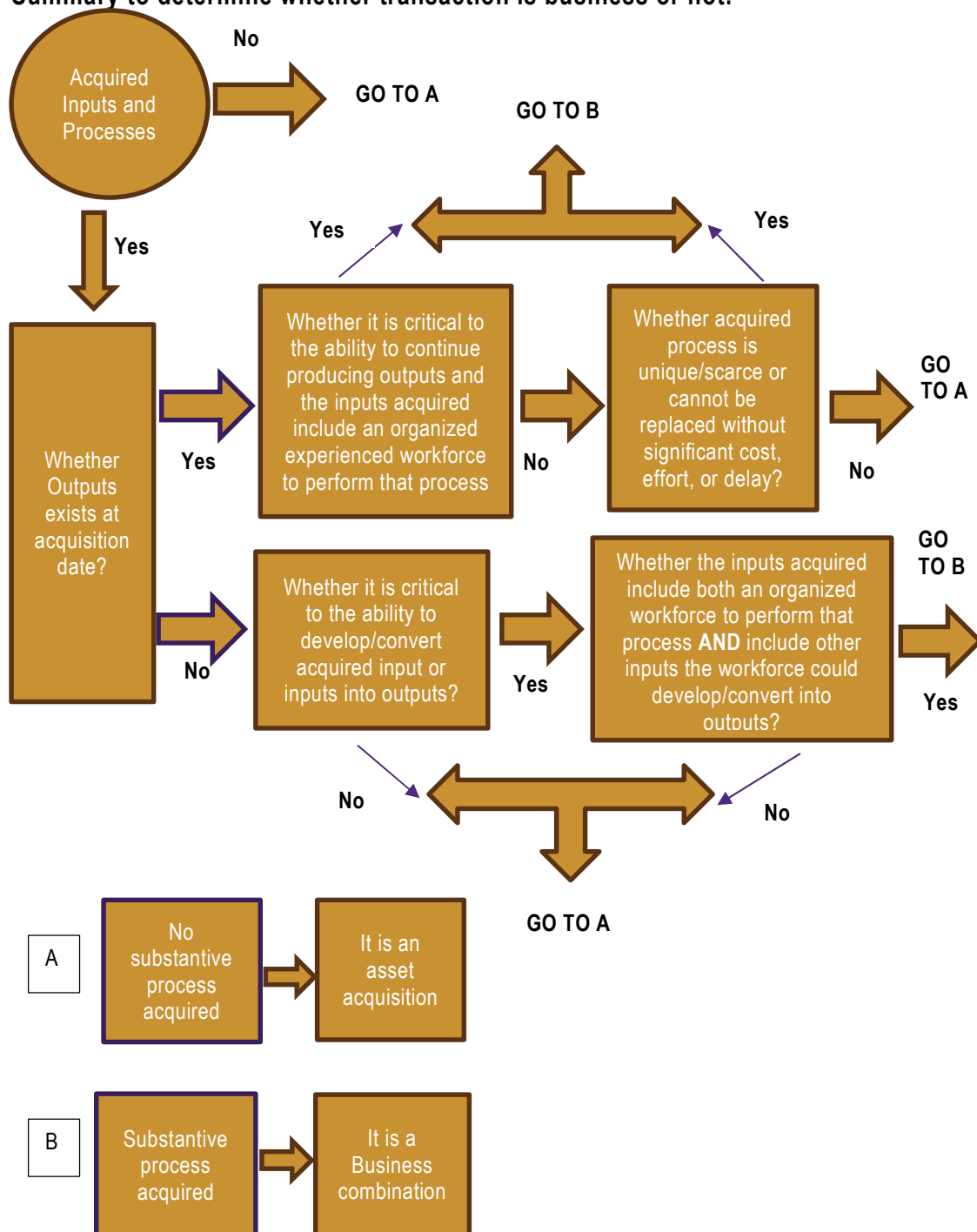
- i) Fair value of consideration transferred (including fair value of non-controlling interest and fair value of previously interest held) = 300 + 120 + 80 = ₹ 500 Crores
- ii) Fair value of liability assumed (excluding deferred tax) – ₹ 800 crores
- iii) Cash and cash equivalent – ₹ 200 crores.

Fair value of gross assets acquired - ₹ 1,100 Crores

In the above scenario, substantially all fair value of gross assets acquired is concentrated in a single identifiable asset i.e. building. Hence it should be asset acquisition. ($1,000 / 1,100 = 91\%$ of value of gross assets is concentrated into single identifiable asset i.e. building). A Judgement is required to conclude on the word substantially as the same is not defined in the standard.

In our view we have considered 91% of the value as substantial to conclude the above transaction as asset acquisition.

Summary to determine whether transaction is business or not:



Example 2: Simple-business combination

Company X is a liquor manufacturer and has traded for a number of years. The company produces a wide variety of liquor and employs a workforce of machine operators, testers, and other operational, marketing and administrative staff. It owns and operates a factory, warehouse, machinery and holds raw material inventory and finished products.

On 1st January, 20X1, Company Y pays USD 80 million to acquire 100% of the ordinary voting shares of Company X. No other type of shares has been issued by the Company X. On the same day, the four main executive directors of the Company Y take on the same roles in the Company X.

In this case, it is clear that the Company X is a business. It operates a trade with a variety of assets that are used by its employees in a number of related activities. These assets and activities are necessarily integrated in order to create and sell the company's products. As per definition the above acquisition includes an input (including four main executive directors of Company X) and thus it can be concluded as the significant process acquired along with the other inputs.

Thus, Company Y obtains control on 1st January, 20X1 by acquiring 100% of the voting rights.

The application of the definition is less clear in situations as illustrated in the following examples:

Example 3: Investment in a development stage entity

Company D is a development stage entity that has not started revenue-generating operations. The workforce consists mainly of research engineers who are developing a new technology that has a pending patent application. Negotiations to license this technology to a number of customers are at an advanced stage. Company D requires additional funding to complete development work and commence planned commercial production.

The value of the identifiable net assets in Company D is ₹ 750 million. Company A pays ₹ 600 million in exchange for 60% of the equity of Company D (a controlling interest).

Although Company D is not yet earning revenues (an example of 'outputs') there are a number of indicators that it has a sufficiently integrated set of activities and assets that are capable of being managed to produce a return for investors. In particular, Company D:

- employs specialist engineers developing the know-how and design specifications of the technology.
- is pursuing a viable plan to complete the development work and commence production.
- has identified and will be able to access customers willing to buy the outputs.

In addition, Company A has paid a premium (or goodwill) for its 60% interest. In the absence of evidence to the contrary, Company D is presumed to be a business.

Example 4: Acquisition of an entity holding investment properties

Company A acquires 100% of the equity and voting rights of Company P, a subsidiary of a property investment group. Company P owns three investment properties. The properties are single-tenant industrial warehouses subject to long-term leases. The leases oblige Company P to provide basic maintenance and security services, which have been outsourced to third party contractors. The administration of Company P's leases was carried out by an employee of its former parent company on a part-time basis but this individual does not transfer to the new owner.

In most cases, an asset or group of assets and liabilities that are being capable of generating revenues, combined with all or many of the activities necessary to earn those revenues, would constitute a business. However, investment property is a specific case in which earning a return for investors is a defining characteristic of the asset. Accordingly, revenue generation and activities that are specific and ancillary to an investment property and its tenancy agreements should therefore be given a lower 'weighting' in assessing whether the acquiree is a business.

Further process (i.e. Basic maintenance, security services and administration) is not critical to the ability to continue producing outputs. Also process (i.e. Basic maintenance, security services and administration) is not unique and it can be replaced easily without significant cost.

In our view the purchase of investment property with tenants and services that are purely ancillary to the property and its tenancy agreements should generally be accounted for as an asset purchase.

Example 5: Acquisition of an entity holding investment properties

Company A acquires 100% of the equity and voting rights of Company Q, which owns three investment properties. The properties are multi-tenant residential condominiums subject to short-term rental agreements that oblige Company Q to provide substantial maintenance and security services, which are outsourced with specialist providers. Company Q has five employees who deal directly with the tenants and with the outsourced contractors to resolve any non-routine security or maintenance requirements. These employees are involved in a variety of lease management tasks (e.g. identification and selection of tenants; lease negotiation and rent reviews) and marketing activities to maximise the quality of tenants and the rental income.

In this case, Company Q consists of a group of revenue-generating assets, together with employees and activities that clearly go beyond activities ancillary to the properties and their tenancy agreements.

Further process (i.e. identification and selection of tenants; lease negotiation and rent reviews) is critical to the ability to continue producing outputs (i.e. in terms to maximise quality of tenants and the rental income).

The assets and activities are clearly integrated so Company Q is considered a business.

Example 6: Seller retains some activities and assets

Company S is a manufacturer of a wide range of products. The company's payroll and accounting system is managed as a separate cost centre, supporting all the operating segments and the head office functions.

Company A agrees to acquire the trade, assets, liabilities and workforce of the operating segments of Company S but does not acquire the payroll and accounting cost centre or any head office functions. Company A is a competitor of Company S.

In this case, the activities and assets within the operating segments are capable of being managed as a business and so Company A accounts for the acquisition as a business combination. The payroll, accounting cost centre and administrative head office functions are typically not used to create outputs and so are generally not considered an essential element in assessing whether an integrated set of activities and assets is a business or not.

Example 7: Acquisition of a shell company

Company A is a property development company with a number of subsidiary companies, each of which holds a single development. After completion of the development, Company A sells its equity investment because the applicable tax rate is lower than that applicable to the sale of the underlying property.

Company A is planning to start the development of a large new retail complex. Rather than incorporating a new company, Company A acquires the entire share capital of a 'shell' company.

The shell company does not contain an integrated set of activities and assets and so does not constitute a business. Consequently, Company A should account for the purchase of the shell company in the same way as the incorporation of a new subsidiary. In the consolidated financial statements, any costs incurred will be accounted for in accordance with their nature and applicable Ind AS. No goodwill is recognised.

Illustration 2

Company A is a pharmaceutical company. Since inception, the Company had been conducting in-house research and development activities through its skilled workforce and recently obtained an intellectual property right (IPR) in the form of patents over certain drugs. The Company's has a production plant that has recently obtained regulatory approvals. However, the Company has

not earned any revenue so far and does not have any customer contracts for sale of goods. Company B acquires Company A.

Determine whether Company A constitute a business in accordance with Ind AS 103.

Solution

The definition of business requires existence of inputs and processes. In this case, the skilled workforce, manufacturing plant and IPR, along with strategic and operational processes constitutes the inputs and processes in line with the requirements of Ind AS 103.

When the said inputs and processes are applied as an integrated set, the Company A will be capable of producing outputs; the fact that the Company A currently does not have revenue is not relevant to the analysis of the definition of business under Ind AS 103. Basis this and presuming that Company A would have been able to obtain access to customers that will purchase the outputs, the present case can be said to constitute a business as per Ind AS 103.

Illustration 3

Modifying the above illustration, if Company A had revenue contracts and a sales force, such that Company B acquires all the inputs and processes other than the sales force, then whether the definition of the business is met in accordance with Ind AS 103?

Solution

Though the sales force has not been taken over, however, if the missing inputs (i.e., sales force) can be easily replicated or obtained by the market participant to generate output, it may be concluded that Company A has acquired business. Further, if Company B is also into similar line of business, then the existing sales force of the Company B may also be relevant to mitigate the missing input. As such, the definition of business is met in accordance with Ind AS 103.



5. THE ACQUISITION METHOD

The following key steps are involved in the acquisition accounting for business combinations:

- Step 1: Identifying the acquirer.
- Step 2: Determining the acquisition date.
- Step 3: Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

Step 4: Recognising and measuring goodwill or a gain from a bargain purchase.

Ask Following questions to account a business combination transaction:

Who is Acquirer?

When business is Acquired ?

Which assets are acquired and liabilities assumed ?

At What value above assets, liabilities and NCI are acquired ?

Check for any Goodwill/Gain from bargain purchase.



6. IDENTIFYING ACQUIRING ENTERPRISE

6.1 The Acquiring Enterprise

All business combination within the scope of Ind AS 103 are accounted under the acquisition method (also known as purchase method). In order to apply the purchase method, the parties involved has to identify the acquirer i.e the entity that obtains the control of another entity. The entity on whom the control is established is termed as acquiree. This is because the acquiree's assets and liabilities are accounted as per the recognition and measurement principles of the standard.

The acquiring enterprise is the enterprise which obtains control and the determination of control is as per the guidance given in Ind AS 110. It may so happen that guidance in Ind AS 110 does not clearly indicate which of the combining entity is the acquirer. In such a case, Ind AS 103 provides additional guidance on identifying the acquirer.

As per Ind AS 110 'Consolidated Financial Statements', an investor controls an investee if and only if the investor has all the following:

- (a) power over the investee;
- (b) exposure, or rights, to variable returns from its involvement with the investee; and
- (c) the ability to use its power over the investee to affect the amount of the investor's returns.

The above definition is very wide and control assessment does not depend only on voting rights instead it depends on the following as well:

- Potential voting rights;
- Rights of non-controlling shareholders; and
- Other contractual right of the investor if those are substantive in nature.

Control assessment has been discussed in detail in the chapter of Consolidated Financial Statements. One example on potential voting rights and its implication on assessment of control is provided below for the students to understand the concept of control.

In order to ascertain control do not look at the voting rights only. Evaluate other factors also like board control, potential voting rights etc.

Indicator of Control		
More than 50% voting rights	Power to appoint and remove board of directors	Investor have currently exercisable potential voting rights

Illustration 4: Potential voting rights

Company P Ltd., a manufacturer of textile products, acquires 40,000 equity shares of Company X (a manufacturer of complementary products) out of 1,00,000 shares in issue. As part of the same agreement, the Company P purchases an option to acquire an additional 25,000 shares. The option is exercisable at any time in the next 12 months. The exercise price includes a small premium to the market price at the transaction date.

After the above transaction, the shareholdings of Company X's two other original shareholders are 35,000 and 25,000. Each of these shareholders also has currently exercisable options to acquire 2,000 additional shares.

Assess whether control is acquired by Company P.

Solution

In assessing whether it has obtained control over Company X, Company P should consider not only the 40,000 shares it owns but also its option to acquire another 25,000 shares (a so-called

potential voting right). In this assessment, the specific terms and conditions of the option agreement and other factors are considered as follows:

- the options are currently exercisable and there are no other required conditions before such options can be exercised
- if exercised, these options would increase Company P's ownership to a controlling interest of over 50% before considering other shareholders' potential voting rights (65,000 shares out of a total of 1,25,000 shares)
- although other shareholders also have potential voting rights, if all options are exercised Company P will still own a majority (65,000 shares out of 1,29,000 shares)
- the premium included in the exercise price makes the options out-of-the-money. However, the fact that the premium is small and the options could confer majority ownership indicates that the potential voting rights have economic substance.

By considering all the above factors, Company P concludes that with the acquisition of the 40,000 shares together with the potential voting rights, it has obtained control of Company X.

6.2 Acquisitions through payment of cash or incurring of liability

In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

6.3 Acquisitions through issue of equity instrument

In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Reverse acquisition has been dealt in a separate section of this chapter.

Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

- a) ***The relative voting rights in the combined entity after the business combination:*** The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

Illustration 5

Veera Limited and Zeera Limited are both in the business of manufacturing and selling of Lubricant. Shareholders of Veera Limited and Zeera Limited agreed to join forces to benefit from lower delivery and distribution costs. The business combination is carried out by setting up a new entity called Meera Limited that issues 100 shares to Veera Limited shareholders and 50 shares to Zeera Limited shareholders in exchange for the transfer of the shares in those entities. The number of shares reflects the relative fair values of the entities before the combination. Also respective company's shareholders get the voting rights in Meera Limited based on their respective shareholdings.

Determine the acquirer by applying the principles of Ind AS 103 'Business Combinations'

Solution

As per para B15 of Ind AS 103, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

The relative voting rights in the combined entity after the business combination - The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity.

Based on above mentioned para, acquirer shall be the either of the combining entities (i.e. Veera Limited or Zeera Limited) whose owners as a Group retain or receive the largest portion of the voting rights in the combined entity.

Hence in the above scenario Veera Limited shareholder gets 67% Share $[(100/150) \times 100]$ and Zeera Limited shareholder gets 33.33% share in Meera Limited. Hence Veera Limited is acquirer as per the principles of Ind AS 103.

- b) **The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest:** The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.
- c) **The composition of the governing body of the combined entity:** The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

- d) **The composition of the senior management of the combined entity:** The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.
- e) **The terms of the exchange of equity interests:** The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.
- f) **The acquirer is usually the combining entity** whose relative size (measured in, for example, assets, revenues or profit) is significantly greater than that of the other combining entity or entities. In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.

Examples 8 & 9

8. Company A and Company B operate in power industry and both entities are operating entities. Company A has much larger scale of operations than Company B. Company B merges with Company A such that the shareholders of Company B would receive 1 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 20% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 80% of the capital in Company A.

In this transaction, Company A is the acquirer for the purposes of accounting for business combination as per Ind AS 103. This is because, by merging the entire shareholding of Company B, Company A has acquired control over Company B. Further, the shareholders of erstwhile Company B do not obtain control over Company A on account of shares received as part of purchase consideration, as they hold only 20% of the paid-up capital of Company A.

9. Company A and Company B operate in power industry and both entities are operating entities. Company A has much smaller scale of operations than Company B. Company B merges Company A such that the shareholders of Company B would receive 10 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 70% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 30% of capital of Company A. Post-acquisition, the management of Company B would manage the operations of the combined entity.

In this transaction, Company B is the acquirer for the purposes of accounting for business combination as per Ind AS 103. This is because, after merger, the shareholders of

erstwhile Company B would have a controlling interest and management of the combined entity. As such, in substance, Company B has acquired control over Company A.

It is important to note that the Company B would be considered as an acquirer for accounting purposes only (i.e., accounting acquirer). For legal purposes as well as for reporting purposes, it is the Company A that would be considered as an acquirer (i.e., legal acquirer).

Appropriate identification of an acquirer is relevant, as the net assets of the accounting acquiree (rather than that of the accounting acquirer) are recognised at fair value.

Illustration 6

ABC Ltd. incorporated a company Super Ltd. to acquire 100% shares of another entity Focus Ltd. (and therefore to obtain control of the Focus Ltd.). To fund the purchase, Super Ltd. acquired a loan from XYZ Bank at commercial interest rates. The loan funds are used by Super Ltd. to acquire entire voting shares of Focus Ltd. at fair value in an orderly transaction. Post the acquisition, Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and also Super Ltd.'s management is in a power where it will be able to dominate the management of the Focus Ltd.

State whether Super Ltd. be identified as the acquirer in this business combination.

Solution

Paragraph 6 of Ind AS 103 states that for each business combination, one of the combining entities shall be identified as the acquirer.

While paragraph 7 states that the guidance in Ind AS 110 shall be used to identify the acquirer that is the entity that obtains control of another entity called the acquiree. If a business combination has occurred but applying the guidance in Ind AS 110 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 of Ind AS 103 shall be considered in making that determination.

Further, paragraph B15 provides that, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

- (a) **The relative voting rights in the combined entity after the business combination:** The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of

owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

- (b) **The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest:** The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.
- (c) **The composition of the governing body of the combined entity:** The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.
- (d) **The composition of the senior management of the combined entity:** The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.
- (e) **The terms of the exchange of equity interests:** The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

The key drivers of the accounting are identifying the party on whose behalf the new entity has been formed and identifying the business acquired. In this scenario, as Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and has the ability to dominate the management of the Focus Ltd. Accordingly, Super Ltd. will be identified as the acquirer unless there are conditions to conclude to the contrary.

6.4 Acquisition involving Shell Company and Reverse Acquisition

A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public entity is the **legal acquirer** because it issued its equity interests, and the private entity is the **legal acquiree** because its equity interests were acquired. However, application of the guidance given in above paragraph results in identifying:

- a) the public entity as the **acquiree** for accounting purposes (the accounting acquiree); and
- b) the private entity as the **acquirer** for accounting purposes (the accounting acquirer).

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles of Ind AS 103, including the requirement to recognise goodwill, will apply.

Example 9: Reverse Acquisition

The Balance Sheets of Entity A and Entity B immediately before business acquisition are as follows:

Particulars	Amount (₹ in thousands)	
	Entity A	Entity B
Current Assets	600	800
Non Current Assets	<u>1,200</u>	<u>2,900</u>
Total Assets	<u>1,800</u>	<u>3,700</u>
Current Liabilities	400	200
Non - Current Liabilities	<u>300</u>	<u>1200</u>
Total Liabilities	<u>700</u>	<u>1400</u>
Equity		
30,000 Shares of ₹ 10 Each	300	
60,000 Shares of ₹ 10 Each		600
Retained Earnings	<u>800</u>	<u>1700</u>
Total Equity	<u>1100</u>	<u>2300</u>
Total Equity and Liability	<u>1800</u>	<u>3700</u>

On 31 March 20X1, Entity A issues 2.5 shares in exchange for each share of Entity B. All of entity B's shareholders exchange their shares. Therefore, Entity A issues 1,50,000 shares in exchange for all 60,000 shares of entity B. Entity A legally owns 100% of entity B.

The shareholders of Entity B own 83.33% (1,50,000/1,80,000) of the combined entity. The directors of entity B are appointed 6 out of 8 positions in combined entity's board. In accordance with Ind AS 103, Entity B (Legal Acquiree) is the accounting acquirer and Entity A (Legal Acquirer) is the accounting acquiree as Entity B shareholders control over combined entity.

The quoted market price of Entity B's share as at 31st March, 20X1 is ₹ 105 per share and Entity A's share price as at 31st March, 20X1 is ₹ 20 per share.

Assume the fair value of Entity A's identifiable net assets as at 31st March, 20X1 are the same as carrying values and ignore tax effect.

The acquisition date fair value (i.e. at 31st March, 20X1) of the accounting acquirer equity instrument is generally used to determine the amount of consideration transferred for business combination. In this case it is 105 per share (Entity B).

So if the business combination had taken place in the form of Entity B issuing additional shares to Entity A's shareholders in exchange for their shares in Entity A, Entity B would have to issue 12,000 shares (30,000 / 2.5) for the ratio of ownership interest in the combined entity to be same. (12,000/72,000). Therefore, the consideration for the business combination effectively transferred by Entity B is ₹ 12,60,000 (12,000 Shares x ₹ 105).

Calculation of Goodwill:

Fair value of Assets less Liabilities Assumed (Entity A)	- ₹ 11,00,000
Consideration transferred (by Entity B)	- <u>(₹ 12,60,000)</u>
Goodwill	- <u>₹ 1,60,000</u>

Example 11: New parent pays cash to effect a business combination

Company A decided to spin-off two of its existing businesses (currently housed in two separate entities, Company B and Company C). To facilitate the spin-off, Company A incorporates a new entity (Company D) with nominal equity and appoints independent directors to the board of Company D. Company D signs an agreement to purchase Companies B and C in cash, conditional on obtaining sufficient funding. To fund these acquisitions, Company D issues a prospectus offering to issue shares for cash.

At the conclusion of the transaction, Company D has owned 99% by the new investors with Company A retaining only a 1% non-controlling interest.

In this situation, a set of new investors paid cash to obtain control of Company D in an arm's length transaction. Company D is then used to effect the acquisition of 100% ownership of Companies B and C by paying cash. Company A relinquishes its control of Companies B and C to the new owners of Company D.

Although Company D is a newly formed entity, Company D is identified as the acquirer not only because it paid cash but also because the new owners of Company D have obtained control of Companies B and C from Company A.

Identification of the acquiring enterprise is very critical and the accounting may change significantly if the accounting acquirer is different than legal acquirer. .



7. DETERMINING THE ACQUISITION DATE

The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree — the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

The acquisition date is a very important step in the business combination accounting because it determines when the acquirer recognises and measures the consideration, the assets acquired and liabilities assumed. The acquiree's results are consolidated from this date. The acquisition date materially impacts the overall acquisition accounting, including post-combination earnings.

Acquisition date will be the date on which the acquirer obtains control.

The acquisition date is often readily apparent from the structure of the business combinations and the terms of the sale and purchase agreement (if applicable) but this is not always the case.

Example 12

Company A acquired 80% equity interest in Company B for cash consideration. The relevant dates are as under:

✓ Date of shareholder agreement	1 st June, 20X1
✓ Appointed date as per shareholder agreement	1 st April, 20X1
✓ Date of obtaining control over the board representation	1 st July, 20X1
✓ Date of payment of consideration	15 th July, 20X1
✓ Date of transfer of shares to Company A	1 st August, 20X1

In this case, as the control over financial and operating policies are acquired through obtaining board representation on 1st July, 20X1, it is this date that is considered as the acquisition date. It may be noted that the appointed date as per the agreement is not considered as the acquisition date, as the Company A did not have control over Company B as at that date.

Illustration 7

Can an acquiring entity account for a business combination based on a signed non-binding letter of intent where the exchange of consideration and other conditions are expected to be completed within 2 months?

Solution

No. as per the requirement of the standard a non-binding Letter of Intent (LOI) does not effectively transfer control and hence this cannot be considered as the basis for determining the acquisition date.

Illustration 8

On 1st April, X Ltd. agrees to acquire the share of B Ltd. in an all equity deal. As per the binding agreement X Ltd. will get the effective control on 1st April. However, the consideration will be paid only when the shareholders' approval is received. The shareholder's meeting is scheduled to happen on 30th April. If the shareholders' approval is not received for issue of new shares, then the consideration will be settled in cash.

Determine the acquisition date.

Solution

The acquisition date in the above case is 1st April. This is because, in the above scenario, even if the shareholders don't approve the shares, consideration will be settled through payment of cash.

Illustration 9 : Business Combination without a Court approved scheme

ABC Ltd. acquired all the shares of XYZ Ltd. The negotiations had commenced on 1st January, 20X1 and the agreement was finalised on 1st March, 20X1. While ABC Ltd. obtains the power to control XYZ Ltd.'s operations on 1st March, 20X1, the agreement states that the acquisition is effective from 1st January, 20X1 and that ABC Ltd. is entitled to all profits after that date. In addition, the purchase price is based on XYZ Ltd.'s net asset position as at 1st January, 20X1.

Determine the date of acquisition.

Solution

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

Further paragraphs 6 and 7 of Ind AS 110, Consolidated Financial Statements, inter alia, state that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Thus, an investor controls an investee if and only if the investor has all the following:

- (a) power over the investee;
- (b) exposure, or rights, to variable returns from its involvement with the investee; and
- (c) the ability to use its power over the investee to affect the amount of the investor's returns.

Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

Therefore, in this case, notwithstanding that the price is based on the net assets as at 1st January, 20X1 and that XYZ Ltd.'s shareholders do not receive any dividends after that date, the date of acquisition for accounting purposes will be 1st March, 20X1. It is only on 1st March, 20X1 and not 1st January, 20X1, that ABC Ltd. has the power to direct the relevant activities of XYZ Ltd. so as to affect its returns from its involvement with XYZ Ltd. Accordingly, the date of acquisition is 1st March, 20X1.

Illustration 10 : Acquisition date- Regulatory approval

ABC Ltd. and XYZ Ltd. are manufacturers of rubber components for a particular type of equipment. ABC Ltd. makes a bid for XYZ Ltd.'s business and the Competition Commission of India (CCI) announces that the proposed transaction is to be scrutinised to ensure that competition laws are not breached. Even though the contracts are made subject to the approval of the CCI, ABC Ltd. and XYZ Ltd. mutually agree the terms of the acquisition and the purchase price before competition authority clearance is obtained.

Can the acquisition date in this situation be the date on which ABC Ltd. and XYZ Ltd. agree the terms even though the approval of CCI is awaited? Assume that the approval of CCI is substantive.

Solution

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree — the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Since CCI approval is a substantive approval for ABC Ltd. to acquire control of XYZ Ltd.'s operations, the date of acquisition cannot be earlier than the date on which approval is obtained from CCI. This is pertinent given that the approval from CCI is considered to be a substantive process and accordingly, the acquisition is considered to be completed only on receipt of such approval.



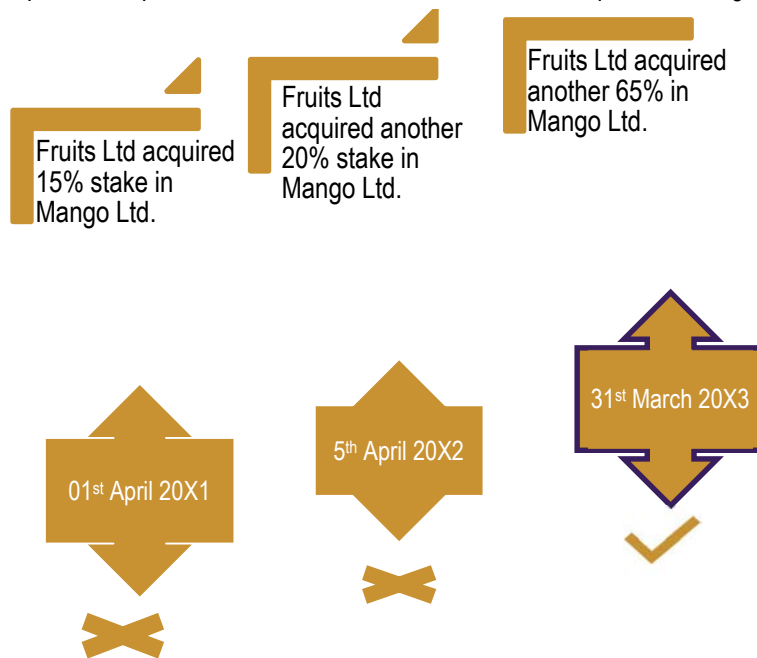
8. STEP ACQUISITIONS

In the case an entity acquires an entity step by step through series of purchase then the acquisition date will be the date on which the acquirer obtains control. Till the time the control is obtained the Investment will be accounted as per the requirements of other Ind AS 109, if the investments are covered under that standard or as per Ind AS 28, if the investments are in Associates or Joint Ventures.

If a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Below is the example for acquisition of business in case of stake acquired in stages:



Control is acquired on 31st March 20X3 in above example because total stake as on that date will be 90%.

Assumption: Control is acquired in form of total stake, unless otherwise stated.



9. DETERMINATION OF THE PURCHASE CONSIDERATION

The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the total of the acquisition-date fair values of the assets (including cash) transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer. Examples of potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, *contingent consideration*, ordinary or preference equity instruments, options, warrants and member interests of *mutual entities*.

Exception to the fair value in determination of Purchase consideration

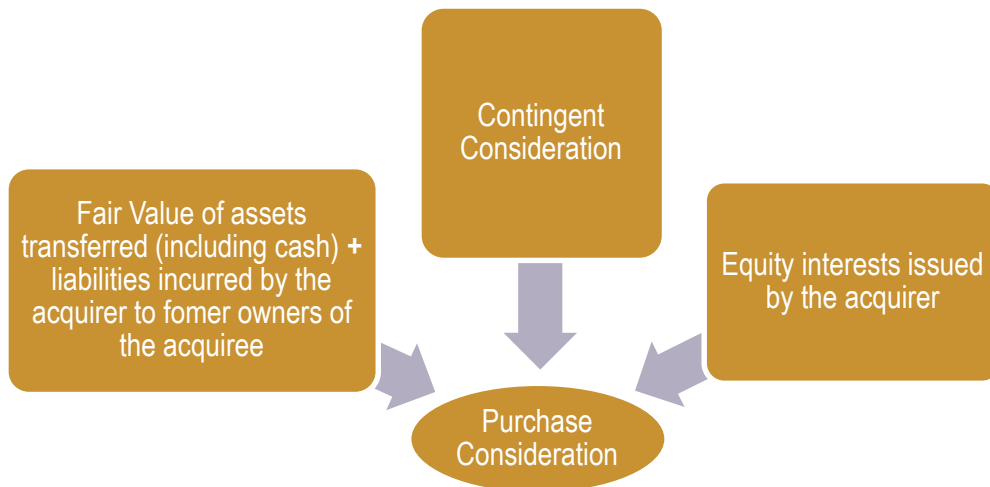
However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees that is included in consideration transferred in the business combination shall be measured in accordance with the requirements of Ind AS 102, Share Based payments.

The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, non-monetary assets or a business of the acquirer). If so, the acquirer shall remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognise the resulting gains or losses, if any, in the statement of profit and loss.

This means that if the acquirer has transferred a land as a part of the business combination arrangement to the owners of the acquiree then the fair value of the land will be considered in determining the fair value of the consideration. Consequently, the land will be de-recognised in the financial statements of the acquirer and the difference between the carrying amount of the land and the fair value considered for purchase consideration will be recorded in profit and loss.

However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognise a gain or loss in statement of profit and loss on assets or liabilities it controls both before and after the business combination. Although no gain or loss is recognised by the transferring entity, the asset transferred will affect the amount of NCI and goodwill that is recognised.

Purchase Consideration can be summarized as:



9.1 A Business Combination achieved in Stages (Step Acquisition)

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date.

Example 13

On 31st December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 per cent interest in Entity B, which gives it control of Entity B. This transaction is referred as a business combination achieved in stages, sometimes also referred to as a step acquisition.

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. As per

Ind AS 109 or Ind AS 27, an entity can elect to measure investments in equity instruments at fair value through other comprehensive income. However, once elected all gains and losses on that investment even on sale is recognized in OCI. Therefore, if the investment is designated as fair value through OCI, the resulting gain or loss, if any, will be recognized in OCI.

When a party to a joint operation, obtains control of a joint operation business, the transaction will be considered as a business combination achieved in stages. The acquirer should re-measure its previously held interest in the joint operation at fair value at the acquisition date.

Illustration 11

On 1st April, 20X1, PQR Ltd. acquired 30% of the voting ordinary shares of XYZ Ltd. for ₹ 8,000 crore. PQR Ltd. accounts its investment in XYZ Ltd. using equity method as prescribed under Ind AS 28. At 31st March, 20X2, PQR Ltd. recognised its share of the net asset changes of XYZ Ltd. using equity accounting as follows:

	(₹ in crore)
Share of profit or loss	700
Share of exchange difference in OCI	100
Share of revaluation reserve of PPE in OCI	50

The carrying amount of the investment in the associate on 31st March, 20X2 was therefore ₹ 8,850 crore (8,000 + 700 + 100 + 50).

On 1st April, 20X2, PQR Ltd. acquired the remaining 70% of XYZ Ltd. for cash ₹ 25,000 crore. The following additional information is relevant at that date:

	(₹ in crore)
Fair value of the 30% interest already owned	9,000
Fair value of XYZ's identifiable net assets	30,000

Determine the accounting such business combination.

Solution

Paragraph 42 of Ind AS 103 provides that in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in statement of profit and loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Applying the above, PQR Ltd. records the following entry in its consolidated financial statements:

		(₹ in crore)	
		Debit	Credit
Identifiable net assets of XYZ Ltd.	Dr.	30,000	
Goodwill (W.N.1)	Dr.	4,000	
Foreign currency translation reserve	Dr.	100	
PPE revaluation reserve	Dr.	50	
To Cash			25,000
To Investment in associate -XYZ Ltd.			8,850
To Retained earnings (W.N.2)			50
To Gain on previously held interest in XYZ recognised in Profit or loss (W.N.3)			250
(To recognise acquisition of XYZ Ltd.)			

Working Notes:

1. Calculation of Goodwill

	₹ in crore
Cash consideration	25,000
Add: Fair value of previously held equity interest in XYZ Ltd.	<u>9,000</u>
Total consideration	34,000
Less: Fair value of identifiable net assets acquired	<u>(30,000)</u>
Goodwill	<u>4,000</u>

2. The credit to retained earnings represents the reversal of the unrealized gain of ₹ 50 crore in Other Comprehensive Income related to the revaluation of property, plant and equipment. In accordance with Ind AS 16, this amount is not reclassified to profit or loss.
3. The gain on the previously held equity interest in XYZ Ltd. is calculated as follows: ₹

	₹ in crore
Fair Value of 30% interest in XYZ Ltd. at 1 st April, 20X2	9,000
Carrying amount of interest in XYZ Ltd. at 1 st April, 20X2	<u>(8,850)</u>
	150
Unrealised gain previously recognised in OCI	<u>100</u>
Gain on previously held interest in XYZ Ltd. recognised in profit or loss	<u>250</u>

9.2 A Business Combination achieved without the transfer of Consideration

An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include:

- The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.
- Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.
- The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no

equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

In a business combination achieved by contract alone, the acquirer shall attribute to the owners of the acquiree the amount of the acquiree's net assets recognised in accordance with this Indian Accounting Standard. In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer's post-combination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the non-controlling interest.

Illustration 12: Business Combination Achieved by Contract Alone

Sita Ltd and Beta Ltd decides to combine together for forming a Dual Listed Corporation (DLC). As per their shareholder's agreement, both the parties will retain original listing and Board of DLC will be comprised of 10 members out of which 6 members will be of Sita Ltd and remaining 4 board members will be of Beta Ltd.

The fair value of Sita Ltd is ₹ 100 crores and fair value of Beta Ltd is ₹ 80 crores. The fair value of net identifiable assets of Beta Limited is ₹ 70 crores. Assume non-controlling Interest (NCI) to be measured at fair value.

Determine the goodwill to be recognised on acquisition.

Solution

Sita Ltd has more Board members and thereby have majority control in DLC. Therefore, Sita Ltd is identified as acquirer and Beta Ltd as acquiree.

Since no consideration has been transferred, the goodwill needs to be calculated as the difference of Part A and Part B:

Part A:

1) Consideration paid by Acquirer.	– Nil
2) Controlling Interest in Acquiree	– ₹ 80 crores
3) Acquirer's previously held interest	– Nil

Part B:

Fair value of net identifiable asset	– ₹ 70 crores

Goodwill is recognised as ₹ 10 crores (80 crores – 70 crores) in business combination achieved through contract alone when NCI is measured at fair value.

9.3 Direct Cost of Acquisition

The direct cost of acquisition is not included in the determination of the purchase consideration. Costs which includes like finder's fees, due diligence cost accounting, legal fees, investment banker fees, even bonuses paid to employees for doing a successful acquisition will not be included in the cost of acquisition.

Illustration 13

Should stamp duty paid on acquisition of land pursuant to a business combination be capitalised to the cost of the asset or should it be treated as an acquisition related cost and accordingly be expensed off?

Solution

As per Ind AS 103, the acquisition-related costs incurred by an acquirer to affect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to affect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception.

Note: The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The stamp duty payable for transfer of assets in connection with the business combination is an acquisition-related cost as described under paragraph 53 of Ind AS 103. Stamp duty is a cost incurred by the acquirer in order to affect the business combination and it is not part of the fair value exchange between the buyer and seller for the business. In such cases, the stamp duty is incurred to acquire the ownership rights in land in order to complete the process of transfer of assets as part of the overall business combination transaction, but it does not represent consideration paid to gain control over business from the sellers.

It may be noted that the accounting treatment of stamp duty incurred for separate acquisition of an item of property, plant and equipment (i.e. not as part of business combination) differs under Ind AS 16, Property, Plant and Equipment. Unlike Ind AS 16, the acquisition accounting as per Ind AS 103 requires assets and liabilities acquired in a business combination to be measured at fair value. While incurred in connection with a business combination, stamp duty does not increase the future economic benefits from the net assets comprising the business (which would be recognised at fair value) and hence cannot be capitalised. The examples of costs given in

paragraph 53 is only an inclusive list; they are only indicative and do not preclude any other cost to be considered as acquisition-related cost. In the given case, the transfer of land and the related stamp duty is required to be accounted as part of the business combination transaction as per requirements of Ind AS 103 and not as a separate transaction under Ind AS.

Accordingly, stamp duty incurred in relation to land acquired as part of a business combination transaction are required to be recognised as an expense in the period in which the acquisition is completed and given effect to in the financial statements of the acquirer.

Illustration 14

ABC Ltd. acquires PQR Ltd. on 30th June, 20X1. The assets acquired from PQR Ltd. include an intangible asset that comprises wireless spectrum license. For this intangible asset, ABC Ltd. is required to make an additional one-time payment to the regulator in PQR's jurisdiction in order for the rights to be transferred for its use.

Whether such additional payment to the regulator is an acquisition-related cost?

Solution

As per Ind AS 103, the acquisition-related costs incurred by an acquirer to affect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to affect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The payment to the regulator represents a transaction cost and will be regarded as acquisition related cost incurred to affect the business combination. Applying the requirements of para 53 of Ind AS 103, it should be expensed as it is incurred. Transfer of rights in the instant case cannot be construed to be separate from the business combination because the transfer of the rights to ABC Ltd. is an integral part of the business combination itself.

It may be noted that had the right been acquired separately (i.e. not as part of business combination), the transaction cost is required to be capitalised as part of the intangible asset as per the requirements of Ind AS 38, Intangible Assets.

9.4 Contingent Consideration

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in accordance with the requirement of Ind AS 32 'Financial Instruments: Presentation', or other applicable Indian Accounting Standards. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

Fair value of the assets transferred or liability incurred should be measured on the acquisition date to determine the fair value. Any direct cost of acquisition should be recorded directly in profit and loss account and should not be included in purchase consideration.

Example 14:

Company A acquires Company B in April, 20X1 for cash. The acquisition agreement states that an additional ₹ 20 million of cash will be paid to B's former shareholders if B succeeds in achieving certain specified performance targets. A determines the fair value of the contingent consideration liability to be 15 million at the acquisition date. At a later date, the probability of meeting the said performance target becomes lower.

As certain consideration is based on achieving certain performance parameters in future, the consideration is contingent on achieving those parameters. As such, the transaction involves contingent consideration. Further, since the consideration is to be settled for a variable amount in cash, such consideration would be in the nature of financial liability rather than equity.

As at the acquisition date, the acquirer should consider the acquisition date fair value of contingent consideration as part of business combination. Accordingly, such recognition would increase goodwill (or reduce gain on bargain purchase, as the case may be).

In the above example, if the chance of meeting the performance criteria becomes less probable, then in such a case, the contingent consideration in the nature of financial liability should be remeasured and the impact for the change in the fair value should be recognised in statement of profit and loss.



10. PURCHASE PRICE ALLOCATION

10.1 Recognition of Assets and Liabilities of the Acquired Entity

As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.

The most important principle in a purchase price allocation exercise is to recognize and measure all the assets and liabilities acquired on the acquisition date.

10.1.1 Recognition

Following conditions have to be considered while recognising the assets and liabilities of the acquire:

- To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards* issued by the Institute of Chartered Accountants of India at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post combination financial statements in accordance with other Ind AS.
- Acquirer should only record the assets and liabilities recorded as a part of the business combination which means only those assets and liabilities which have been assumed as a part of the business combination deal should only be recorded and not any other assets which are not related to the acquisition to which other applicable Ind AS should be applied.
- When the acquirer applies the recognition principle under business combination it may record certain assets and liabilities which the acquiree had not recorded earlier in their financial statements. For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the

* For this Standard, acquirers are required to apply the definitions of an asset and a liability given in *Framework for Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards* rather than the *Conceptual Framework for Financial Reporting under Indian Accounting Standards* issued in 2021.

acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

There are certain exceptions to specific assets and liabilities which have been discussed below.

- The assets and liabilities have to be classified as per the requirement of applicable Ind AS which will depend on the contractual terms, economic conditions etc.
- In some situations, Ind AS provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:
 - ◆ classification of particular financial assets and liabilities as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income in accordance with Ind AS 109, Financial Instruments;
 - ◆ designation of a derivative instrument as a hedging instrument in accordance with Ind AS 109; and
 - ◆ assessment of whether an embedded derivative should be separated from a host contract in accordance with Ind AS 109 (which is a matter of 'classification' as this Ind AS uses that term).

The only exception to the above principle is that for lease contract (in which acquiree is the lessor as either an operating lease or a finance lease) and insurance contracts classification will be based on the basis of the conditions existing at inception and not on acquisition date. Therefore, they are not reassessed at the acquisition date, unless they are modified at that date.

10.2 Measurement Principle

The assets and liabilities recognized based on the aforesaid recognition principles has to be measured based on the following principles:

- The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.
- For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interest (under existing AS it is called as minority interest) in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:
 - ◆ fair value; or

- ◆ The present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets
- All other components of non-controlling interests shall be measured at their acquisition date fair values, unless another measurement basis is required by Ind AS.

10.2.1 Exception to the recognition or measurement principle

The exception principles laid out in this standard for recognition or measurement of certain assets and liabilities are only limited to acquisition date accounting and may be different than the requirements of other accounting standards. The application of the above principles may result in two scenarios:

- An asset or liability which otherwise would not have been recorded gets recorded.
- The assets and liabilities are measured at a value other than the acquisition date fair values.

Items	Guidance under Ind AS 103
Contingent liability	Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, defines a contingent liability as: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: i. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or ii. the amount of the obligation cannot be measured with sufficient reliability. The requirements in Ind AS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to Ind AS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

	Summary of above:		
	Outcome	Ind AS 37	Business Combination
	Possible obligation	Not recognised	Not recognised
	Present obligation – not probable that an outflow of economic benefits will occur	Not recognised	Recognised if reliably measured
	Present obligation – probable that an outflow of economic benefits will occur, but cannot be measured reliably	Not recognised	Not recognised
Example 15 A suit for damages worth ₹ 10 million was filed on Company B for alleged breach of certain contract provisions. Company B had disclosed the same as a contingent liability in its financial statements, as it considered that it is a present obligation for which it was not probable that the amount would be payable. Company A acquires Company B and determines the fair value of the contingent liability to be ₹ 2 million. Company A would recognise ₹ 2 million in its financial statements as part of acquisition accounting, even if it is not probable that payment will be required to settle the obligation.			
Income taxes	As per the requirement of Ind AS 12, no deferred tax consequence should be recorded on initial recognition of deferred tax except assets and liabilities acquired during business combination. Accordingly, the acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with Ind AS 12, Income Taxes. The acquirer shall account for the potential tax effects of temporary differences and carry forwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with Ind AS 12.		
Employee benefits	The acquirer records the fair value of the obligations for any post retirement obligation as per the principles of Ind AS 19 which is an exception of the general fair value rule.		
Indemnification assets	The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the		

	acquirer obtains an indemnification asset. The acquirer shall recognise an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts.

Example 16:

Company A acquires Company B in a business combination on 1st April, 20X1. B is being sued by one of its customers for breach of contract for ₹ 250. The sellers of B provide indemnification to A for the reimbursement of any losses greater than ₹ 100. There are no collectability issues around this indemnification. At the acquisition date, Company A determined that there is a present obligation and therefore the fair value of the contingent liability of ₹ 250 is recognised by A in the acquisition accounting. In the acquisition accounting A also recognises an indemnification asset of ₹ 150 (₹ 250 – ₹ 100).

Illustration 15

ABC Ltd. acquired a beverage company PQR Ltd. from XYZ Ltd. At the time of the acquisition, PQR Ltd. is the defendant in a court case whereby certain customers of PQR Ltd. have alleged that its products contain pesticides in excess of the permissible levels that have caused them health damage.

PQR Ltd. is being sued for damages of ₹ 2 crore. XYZ Ltd. has indemnified ABC Ltd. for the losses, if any, due to the case for amount up to ₹ 1 crore. The fair value of the contingent liability for the court case is ₹ 70 lakh.

How should ABC Ltd. account for the contingent liability and the indemnification asset? What if the fair value of the liability is ₹ 1.2 crore instead of ₹ 70 lakh.

Solution

In the current scenario, ABC Ltd. measures the identifiable liability of entity PQR Ltd. at ₹ 70 lakh and also recognises a corresponding indemnification asset of ₹ 70 lakhs on its consolidated balance sheet. The net impact on goodwill from the recognition of the contingent liability and associated indemnification asset is nil.

However, in the case where the liability's fair value is more than ₹ 1 crore ie. ₹ 1.2 crore, the indemnification asset will be limited to ₹ 1 crore only.

Illustration 16

ABC Ltd. pays ₹ 50 crore to acquire PQR Ltd. from XYZ Ltd. PQR Ltd. manufactured products containing fiber glass and has been named in 10 class actions concerning the effects of these fiber glass. XYZ Ltd. agrees to indemnify ABC Ltd. for the adverse results of any court cases up

to an amount of ₹ 10 crore. The class actions have not specified amounts of damages and past experience suggests that claims may be up to ₹ 1 crore each, but that they are often settled for small amounts.

ABC Ltd. makes an assessment of the court cases and decides that due to the potential variance in outcomes, the contingent liability cannot be measured reliably and accordingly no amount is recognised in respect of the court cases.

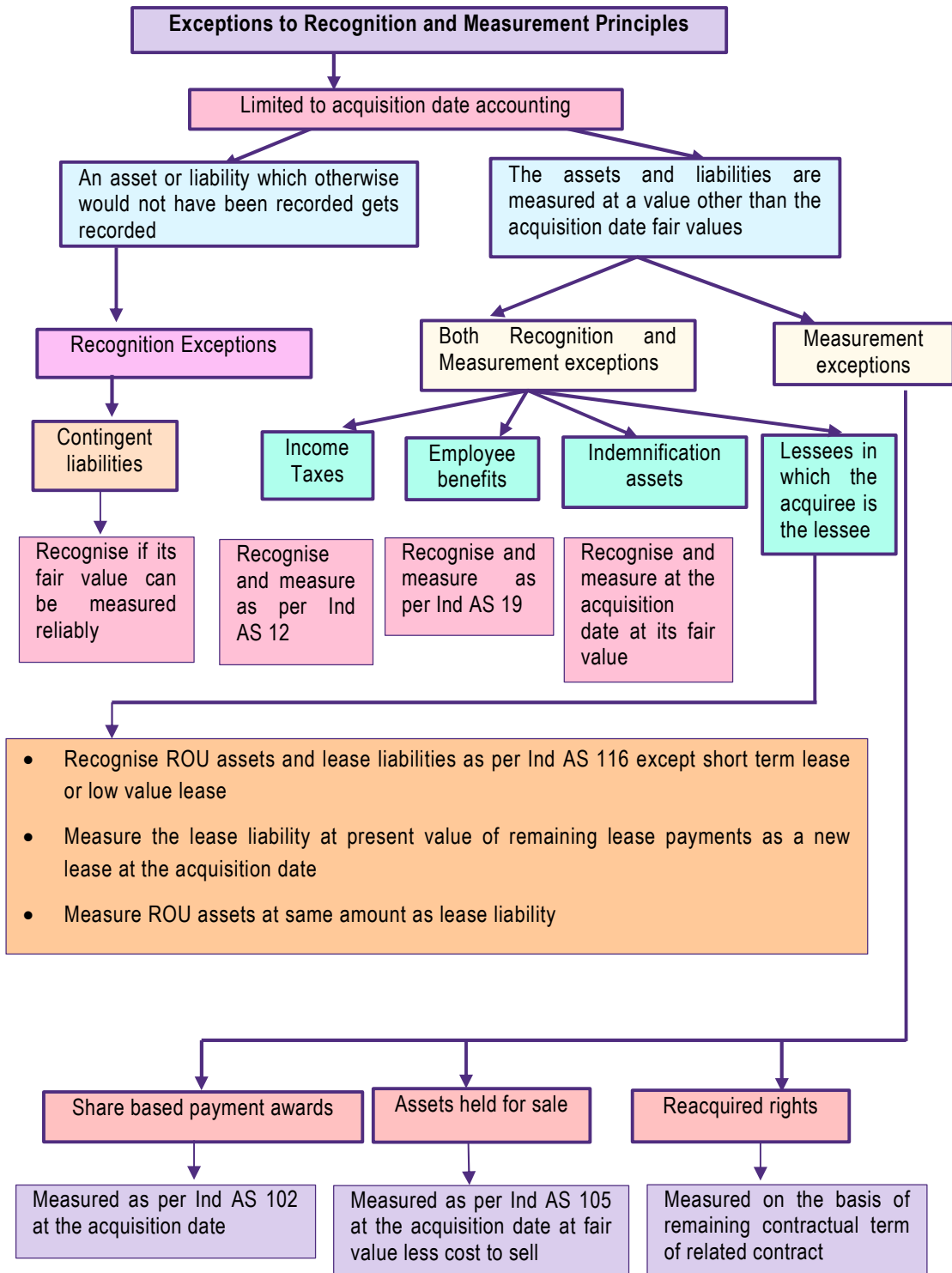
How should indemnification asset be accounted for?

Solution

Since no liability is recognised in the given case, ABC Ltd. will also not recognise an indemnification asset as part of the business combination accounting.

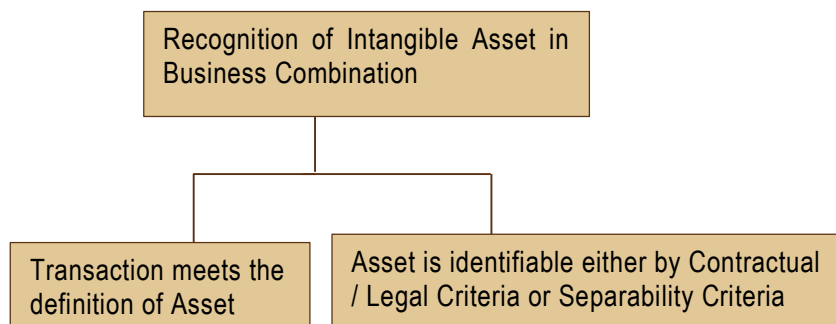
Reacquired rights	These are the rights which the acquirer before acquisition may have granted to the acquiree to use certain assets which belongs to the acquirer. It does not matter whether the asset was recorded in the financial statement of the acquirer or not. For example, license to use the brand name, Franchisee rights etc. if an acquirer acquires an acquiree which had certain rights granted to it by the acquirer then the business combination results in settlement of the right and accordingly any settlement gain or loss should be considered as a separate transaction from business combination and will be recorded in the financial statement of the acquirer. The acquirer shall measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract without considering the effect of potential renewals.
Intangible assets	The acquirer shall record separately from Goodwill, the identifiable intangible acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion. (Refer a section below on intangible asset highlighting detailed guidance on recognition and measurement criteria)
Share based payment transactions	The acquirer shall measure a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer in accordance with the method in Ind AS 102, Share-based Payment, at the acquisition date.

Assets held for sale	The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, at fair value less costs to sell in accordance with that Ind AS.
Leases	Acquiree is a lessee • The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with Ind AS 116. • The acquirer is not required to recognise right-of-use assets and lease liabilities for: (a) leases for which the lease term ends within 12 months of the acquisition date; or (b) leases for which the underlying asset is of low value. • The acquirer shall measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date. • The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms. Acquiree is a lessor In measuring the acquisition-date fair value of an asset, the acquirer shall take into account the terms of the lease. The acquirer does not recognise a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms.
Assembled workforce	The acquirer subsumes into Goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.



10.3 Intangible Assets

As explained above an intangible asset should be recorded separately from Goodwill if either the separability criteria is met or it arises out of contractual legal criterion.



10.3.1 Contractual Legal criterion

An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.

For example:

- a. an acquiree owns and operates a nuclear power plant. The licence to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognise the fair value of the operating licence and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.
- b. an acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future revenue in foreign exchange. Both the technology patent and the related licence agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related licence agreement separately from one another would not be practical.

10.3.2 Separability criteria

The separability criterion means that an acquired intangible asset is **capable** of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability. An intangible asset that the acquirer would be able to sell, license or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license or otherwise exchange it. An acquired intangible asset meets the separability criterion if there is

evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.

Example 17:

Customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset or liability.

For example:

- a. market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognise the depositor relationship intangible asset separately from goodwill.
- b. an acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

Accordingly, as per the guidance above it follows that identification of intangible asset will be judgemental and will vary in each case.

Following are the possible sources of information and broad indicator to be used to identify any possible intangible separately from goodwill:

A. Internal sources:**◆ Financial statements of the acquiree-**

- significant R&D cost may be indicator that there may be possible technology related intangible.
- Significant sales promotion or marketing cost- this is a strong indicator of marketing related intangible like distributor network, Marketing collaterals etc.

- Customer acquisition cost- lot of companies spend money to acquire new customers like online e-commerce companies provide incentive to register a customer as a first- time user or download their app. This may be a strong indicator of existence of customer list as an intangible.
- ◆ **Share purchase agreement-** This can also be a strong indicator of existence of intangible in the form of any technical know-how, trademarks or patent which are included in the agreement.
- ◆ **Purpose of acquisition-** The reason for acquisition may also indicate the possible intangible to be recorded. For e.g. Coca Cola acquired Thumps Up with an intention to close the brand which will result in increase in its market share. Accordingly, this will also be a possible intangible asset.

Illustration 17

Company A, FMCG company acquires an online e-commerce company E, with the intention to start its retail business. The e-commerce company has over the period have 10 million registered users. However, the e-commerce company E does not have any intention to sell the customer list.

Should this customer list be recorded as an intangible in a business combination?

Solution

In this situation the customer database does not give rise to legal or contractual right. Accordingly, the assessment of its separability will be assessed. The database can be useful to other players and Company E has the ability to transfer this to them. Accordingly, the intention not to transfer will not affect the assessment whether to record this as an intangible or not. Hence customer list should be recorded as an intangible in a business combination.

Illustration 18

ABC Ltd. a pharmaceutical group acquires XYZ Ltd. another pharmaceutical business. XYZ Ltd. has incurred significant research costs in connection with two new drugs that have been undergoing clinical trials. Out of the two drugs, one drug has not been granted necessary regulatory approvals. However, ABC Ltd. expects that approval will be given within two years. The other drug has recently received regulatory approval. The drugs' revenue-earning potential was one of the principal reasons why entity ABC Ltd. decided to acquire entity XYZ Ltd.

Whether the research and development on either of the drugs be recognised as an intangible asset in the books of ABC Ltd.?

Solution

Ind AS 38, Intangible Assets provides explicit guidance on recognition of acquired in-process research and development.

Paragraph 21 of Ind AS 38 provides guidance regarding general recognition conditions which require it to be probable that expected future economic benefits will flow to the entity before an intangible asset can be recognised and for the cost to be measured reliably.

As per paragraph 33 of Ind AS 38, both of the standard's general recognition criteria, i.e. probability of benefits and reliable measurement, are always considered to be satisfied for intangible assets acquired in a business combination.

The fair value of an intangible asset reflects expectations about the probability of these benefits, despite uncertainty about the timing or the amount of the inflow. There will be sufficient information to measure the fair value of the asset reliably if it is separable or arises from contractual or other legal rights. If there is a range of possible outcomes with different probabilities, this uncertainty is taken into account in the measurement of the asset's fair value.

Paragraph 34 of Ind AS 38, provides that in accordance with this Standard and Ind AS 103, an acquirer recognises at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognised by the acquiree before the business combination.

This means that the acquirer recognises 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, i.e. is separable or arises from contractual or other legal rights.

In accordance with above,

- (i) The fair value of the first drug reflects the probability and the timing of the regulatory approval being obtained. As per the standard, the recognition criterion of probable future economic benefits is considered to be satisfied in respect of the asset acquired accordingly an asset is recognised. Subsequent expenditure on an in-process research or development project acquired separately is to be dealt with in accordance with paragraph 43 of Ind AS 38.
- (ii) The rights to the second drug also meet the recognition criteria in Ind AS 8 and are recognised. The approval means it is probable that future economic benefits will flow to ABC Ltd. This will be reflected in the fair value assigned to the intangible asset.

Thus, recognising in-process research and development as an asset on acquisition applies different criteria to those that are required for internal projects. The research costs of internal R&D projects may under no circumstances be capitalised as an intangible asset. It may be pertinent to note that entities will be required to recognise on acquisition some research and development expenditure that they would not have been able to recognise if it had been an internal project. Although the amount attributed to the project is accounted for as an asset, Ind AS 38 requires that any subsequent expenditure incurred after the acquisition of the project is to be accounted for in accordance with paragraphs 54 to 62 of Ind AS 38.

10.3.3 Assembled workforce and other items that are not identifiable

The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date.

An assembled workforce does not represent the intellectual capital of the skilled workforce — the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.

The acquirer also subsumes into goodwill any value attributed to items that do not qualify as assets at the acquisition date. For example, the acquirer might attribute value to potential contracts the acquiree is negotiating with prospective new customers at the acquisition date. Because those potential contracts are not themselves assets at the acquisition date, the acquirer does not recognise them separately from goodwill. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding the events occurring shortly after the acquisition to determine whether a separately recognisable intangible asset existed at the acquisition date.

After initial recognition, an acquirer accounts for intangible assets acquired in a business combination in accordance with the provisions of Ind AS 38, Intangible Assets. However, as described in paragraph 3 of Ind AS 38, the accounting for some acquired intangible assets after initial recognition is prescribed by other Ind AS.

The identifiability criteria determine whether an intangible asset is recognised separately from goodwill. However, the criteria neither provides guidance for measuring the fair value of an intangible asset nor restrict the assumptions used in measuring the fair value of an intangible asset. For example, the acquirer would take into account the assumptions that market

participants would use when pricing the intangible asset, such as expectations of future contract renewals, in measuring fair value. It is not necessary for the renewals themselves to meet the identifiability criteria.

10.4 Reacquired Rights

As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognises separately from goodwill.

If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss.

Illustration 19

Vadapav Ltd. is a successful company has number of own stores across India and also offers franchisee to other companies. Efficient Ltd. is one of the franchisee of Vadapav Ltd. and it operates number of store in south India. Vadapav Ltd. decided to acquire Efficient Ltd. due to its huge distribution network and accordingly purchased the outstanding shares on 1st April, 20X2. On the acquisition date, Vadapav Ltd. determines that the license agreement reflects current market terms.

Determine the accounting for franchisee right by Vadapav Ltd. at the time of acquisition of business.

Solution

Vadapav will record the franchisee right as an intangible asset (reacquired right) while doing purchase price allocation and since it is at market terms no gain or loss will be recorded on settlement.

Illustration 20

ABC Ltd. acquires PQR Ltd. for a consideration of ₹ 1 crore. Four years ago, ABC Ltd. had granted a ten-year license allowing PQR Ltd. to operate in Europe. The cost of the license was ₹ 2,50,000. The contract allows either party to terminate the franchise at a cost of the unexpired initial fee plus 20%. At the date of acquisition, the settlement amount is ₹ 1,80,000 $[(₹ 2,50,000 \times 6/10) + 20\%]$.

ABC Ltd. has acquired PQR Ltd., because it sees high potential in the European market and wishes to exploit it. ABC Ltd. calculates that under current economic conditions and at current prices it could grant a six-year franchise for a price of ₹ 4,50,000.

How is the license accounted for as part of the business combination?

Solution

Paragraph B51 of Ind AS 103 provides that “the acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a ‘pre-existing relationship’. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant).”

Further, paragraph B52 of Ind AS 103 provides that “if the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:

- (a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.
- (b) for a pre-existing contractual relationship, the lesser of (i) and (ii):
 - (i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)
 - (ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

If (ii) is less than (i), the difference is included as part of the business combination accounting.

The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements.”

Based on the above in the instant case, the license is recognised at ₹ 4,50,000, the fair value at market rates of a license based on the remaining contractual life.

The gain or loss on settlement of the contract is the lower of:

- ₹ 3,00,000, which is the amount by which the right is unfavorable to ABC Ltd. compared to market terms. This is the difference between the amount that ABC Ltd. could receive for

granting a similar right, ₹ 4,50,000, compared to the carrying value (or the unamortised value) that it was granted for, ₹ 1,50,000 (2,50,000 X 6/10).

- ₹ 1,80,000, which is the amount that ABC Ltd. would have to pay to terminate the right at the date of acquisition.

The loss on settlement of the contract is ₹ 1,80,000. Therefore, out of the ₹ 1 crore paid, ₹ 98.2 lakh is accounted for as consideration for the business combination and ₹ 1,80,000 is accounted for separately as a settlement loss on the re-acquired right.

10.5 Goodwill – Recognition and Measurement

The acquirer shall recognise Goodwill as of the acquisition date measured as the excess of (a) over (b) below:

- a) the aggregate of:
 - i. the purchase consideration transferred at acquisition-date fair value;
 - ii. the amount of any non-controlling interest in the acquiree measured in accordance with this Ind AS (refer non-controlling section); and
 - iii. in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
- b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Ind AS.

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred. To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree in place of the acquisition-date fair value of the consideration transferred (paragraph 32(a)(i)).

10.6 Bargain Purchase

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the value of net assets acquired in a business combination exceeds the purchase consideration.

The acquirer shall recognise the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve, if the reason for bargain purchase gain is clear and evidence exist. If there does not exist clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, then the gain shall be recognised directly in equity as capital reserve.

The gain shall be attributed to the acquirer and there will no allocation to the non-controlling shareholders.

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.

The Ind AS itself acknowledges that it is very rare that a bargain purchase in a business combination will arise and accordingly the standard re-emphasises the above point by requiring the entities to reassess and identify the clear reason why it is a bargain purchase business combination. For e.g. acquisition of business in a bankruptcy sale, or sale of business due to a regulatory requirement.

Example 18:

Entity X is one of the largest liquor manufacturing company in the world and it acquires another Entity Y which has significant presence in India and UK. However, the competition commission in UK has issued orders to sell one division of the UK assets of Entity Y in order to comply with the local competition regulation in UK within a specified timeline. Entity Z another boutique liquor manufacturer realises the opportunity and purchase the assets of Entity Y from Entity X.

In the given case above it is more likely than not that there could be an element of bargain purchase as the Entity X was under compulsion to sell the assets within a specified timeline.

As mentioned above before recognising a gain on a bargain purchase, the acquirer shall determine whether there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase. If such evidence exists, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review.

The acquirer shall then review the procedures used to measure the amounts this Ind AS requires to be recognised at the acquisition date for all of the following:

- the identifiable assets acquired and liabilities assumed;
- the non-controlling interest in the acquiree, if any;
- for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and
- the consideration transferred.

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

Illustration 21

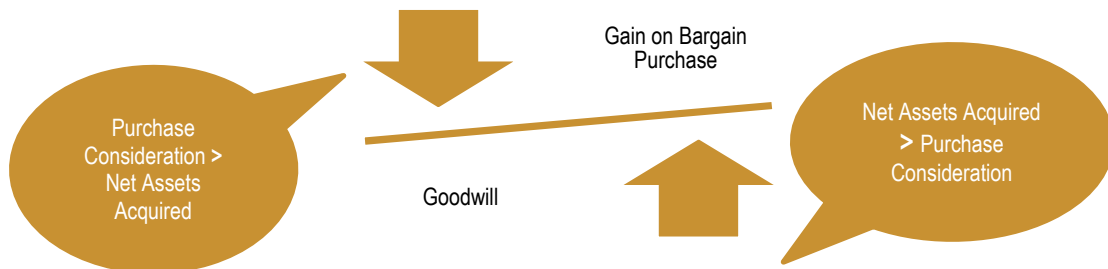
On 1st January, 20X1, A Ltd. acquires 80 per cent of the equity interests of B Ltd. in exchange for cash of ₹ 15 crore. The former owners of B Ltd. were required to dispose off their investments in B Ltd. by a specified date, and accordingly they did not have sufficient time to find potential buyers. A qualified valuation professional hired by the management of A Ltd. measures the identifiable net assets acquired, in accordance with the requirements of Ind AS 103, at ₹ 20 crore and the fair value of the 20 per cent non-controlling interest in B Ltd. at ₹ 4.2 crore. How should A Ltd. recognise the above bargain purchase?

Solution

The amount of B Ltd.'s identifiable net assets i.e., ₹ 20 crore exceeds the fair value of the consideration transferred plus the fair value of the non-controlling interest in B Ltd. i.e. ₹ 19.2 crore. Therefore, A Ltd. should review the procedures it used to identify and measure the net assets acquired and the fair value of non-controlling interest in B Ltd. and the consideration transferred. After the review, A Ltd. decides that the procedures and resulting measures were appropriate. A Ltd. measures the gain on its purchase of the 80 per cent interest at ₹ 80 lakh, as the difference between the amount of the identifiable net assets which is ₹ 20 crore and the sum of purchase consideration and fair value of non-controlling interest, which is ₹ 19.2 crore (cash consideration of ₹ 15 crore and fair value of non-controlling interest of ₹ 4.2 crore).

Assuming there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, the gain on bargain purchase of 80 per cent interest calculated at ₹ 80 lakh, which will be recognised in other comprehensive income on the acquisition date and accumulated the same in equity as capital reserve.

If the acquirer chose to measure the non-controlling interest in B Ltd. on the basis of its proportionate share of identifiable net assets of the acquiree, the recognised amount of the non-controlling interest would be ₹ 4 crore ($₹ 20 \text{ crore} \times 0.20$). The gain on the bargain purchase then would be ₹ 1 crore ($₹ 20 \text{ crore} - (₹ 15 \text{ crore} + ₹ 4 \text{ crore})$).



10.7 Measurement Period

Ind AS 103 provides a measurement period window wherein if all the required information is not available on the acquisition date then the entity will be required to do the purchase price allocation on a provision basis. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this Ind AS:

- the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;
- the consideration transferred for the acquiree (or the other amount used in measuring goodwill);
- in a business combination achieved in stages, the equity interest in the acquire previously held by the acquirer; and
- the resulting goodwill or gain on a bargain purchase.

Any change i.e. increase or decrease in the net assets acquired due to new information available during the measurement period which existed on the acquisition date will be adjusted against goodwill.

However, after the measurement period ends, any change in the value of assets and liabilities due to an information which existed on the valuation date will be accounted as an error as per Ind AS 8, Accounting policies, Changes in Accounting Estimates and Errors.

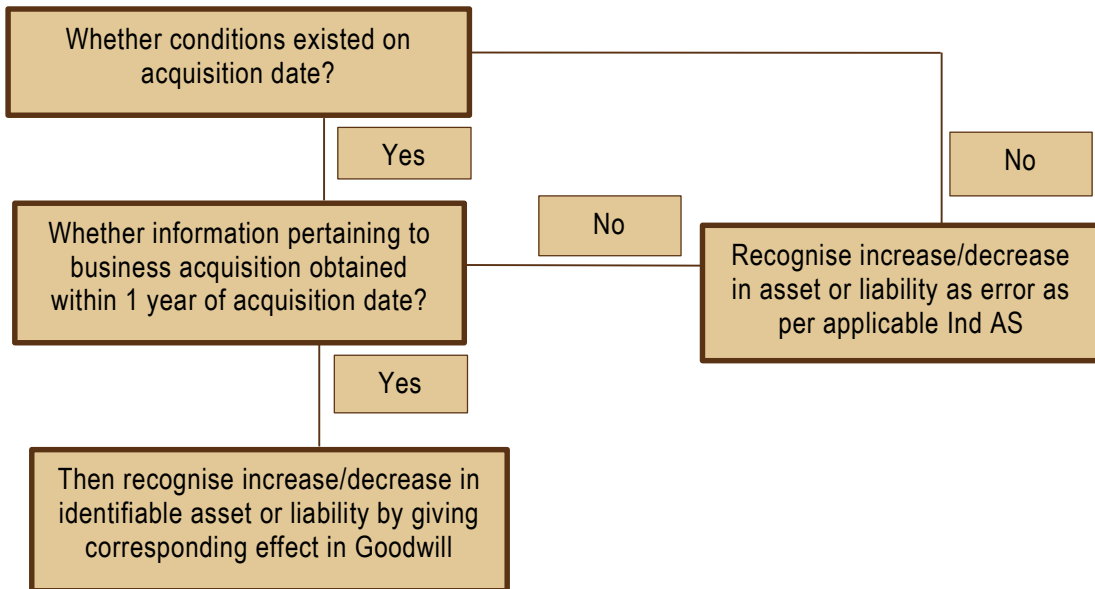


Illustration 22

Entity X acquired 100% shareholding of Entity Y on 1st April, 20X1 and had completed the preliminary purchase price allocation and accordingly recorded net assets of ₹ 100 million against the purchase consideration of 150 million. Entity Y had significant carry forward losses on which deferred tax asset was not recorded due to lack of convincing evidence on the acquisition date. However, on 31st March, 20X2, Entity Y won a significant contract which is expected to generate enough taxable income to recoup the losses. Accordingly, the deferred tax asset was recorded on the carry forward losses on 31st March, 20X2.

Whether the aforesaid losses can be adjusted with the Goodwill recorded based on the preliminary purchase price allocation?

Solution

No, as per the requirement of Ind AS 103, changes to the net assets are allowed which results from the discovery of a fact which existed on the acquisition date. However, change of facts resulting in recognition and de-recognition of assets and liabilities after the acquisition date will be accounted in accordance with other Ind AS. In the above scenario deferred tax asset was not eligible for recognition on the acquisition date and accordingly the new contract on 31st March, 20X2 will tantamount to change of estimate and accordingly will not impact the Goodwill amount.

Illustration 23

ABC Ltd. acquires XYZ Ltd. in a business combination on 15th January, 20X1. Few days before the date of acquisition, one of XYZ Ltd.'s customers had claimed that certain amounts were due by XYZ Ltd. under penalty clauses for completion delays included in the contract.

ABC Ltd. evaluates the dispute based on the information available at the date of acquisition and concludes that XYZ Ltd. was responsible for at least some of the delays in completing the contract. Based on the evaluation, ABC Ltd. recognises ₹ 1 crore towards this liability which is its best estimate of the fair value of the liability to the customer based on the information available at the date of acquisition.

In October, 20X1 (within the measurement period), the customer presents additional information as per which ABC Ltd. concludes the fair value of liability on the date of acquisition to be ₹ 2 crore.

ABC Ltd. continues to receive and evaluate information related to the claim after October, 20X1. Its evaluation doesn't change till February, 20X2 (i.e. after the measurement period), when it concludes that the fair value of the liability for the claim at the date of acquisition is ₹ 1.9 crore. ABC Ltd. determines that the amount that would be recognised with respect to the claim under Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets as at February, 20X2 is ₹ 2.2 crore.

How should the adjustment to the provisional amounts be made in the financial statements during and after the measurement period?

Solution

The consolidated financial statements of ABC Ltd. for the year ended 31st March, 20X1 should include ₹ 1 crore towards the contingent liability in relation to the customer claim.

When the customer presents additional information in support of its claim, the incremental liability of ₹ 1 crore (₹ 2 crore – ₹ 1 crore) will be adjusted as a part of acquisition accounting as it is within the measurement period. In its financial statements for the year ending on 31st March, 20X2, ABC Ltd. will disclose the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, it will disclose that the comparative information for the year ending on 31st March, 20X1 is adjusted retrospectively to increase the fair value of the item of liability at the acquisition date by ₹ 1 crore, resulting in a corresponding increase in goodwill.

The information resulting in the decrease in the estimated fair value of the liability for the claim in February, 20X2 was obtained after the measurement period. Accordingly, the decrease is not recognised as an adjustment to the acquisition accounting. If the amount determined in

accordance with Ind AS 37 subsequently exceeds the previous estimate of the fair value of the liability, then ABC Ltd. recognises an increase in the liability. As the change has occurred after the end of the measurement period, the increase in the liability amounting to ₹ 20 lakh (₹ 2.2 crore – ₹ 2 crore) is recognised in profit or loss.

10.8 Determining what is part of the Business Combination Transaction

The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, i.e. amounts that are not part of the exchange for the acquiree. The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant Ind AS.

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

- a transaction that in effect settles pre-existing relationships between the acquirer and acquiree;
- a transaction that remunerates employees or former owners of the acquiree for future services; and
- a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, in determining whether the transaction is separate from Business combination:

- I. **The reasons for the transaction-** Understanding the reasons why the parties to the combination (the acquirer and the acquiree and their owners, directors and managers -and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities

assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

- II. **Who initiated the transaction**—Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.
- III. **The timing of the transaction**—The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

Illustration 24

Progressive Ltd. is being sued by Regressive Ltd. for an infringement of its Patent. At 31st March, 20X2, Progressive Ltd. recognised a ₹ 10 million liability related to this litigation.

On 30th July, 20X2, Progressive Ltd. acquired the entire equity of Regressive Ltd. for ₹ 500 million. On that date, the estimated fair value of the expected settlement of the litigation is ₹ 20 million.

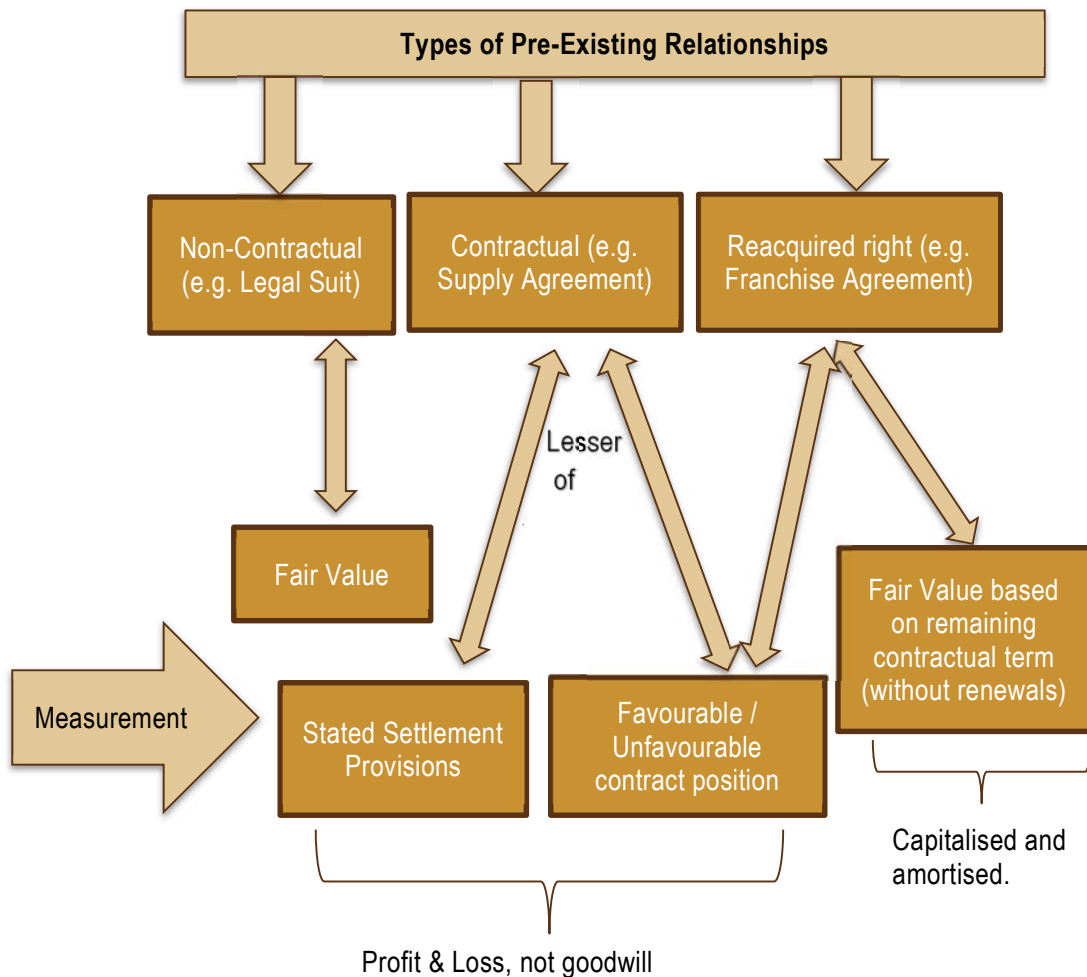
Recommend the accounting for such litigation liability at the time of business combination of Progressive Ltd. and Regressive Ltd.

Solution

In the above scenario the litigation is in substance settled with the business combination transaction and accordingly ₹ 20 million being the fair value of the litigation liability will be considered as paid for settling the litigation claim and will be not included in the business

combination. Accordingly, the purchase price will reduce by ₹ 20 million and the difference between ₹ 20 million and ₹ 10 million will be recorded in income statement of the Progressive limited as loss on settlement of the litigation.

Summary of accounting for a pre-existing relationship:



10.9 Contingent Payments to Employees or Selling Shareholders

Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement

includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

- a) **Continuing employment**—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.
- b) **Duration of continuing employment** — If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, remuneration.
- c) **Level of remuneration** — Situations in which employee remuneration (other than the contingent payments) is at a reasonable level in comparison with that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than remuneration.
- d) **Incremental payments to employees** — If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration.
- e) **Number of shares owned**—The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit sharing arrangement intended to provide remuneration for post-combination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The pre-acquisition ownership interests held by parties related to selling

shareholders who continue as key employees, such as family members, should also be considered.

- f) **Linkage to the valuation**—If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquire and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide remuneration.
- g) **Formula for determining consideration**—The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to remunerate employees for services rendered.
- h) **Other agreements and issues** — The terms of other arrangements with selling shareholders (such as agreements not to compete, executory contracts, consulting contracts and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognise separately in its post-combination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

Illustration 25

KKV Ltd acquires a 100% interest in VIVA Ltd, a company owned by a single shareholder who is also the KMP in the Company, for a cash payment of USD 20 million and a contingent payment of USD 2 million. The terms of the agreement provide for contingent payment 2 years after the acquisition if, the following conditions are met:

- *the EBITDA margins of the Company after 2 years post-acquisition is 21%.*

- *the former shareholder continues to be employed with VIVA Ltd for at least 2 years after the acquisition. No part of the contingent payment will be paid if the former shareholder does not complete the 2 year employment period.*

Determine the purchase consideration in the above case.

Solution

In the above scenario the former shareholder is required to continue in employment and the contingent consideration will be forfeited if the employment is terminated or if he resigns. Accordingly, only USD 20 million is considered as purchase consideration and the contingent consideration is accounted as employee cost and will be accounted as per the other Ind AS.

Illustration 26 : Contingent consideration- Payments to employees who are former owners of acquiree

ABC Ltd. acquires all of the outstanding shares of XYZ Ltd. in a business combination. XYZ Ltd. had three shareholders with equal shareholdings, two of whom were also senior-level employees of XYZ Ltd. and would continue as employee post-acquisition of shares by ABC Ltd.

- *The employee shareholders each will receive ₹ 60,00,000 plus an additional payment of ₹ 1,50,00,000 to 2,00,00,000 based on a multiple of earnings over the next two years.*
- *The non-employee shareholders each receive ₹ 1,00,00,000.*

The additional payment of each of these employee shareholders will be forfeited if they leave the employment of XYZ Ltd. at any time during the two years following its acquisition by ABC Ltd. The salary received by them is considered reasonable remuneration for their services.

How much amount is attributable to post combination services?

Solution

Paragraph B55(a) of Ind AS 103 provides an indication that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services.

Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.

In accordance with the above, in the instant case, the additional consideration of ₹ 1,50,00,000 to ₹ 2,00,00,000 represents compensation for post-combination services, as the same represents that part of the payment which is forfeited if the former shareholder does not remain

in the employment of XYZ Ltd. for two years following the acquisition - i.e., only ₹ 60,00,000 is attributed to consideration in exchange for the acquired business.

10.10 Acquirer Share Based Payment Awards Exchanged for Awards held by the Acquiree's Employees

- An acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree.
- The above share-based payment awards will include vested and unvested shares.
- Exchanges of share options or other share-based payment awards in conjunction with a business combination are accounted for as modifications of share-based payment awards in accordance with Ind AS 102, Share based Payment.
- If the acquirer replaces the acquiree awards, either all or a portion of the market-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. Market based measure means that awards will be re-measured on the acquisition date as per the requirements of Ind AS 102.
- In situations in which acquiree awards would expire as a consequence of a business combination and if the acquirer replaces those awards when it is not obliged to do so, all of the market-based measure of the replacement awards shall be recognised as remuneration cost in the post-combination financial statements in accordance with Ind AS 102. That is to say, none of the market-based measure of those awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obliged to replace the acquiree awards if the acquiree or its employees have the ability to enforce replacement.

For example, for the purposes of applying this guidance, the acquirer is obliged to replace the acquiree's awards if replacement is required by:

- (a) the terms of the acquisition agreement;
 - (b) the terms of the acquiree's awards; or
 - (c) applicable laws or regulations.
- To determine the portion of a replacement award that is part of the consideration transferred for the acquiree and the portion that is remuneration for post-combination service, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with Ind AS 102. The portion of the market-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to pre-combination service.
 - The portion of the replacement award attributable to pre-combination service is the market-based measure of the acquiree award multiplied by the ratio of the portion of the vesting

period completed to the greater of the total vesting period or the original vesting period of the acquiree award. The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in Ind AS 102.

- The portion of a non-vested replacement award attributable to post-combination service, and therefore recognised as remuneration cost in the post-combination financial statements, equals the total market-based measure of the replacement award less the amount attributed to pre-combination service. Therefore, the acquirer attributes any excess of the market-based measure of the replacement award over the market-based measure of the acquiree award to post-combination service and recognises that excess as remuneration cost in the post-combination financial statements.
- The acquirer shall attribute a portion of a replacement award to post-combination service if it requires post combination service, regardless of whether employees had rendered all of the service required for their acquiree awards to vest before the acquisition date.
- The portion of a non-vested replacement award attributable to pre-combination service, as well as the portion attributable to post-combination service, shall reflect the best available estimate of the number of replacement awards expected to vest.

Example 19

If the market-based measure of the portion of a replacement award attributed to pre-combination service is ₹ 100 and the acquirer expects that only 95 per cent of the award will vest, the amount included in consideration transferred in the business combination is ₹ 95.

- Changes in the estimated number of replacement awards expected to vest are reflected in remuneration cost for the periods in which the changes or forfeitures occur not as adjustments to the consideration transferred in the business combination. Similarly, the effects of other events, such as modifications or the ultimate outcome of awards with performance conditions, that occur after the acquisition date are accounted for in accordance with Ind AS 102 in determining remuneration cost for the period in which an event occurs.
- The same requirements for determining the portions of a replacement award attributable to pre-combination and post-combination service apply regardless of whether a replacement award is classified as a liability or as an equity instrument in accordance with the provisions of Ind AS 102. All changes in the market-based measure of awards classified as liabilities after the acquisition date and the related income tax effects are recognised in the acquirer's post-combination financial statements in the period(s) in which the changes occur.
- The income tax effects of replacement awards of share-based payments shall be recognised in accordance with the provisions of Ind AS 12, Income Taxes.

The above guidance on Share based payment as per the Ind AS 103 can be summarized as follows:

ACQUIRER SHARE BASED PAYMENT AWARDS EXCHANGED FOR AWARDS HELD BY THE ACQUIREE'S EMPLOYEES

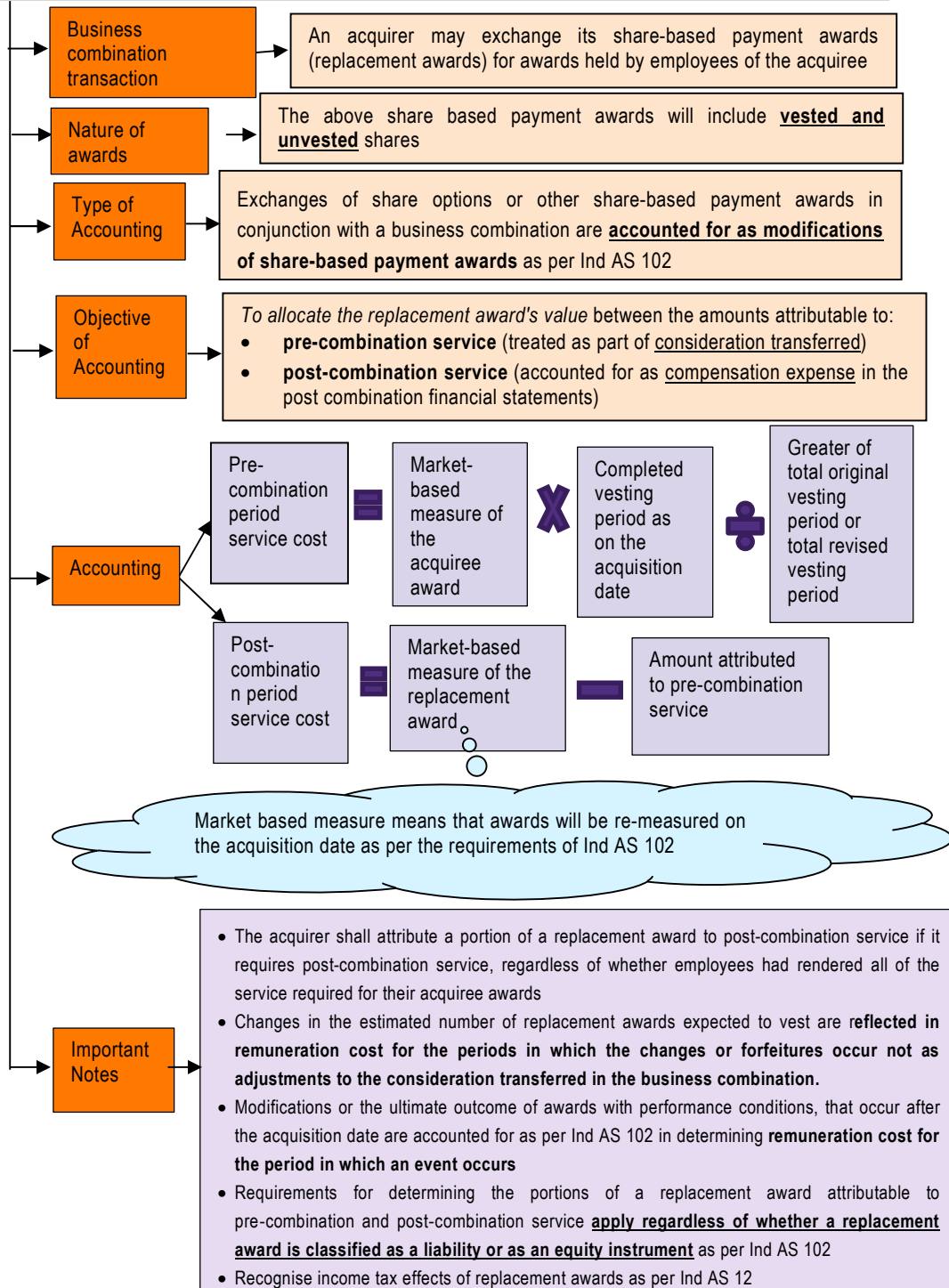


Illustration 27

Green Ltd acquired Pollution Ltd. As a part of the arrangement Green Ltd. had to replace the Pollution Ltd.'s existing equity-settled award. The original awards specify a vesting period of five years. At the acquisition date, Pollution Ltd employees have already rendered two years of service.

As required, Green Ltd replaced the original awards with its own share-based payment awards (replacement award). Under the replacement awards, the vesting period is reduced to 2 year (from the acquisition date).

The value (market-based measure) of the awards at the acquisition date are as follows:

- *original awards: ₹ 500*
- *replacement awards: ₹ 600*

As of the acquisition date, all awards are expected to vest.

Determine the accounting for the above replacement award.

Solution**Pre-combination period**

The value of the replacement awards will have to be allocated between the pre-combination and post combination period. As of the acquisition date, the fair value of the original award (₹ 500) will be multiplied by the service rendered upto acquisition date (2 years) divided by greater of original vesting period (5 years) or new vesting period (4 years). Accordingly, $₹ 500 \times 2/5 = ₹ 200$ will be considered as pre-combination service and will be included in the purchase consideration.

Post- Combination period

The fair value of the award on the acquisition date is ₹ 600 which means the difference between the replacement award which is ₹ 600 and the amount allocated to pre-combination period (₹ 200) is ₹ 400 which will be now recorded over the remaining vesting period which is 2 years as an employee compensation cost.

10.11 Non-replacement Awards

The acquiree may have outstanding share-based payment transactions that the acquirer does not exchange for its share-based payment transactions. If vested, those acquiree share-based

payment transactions are part of the non-controlling interest in the acquiree and are measured at their market-based measure. If unvested, they are measured at their market-based measure as if the acquisition date were the grant date in accordance with paragraphs 19 and 30.

The market-based measure of unvested share-based payment transactions is allocated to the non-controlling interest on the basis of the ratio of the portion of the vesting period completed to the greater of the total vesting period and the original vesting period of the share-based payment transaction. The balance is allocated to post-combination service.

The above means that the acquiree's existing award will be settled in its own shares and the consequential shareholders will become the Non-controlling shareholders. The above principles can be summarized as follows:

Vested shares -

- the value credited to Share based payment reserve is classified as NCI.

Unvested-

- Pre-combination period is considered as a part of NCI
- Post-combination period- is recorded as employee cost and the credit forms part of the NCI in the balance sheet.

EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS OF THE ACQUIREE

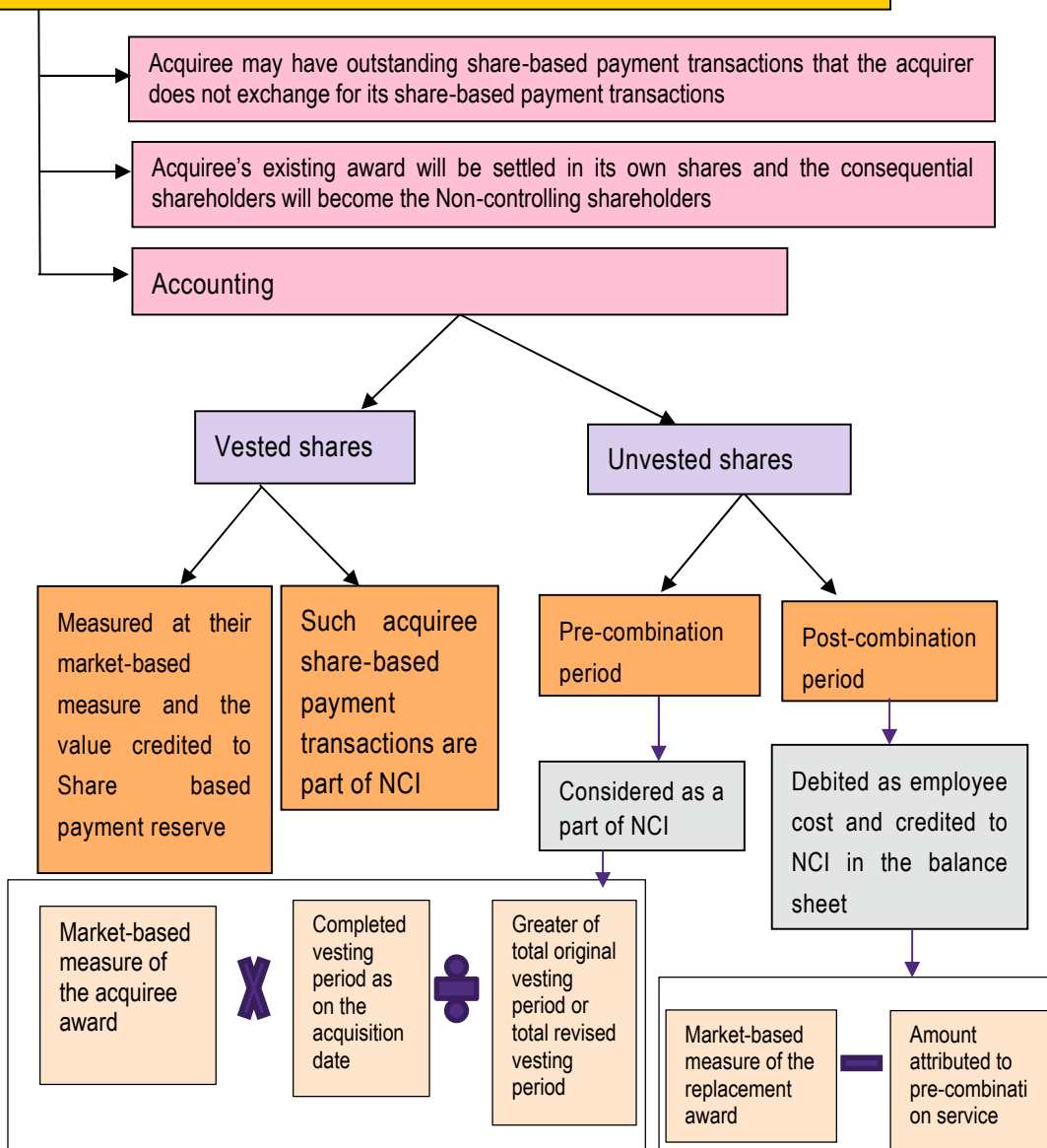


Illustration 28

P Ltd. a real estate company acquires Q Ltd. another construction company which has an existing equity settled share-based payment scheme. The awards vest after 5 years of employee service. At the acquisition date, Company Q's employees have rendered 2 years of service. None of the awards are vested at the acquisition date. P did not replace the existing share-based payment scheme but reduced the remaining vesting period from 3 years to 2 years. Company P determines that the market-based measure of the award at the acquisition date is

₹ 500 (based on measurement principles and conditions at the acquisition date as per Ind AS 102).

Determine the accounting for market-based measure of the award.

Solution

The market-based measure or the fair value of the award on the acquisition date of 500 is allocated to NCI and post combination employee compensation expense. The portion allocable to pre-combination period is ₹ 500 x 2/5 = ₹ 200 which will be included in pre-combination period and is allocated to NCI on the acquisition date. The amount is computed based on original vesting period.

The remaining expense which is ₹ 500 – ₹ 200 = ₹ 300 is accounted over the remaining vesting period of 2 years as compensation expenses.

10.12 Non-controlling Interest in an Acquiree

Ind AS 103 allows the acquirer to measure a non-controlling interest in the acquiree at its fair value at the acquisition date. Sometimes an acquirer will be able to measure the acquisition-date fair value of a non-controlling interest on the basis of a quoted price in an active market for the equity shares (ie those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the non-controlling interest using other valuation techniques.

The fair values of the acquirer's interest in the acquiree and the non-controlling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a non-controlling interest discount) in the per-share fair value of the non-controlling interest if market participants would take into account such a premium or discount when pricing the non-controlling interest.

Illustration 29

Classic Ltd. acquires 60% of the ordinary shares of Natural Ltd. a private entity, for ₹ 97.5 crore. The fair value of its identifiable net assets is ₹ 150 crore. The fair value of the 40% of the ordinary shares owned by non-controlling shareholders is ₹ 65 crore. Carrying amount of Natural Ltd.'s net assets is ₹ 120 crore.

Measure the non-controlling interest.

Solution

Paragraph 19 of Ind AS 103 states that for each business combination, the acquirer shall measure at the acquisition date components of non-controlling interest in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

- (a) fair value; or
- (b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by Ind AS.

In accordance with above, non-controlling interests will be measured in either of the following manner:

(a) Non-controlling interests are measured at fair value

Under this method, goodwill represents the difference between the fair value of Natural Ltd. and the fair value of its identifiable net assets.

Thus, Classic Ltd. will recognise the business combination as follows: (₹ in crores)

Identifiable net assets at fair value	Dr.	150	
Goodwill*	Dr.	12.5	
To Non-controlling interest			65
To Investment in Natural Ltd.			97.5

*Note: Goodwill is calculated as $97.5 + 65 - 150 = 12.5$ or $162.5 - 150 = 12.5$

(b) Non-controlling interests are measured at proportionate share of identifiable net assets

Under this method, goodwill represents the difference between the total of the consideration transferred less the fair value of the acquirer's share of net assets acquired and liabilities assumed. The non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the Natural Ltd 's net assets in the event of liquidation (i.e. the ordinary shares) are measured at the non-controlling interest's proportionate share of the identifiable net assets of Natural Ltd.

Thus, Classic will recognise the business combination as follows:

(₹ in Crores)

Identifiable net assets at fair value	Dr.	150	
Goodwill*	Dr.	7.5	
To Non-controlling interest (40% x 150)			60
To Investment in Natural Ltd.			97.5

*Note: Goodwill is calculated as $97.5 + 60 - 150 = 7.5$ or $97.5 - (150 \times 60\%) = 7.5$



11. SUBSEQUENT MEASUREMENT AND ACCOUNTING

In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable Ind AS for those items, depending on their nature. However, this Ind AS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:

- a) reacquired rights;
- b) contingent liabilities recognised as of the acquisition date;
- c) indemnification assets; and
- d) Contingent consideration.

11.1 Reacquired Rights

A reacquired right recognised as an intangible asset shall be amortised over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

11.2 Contingent Liabilities

After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:

- (a) the amount that would be recognised in accordance with Ind AS 37; and
- (b) the amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115, Revenue from Contracts with Customers.

11.3 Indemnification Assets

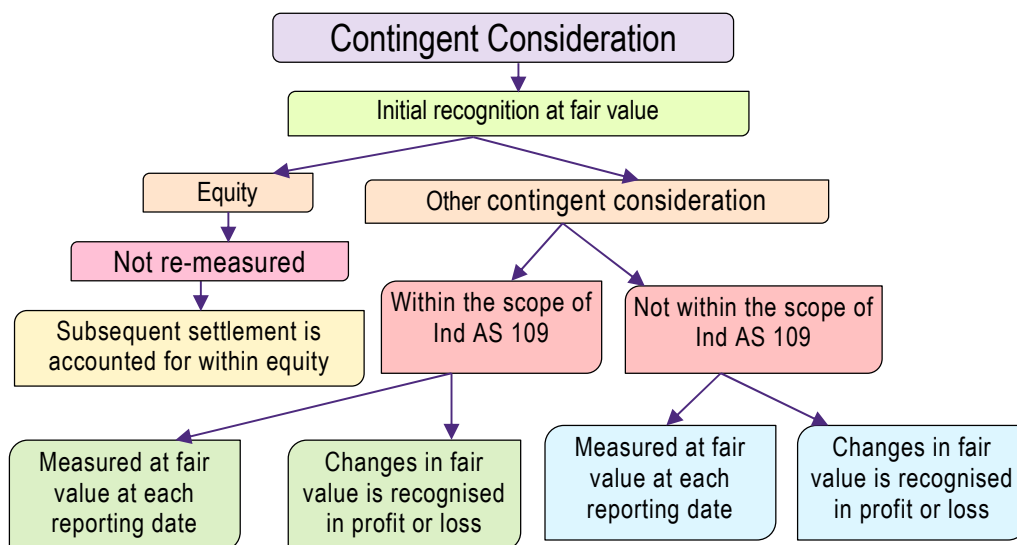
At the end of each subsequent reporting period, the acquirer shall measure an indemnification asset that was recognised at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's needs to do assessment of the collectability of the indemnification asset. The acquirer shall derecognise the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it.

11.4 Contingent Consideration

Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date.

Such changes are measurement period adjustments to the extent it is on account of conditions which existed as of the acquisition date will be adjusted against goodwill. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

- (a) Contingent consideration classified as equity shall not be re-measured and its subsequent settlement shall be accounted for within equity.
- (b) Other contingent consideration that:
 - i. is within the scope of Ind AS 109 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss in accordance with Ind AS 109.
 - ii. is not within the scope of Ind AS 109 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss.





12. DISCLOSURES

The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

- a) during the current reporting period; or
- b) after the end of the reporting period but before the financial statements are approved for issue.

Ind AS 103 requires detailed disclosures on Business Combination. The acquirer shall disclose the following information for each business combination that occurs during the reporting period:

- a. the name and a description of the acquiree.
- b. the acquisition date.
- c. the percentage of voting equity interests acquired.
- d. the primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree.
- e. a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.
- f. the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:
 - I. cash;
 - II. other tangible or intangible assets, including a business or subsidiary of the acquirer;
 - III. liabilities incurred, for example, a liability for contingent consideration; and
 - IV. equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of measuring the fair value of those instruments or interests.
- g. for contingent consideration arrangements and indemnification assets:
 - i. the amount recognised as of the acquisition date;
 - ii. a description of the arrangement and the basis for determining the amount of the payment; and

- iii. an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.
- h. for acquired receivables:
 - i. the fair value of the receivables;
 - ii. the gross contractual amounts receivable; and
 - iii. the best estimate at the acquisition date of the contractual cash flows not expected to be collected. The disclosures shall be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables.
- i. the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.
- j. for each contingent liability recognised, the information required in paragraph 85 of Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets. If a contingent liability is not recognised because its fair value cannot be measured reliably, the acquirer shall disclose:
 - i. the information required by paragraph 86 of Ind AS 37; and
 - ii. the reasons why the liability cannot be measured reliably.
- k. the total amount of goodwill that is expected to be deductible for tax purposes.
- l. for transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination:
 - i. a description of each transaction;
 - ii. how the acquirer accounted for each transaction;
 - iii. the amounts recognised for each transaction and the line item in the financial statements in which each amount is recognised; and
 - iv. if the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement amount.
- m. the disclosure of separately recognised transactions required by (l) shall include the amount of acquisition-related costs and, separately, the amount of those costs recognised as an expense and the line item or items in the statement of profit and loss in which those expenses are recognised. The amount of any issue costs not recognised as an expense and how they were recognised shall also be disclosed.
- n. in a bargain purchase (see paragraphs 34–36A):
 - i. the amount of any gain recognised in other comprehensive income in accordance with paragraph 34;

- ii. the amount of any gain directly recognised in equity in accordance with paragraph 36A; and
- iii. a description of the reasons why the transaction resulted in a gain in case of (i) above.
- o. for each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date:
 - i. the amount of the non-controlling interest in the acquiree recognised at the acquisition date and the measurement basis for that amount; and
 - ii. for each non-controlling interest in an acquiree measured at fair value, the valuation technique(s) and significant inputs used to measure that value.
- p. in a business combination achieved in stages:
 - i. the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and
 - ii. the amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination (see paragraph 42) and the line item in the statement of profit and loss in which that gain or loss is recognised.
- q. Following additional information:
 - i. the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of profit and loss for the reporting period; and
 - ii. the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. This Ind AS uses the term 'impracticable' with the same meaning as in Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are approved for issue, the acquirer shall disclose the information required as above unless the initial accounting for the business combination is incomplete at the time the financial statements are approved for issue. In that situation, the acquirer shall describe which disclosures could not be made and the reasons why they cannot be made.

To meet the objective of the Ind AS 103 disclosure requirements, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

- a) if the initial accounting for a business combination is incomplete for particular assets, liabilities, non-controlling interests or items of consideration and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally
 - i. the reasons why the initial accounting for the business combination is incomplete;
 - ii. the assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete; and
 - iii. the nature and amount of any measurement period adjustments recognised during the reporting period.
- b) for each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires:
 - i. any changes in the recognised amounts, including any differences arising upon settlement;
 - ii. any changes in the range of outcomes (undiscounted) and the reasons for those changes; and
 - iii. the valuation techniques and key model inputs used to measure contingent consideration.
- c) for contingent liabilities recognised in a business combination, the acquirer shall disclose the information required by paragraphs 84 and 85 of Ind AS 37 for each class of provision.
- d) a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period showing separately:
 - i. the gross amount and accumulated impairment losses at the beginning of the reporting period.
 - ii. additional goodwill recognised during the reporting period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations.
 - iii. adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period

- iv. goodwill included in a disposal group classified as held for sale in accordance with Ind AS 105 and goodwill derecognised during the reporting period without having previously been included in a disposal group classified as held for sale
 - v. impairment losses recognised during the reporting period in accordance with Ind AS 36. (Ind AS 36 requires disclosure of information about the recoverable amount and impairment of goodwill in addition to this requirement.)
 - vi. net exchange rate differences arising during the reporting period in accordance with Ind AS 21, The Effects of Changes in Foreign Exchange Rates.
 - vii. any other changes in the carrying amount during the reporting period.
 - viii. the gross amount and accumulated impairment losses at the end of the reporting period.
- e) the amount and an explanation of any gain or loss recognised in the current reporting period that both:
- i. relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and
 - ii. is of such a size, nature or incidence that disclosure is relevant to understand the combined entity's financial statements.

The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or in previous reporting periods.



13. COMMON CONTROL TRANSACTIONS INCLUDING MERGER

Common control transaction accounting guidance is included in Appendix C of Ind AS 103.

13.1 Definitions

Transferor means an entity or business which is combined into another entity as a result of a business combination.

Transferee means an entity in which the transferor entity is combined.

Reserve means the portion of earnings, receipts or other surplus of an entity (whether capital or revenue) appropriated by the management for a general or a specific purpose other than provision for depreciation.

Common control business combination means a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

13.2 Common Control Business Combinations

Common control business combinations will include transactions, such as transfer of subsidiaries or businesses, between entities within a group.

The extent of non-controlling interests in each of the combining entities before and after the business combination is not relevant in determining whether the combination involves entities under common control. This is because a partially-owned subsidiary is nevertheless under the control of the parent entity.

An entity can be controlled by an individual, or by a group of individuals acting together under a **contractual arrangement**, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one having entities under common control.

A group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

Common control combinations are the most frequent. Broadly, these are transactions in which an entity obtains control of a business (hence a business combination) but both combining parties are ultimately controlled by the same party or parties both before and after the combination. These combinations often occur as a result of a group reorganisation in which the direct ownership of subsidiaries changes but the ultimate parent remains the same. However, such combinations can also occur in other ways and careful analysis and judgement are sometimes required to assess whether some combinations are covered by the definition (and the scope exclusion). In particular:

- an assessment is required as to whether common control is 'transitory' (if so, the combination is not a common control combination and Ind AS 103 applies). The term transitory is not explained in the standard. In our view it is intended to ensure that Ind AS 103 is applied when a transaction that will lead to a substantive change in control is structured such that, for a brief period before and after the combination, the entity to be acquired/sold is under common control. However, common control should not be considered transitory simply because a combination is carried out in contemplation of an initial public offering or sale of combined entities.

- when a group of two or more individuals have control before and after the transaction, an assessment is needed as to whether they exercise control collectively as a result of a contractual agreement.

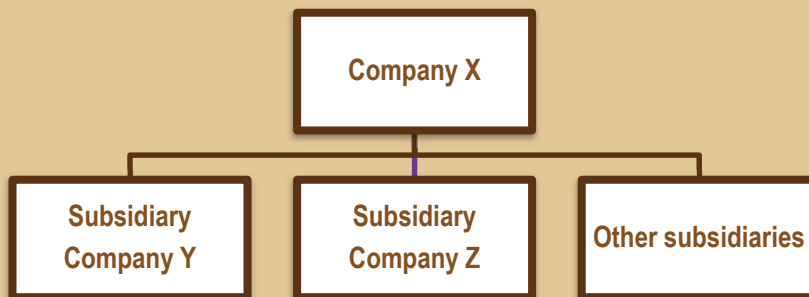
Examples of common control transaction

- ◆ Merger between fellow subsidiaries
- ◆ Merger of subsidiary with parent
- ◆ Acquisition of an entity from an entity within the same group
- ◆ Bringing together entities under common control in a corporate legal structure

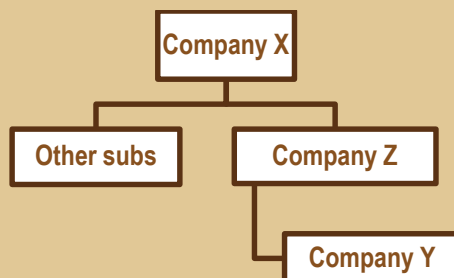
Illustration 30

Company X, the ultimate parent of a large number of subsidiaries, reorganises the retail segment of its business to consolidate all of its retail businesses in a single entity. Under the reorganisation, Company Z (a subsidiary and the biggest retail company in the group) acquires Company X's shareholdings in its one operating subsidiary, Company Y by issuing its own shares to Company X. After the transaction, Company Z will directly control the operating and financial policies of Company Y.

Before Reorganisation



After Reorganisation



Analyse the above transaction.

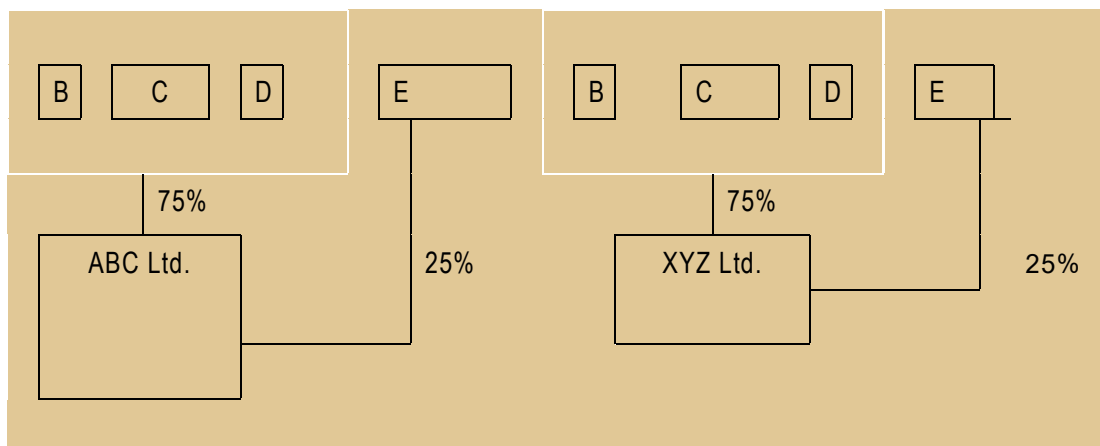
Solution

In this situation, Company Z pays consideration to Company X to obtain control of Company Y. The transaction meets the definition of a business combination. Prior to the reorganisation, each of the parties are controlled by Company X. After the reorganisation, although Company Y is now owned by Company Z, all two companies are still ultimately owned and controlled by Company X. From the perspective of Company X, there has been no change as a result of the reorganisation. This transaction therefore meets the definition of a common control combination and is within the scope of Ind AS 103.

Illustration 31

ABC Ltd. and XYZ Ltd. are owned by four shareholders B, C, D and E, each of whom holds 25% of the shares in each company. Shareholders B, C and D have entered into a shareholders' agreement in terms of governance of ABC Ltd. and XYZ Ltd. due to which they exercise joint control.

Determine whether ABC Ltd. and XYZ Ltd. are under common control.

Solution

Appendix C to Ind AS 103 defines common control business combination as a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraphs 6 and 7 of Appendix C to Ind AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one having

entities under common control. Also, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

In the instant case, both ABC Ltd. and XYZ Ltd. are jointly controlled by group of individuals (B, C and D) as a result of contractual arrangement. Therefore, in the current scenario, ABC Ltd. and XYZ Ltd. are considered to be under common control.

Illustration 32

ABC Ltd. and XYZ Ltd. are owned by four shareholders B, C, D and E, each of whom holds 25% of the shares in each company. However, there are no agreements between any of the shareholders that they will exercise their voting power jointly.

Determine whether ABC Ltd. and XYZ Ltd. are under common control.

Solution

Appendix C to Ind AS 103 defines 'Common control business combination' as business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

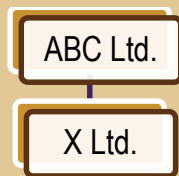
Further as per paragraphs 6 and 7 of Appendix C to Ind AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a control. Also a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

In the present case, there is no contractual arrangement between the shareholders who exercise control collectively over either company. Thus, ABC Ltd. and XYZ Ltd. are not considered to be under common control even if there is an established pattern of voting together.

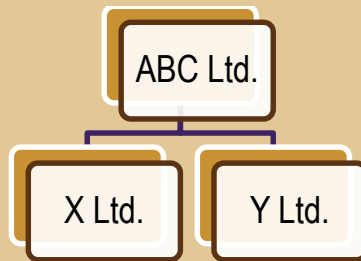
Illustration 33

ABC Ltd. had a subsidiary, namely, X Ltd. which was acquired on 1st April, 2XX0. ABC Ltd. acquires all of the shares of Y Ltd. on 1st April, 2X17. ABC Ltd. transfers the shares in Y Ltd. to X Ltd. on 2nd April, 2X17. How should the above transfer of Y Ltd. into X Ltd. be accounted for in the consolidated financial statements of X Ltd.?

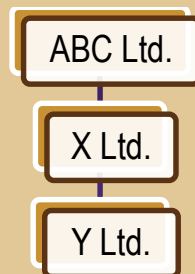
Before:



Intermediate:



After:



Solution

Appendix C to Ind AS 103 defines common control business combination as business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraph 7 of Appendix C to Ind AS 103, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

The term 'transitory' has been included as part of Appendix C to Ind AS 103.

The word 'transitory' has been included in the common control definition to ensure that acquisition accounting applies to those transactions that look as though they are combinations involving entities under common control, but which in fact represent genuine substantive business combinations with unrelated parties.

Based on above, if the intermediate step had been omitted and instead X Ltd. had been the ABC group's vehicle for the acquisition of Y Ltd. - i.e. going straight to the 'after' position - then X Ltd. would have been identified as the acquirer.

Considering X Ltd. and Y Ltd. are under common control (with common parent), it might seem that acquisition accounting is not required because of the specific requirement for common control business combination. However, X Ltd. should be identified as the acquirer and should account for its combination with Y Ltd. using acquisition accounting. This is because X Ltd. would have applied acquisition accounting for Y Ltd. if X Ltd. had acquired Y Ltd directly rather than through ABC Ltd. Acquisition accounting cannot be avoided in the financial statements of X Ltd. simply by placing X Ltd. and Y Ltd. under the common control ABC Ltd shortly before the transaction.

13.3 Method of Accounting for Common Control Business Combinations

Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interest method.

The pooling of interest method is considered to involve the following:

- (i) The assets and liabilities of the combining entities are reflected at their carrying amounts.
- (ii) No adjustments are made to reflect fair values or recognise any new assets or liabilities. The only adjustments that are made is to harmonise accounting policies.
- (iii) The financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the earliest period presented in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.

The consideration for the business combination may consist of securities, cash or other assets. Securities shall be recorded at nominal value. In determining the value of the consideration, assets other than cash shall be considered at their fair values.

The balance of the retained earnings appearing in the financial statements of the transferor is aggregated with the corresponding balance appearing in the financial statements of the transferee. Alternatively, it is transferred to General Reserve, if any.

The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor. Thus, for example, the General Reserve of the transferor entity becomes the General Reserve of the transferee, the Capital Reserve of the transferor becomes the Capital Reserve of

the transferee and the Revaluation Reserve of the transferor becomes the Revaluation Reserve of the transferee. As a result of preserving the identity, reserves which are available for distribution as dividend before the business combination would also be available for distribution as dividend after the business combination.

The difference, if any, between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.

The acid test in assessing common control transaction is that before and after the reorganisation the entity should be controlled by the same shareholders.

Illustration 34

How will the financial statement of the prior periods be restated under common control in the following scenarios:

a) Common Control period extends beyond the start of comparative period

XYZ Ltd acquired PQR Ltd in a common control transaction on 1 October 20X9. The year-end of XYZ Ltd is 31 March. Both XYZ Ltd and PQR Ltd have been controlled by shareholders since their incorporation.

b) Common Control period started in the comparative period

ABC Ltd acquired DEF Ltd in a common control transaction on 1st October 20X9. The year-end of ABC Ltd is 31st March. Both ABC Ltd and DEF Ltd are controlled by shareholder A. A made investment in ABC Ltd in 20X0 and made investment in DEF Ltd on 1st October 20X8.

Solution

Paragraph 9(iii) of Appendix C to Ind AS 103 states that the financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the preceding period in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.

- a) In accordance with Paragraph 9(iii) above, the entity will be required to restate its financial statements as if the business combination had occurred from the beginning of the preceding period in the financial statements, accordingly in the present case XYZ Ltd will have to restate its comparatives for the financial year 20X8-20X9 as if the acquisition had occurred before 1st April 20X8. Additionally, the results of current year of PQR Ltd will be

required to include XYZ's financial statements for the period from 1st April 20X9 to 30th September 20X9.

- b) In accordance with paragraph 9(iii) above, ABC Ltd will have to restate its comparatives for the financial year ended 20X8-20X9 as if the acquisition had occurred on 1st October 20X8, but not earlier. Additionally, the results of current year of DEF Ltd will be required to include the financial statements of ABC Ltd for the period from 1 April 20X9 to 1st October 20X9.

Illustration 35

Entity A owns 100% equity shares of entity B since 01.04.20X1. Entity A arranges loan funding from a financial institution in a new wholly owned subsidiary called "Entity C". The loan is used by Entity C to acquire 100% shareholding in entity B, for cash consideration of ₹ 2,00,000. Entity A applies Ind AS 103 to account for common control transactions and Entity C will adopt the same policy. Fair value of net identifiable assets is ₹ 1,50,000 and carrying value of net identifiable assets is ₹ 1,00,000.

How will Entity C apply acquisition accounting in its consolidated financial statements?

Solution:

As per para 2 of appendix C of Ind AS 103, Common control business combination means a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

In the above scenario, the Entity A controls Entity B before and after the acquisition. After acquisition, entity A controls entity B through entity C.

As per para 8 of appendix C of Ind AS 103, Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interest method.

As per para 9(i) of appendix C of Ind AS 103, the pooling of interest method is considered to involve the assets and liabilities of the combining entities are reflected at their carrying amounts.

Based on the above analysis, Entity C cannot be the acquirer. Entity A has created Entity C and is the seller, so Entity C has effectively been formed and issued shares to effect the business combination. Entity C is not a business and the transaction between entity B and Entity C is not a business combination. It is a reorganisation of entity B. As a result, entity B's assets and liabilities are included in Entity C consolidated financial statements at their pre-combination carrying amounts without a fair value uplift.

Illustration 36

Enterprise Ltd. has 2 divisions Laptops and Mobiles. Division Laptops has been making constant profits while division Mobiles has been invariably suffering losses.

On 31st March, 20X2, the division-wise draft extract of the Balance Sheet was: (*₹ in crores*)

	Laptops	Mobiles	Total
Property, Plant and Equipment cost	250	500	750
Depreciation	<u>(225)</u>	<u>(400)</u>	<u>(625)</u>
Net Property, Plant and Equipment (A)	<u>25</u>	<u>100</u>	<u>125</u>
Current assets:	200	500	700
Less: Current liabilities	<u>(25)</u>	<u>(400)</u>	<u>(425)</u>
(B)	<u>175</u>	<u>100</u>	<u>275</u>
Total (A+B)	<u>200</u>	<u>200</u>	<u>400</u>
Financed by:			
Loan funds	-	300	300
Capital : Equity ₹ 10 each	25	-	25
Surplus	<u>175</u>	<u>(100)</u>	<u>75</u>
	<u>200</u>	<u>200</u>	<u>400</u>

Division Mobiles along with its assets and liabilities was sold for ₹ 25 crores to Turnaround Ltd. a new company, who allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share to the members of Enterprise Ltd. in full settlement of the consideration, in proportion to their shareholding in the company. One of the members of Enterprise Ltd. was holding 52% shareholding of the Company.

Assuming that there are no other transactions, you are asked to:

- Pass journal entries in the books of Enterprise Ltd.
- Prepare the Balance Sheet of Enterprise Ltd. after the entries in (i).
- Prepare the Balance Sheet of Turnaround Ltd.

Solution

Journal of Enterprise Ltd.

(₹ in crores)

			Dr.	Cr.
(1)	Loan Funds	Dr.	300	
	Current Liabilities	Dr.	400	
	Provision for Depreciation	Dr.	400	
	To Property, Plant and Equipment			500
	To Current Assets			500
	To Capital Reserve			100
	(Being division Mobiles along with its assets and liabilities sold to Turnaround Ltd. for ₹ 25 crores)			

Notes :

- (1) Any other alternative set of entries, with the same net effect on various accounts, may be given by the students.
- (2) In the given scenario, this demerger will meet the definition of common control transaction. Accordingly, the transfer of assets and liabilities will be derecognized and recognized as per book value and the resultant loss or gain will be recorded as capital reserve in the books of demerged entity (Enterprise Ltd).

Enterprise Ltd.

Balance Sheet after reconstruction

(₹ in crores)

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		25
Current assets		
Other current assets		200
		<u>225</u>
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		25
Other equity (Surplus)		175
Liabilities		
Current liabilities		
Current liabilities		25
		<u>225</u>

Notes to Accounts

	(₹ in crores)
1. Other Equity	
Surplus (175-100)	75
Add: Capital Reserve on reconstruction	<u>100</u>
	<u>175</u>

Notes to Accounts: Consequent on transfer of Division Mobiles to newly incorporated company Turnaround Ltd., the members of the company have been allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share of Turnaround Ltd., in full settlement of the consideration in proportion to their shareholding in the company.

Balance Sheet of Turnaround Ltd.

(₹ in crores)

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		100
Current assets		
Other current assets		<u>500</u>
		<u>600</u>
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	10
Other equity	2	(110)
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings		300
Current liabilities		
Current liabilities		<u>400</u>
		<u>600</u>

Notes to Accounts

		(₹ in crores)
1.	Share Capital: Issued and Paid-up capital 1 crore Equity shares of ₹ 10 each fully paid up (All the above shares have been issued for consideration other than cash, to the members of Enterprise Ltd. on takeover of Division Mobiles from Enterprise Ltd.)	10
2.	Other Equity: Securities Premium Capital reserve [25- (600 – 700)]	15 <u>(125)</u> <u>(110)</u>

Working Note:

In the given case, since both the entities are under common control, this will be accounted as follows:

- All assets and liabilities will be recorded at book value
- Identity of reserves to be maintained.
- No goodwill will be recorded.
- Securities issued will be recorded as per the nominal value.

Illustration 37

Maxi Mini Ltd. has 2 divisions - Maxi and Mini. The draft information of assets and liabilities as at 31st October, 20X2 was as under:

	Maxi division	Mini division	Total (in crores)
<i>Property, Plant and Equipment</i>			
Cost	600	300	900
Depreciation	<u>(500)</u>	<u>(100)</u>	<u>(600)</u>
W.D.V. (A)	<u>100</u>	<u>200</u>	<u>300</u>
Current assets	400	300	700
Less: Current liabilities	<u>(100)</u>	<u>(100)</u>	<u>(200)</u>
(B)	<u>300</u>	<u>200</u>	<u>500</u>
Total (A+B)	<u>400</u>	<u>400</u>	<u>800</u>

Financed by :			
Loan funds (A)	—	100	100
(secured by a charge on property, plant and equipment)			
Own funds:			
Equity capital			50
(fully paid up ₹ 10 per share)			
Other Equity	—	—	650
(B)	?	?	700
Total (A+B)	400	400	800

It is decided to form a new company Mini Ltd. to take over the assets and liabilities of Mini division.

Accordingly, Mini Ltd. was incorporated to take over at Balance Sheet figures, the assets and liabilities of that division. Mini Ltd. is to allot 5 crore equity shares of ₹ 10 each in the company to the members of Maxi Mini Ltd. in full settlement of the consideration. The members of Maxi Mini Ltd. are therefore to become members of Mini Ltd. as well without having to make any further investment.

- You are asked to pass journal entries in relation to the above in the books of Maxi Mini Ltd. and Mini Ltd. Also show the Balance Sheets of the 2 companies as on the morning of 1st November, 20X2, showing corresponding previous year's figures.
- The directors of the 2 companies ask you to find out the net asset value of equity shares pre and post demerger.
- Comment on the impact of demerger on "share holders wealth".

Solution

Demerged Company: Mini Division of "Maxi Mini Ltd"

Resulting Company: "Mini Ltd."

(a) Journal of Maxi Mini Ltd. (Demerged Company)

		(₹ in crores)	
		Dr.	Cr.
Current liabilities A/c	Dr.	100	
Loan fund (secured) A/c	Dr.	100	
Provision for depreciation A/c	Dr.	100	
Loss on reconstruction (Balancing figure)	Dr.	300	
To Property, Plant and Equipment A/c			300

To Current assets A/c (Being the assets and liabilities of Mini division taken out of the books on transfer of the division to Mini Ltd., the consideration being allotment to the members of the company of one equity share of ₹ 10 each of that company at par for every share held in the company vide scheme of reorganisation)		300

Note: Any other alternatives set of entries, with the same net effect on various accounts, may be given by the students. In the absence of additional information on fair value of the assets transferred it has been assumed that the group of shareholders control both the demerged and the resultant entity. It is expected that students should evaluate all reorganization from common control parameters and aptly highlight the assumptions in the note while solving the question.

Journal of Mini Ltd.

		(₹ in crores)	
		Dr.	Cr.
Property, Plant and Equipment (300-100) A/c	Dr.	200	
Current assets A/c	Dr.	300	
To Current Liabilities A/c			100
To Secured loan funds A/c			100
To Equity share capital A/c			50
To Capital reserve			250
(Being the assets and liabilities of Mini division of Maxi Mini Ltd. taken over and allotment of 5 crores equity shares of ₹ 10 each at par as fully paid up to the members of Maxi Mini Ltd.)			

Maxi Mini Ltd.

Balance Sheet as at 1st November, 20X2

₹ in crore

ASSETS	Note No.	After Reconstruction	Before Reconstruction
Non-current assets			
Property, Plant and Equipment	2	100	300

Current assets			
Other current assets		<u>400</u>	<u>700</u>
		<u>500</u>	<u>1,000</u>
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		50	50
Other equity	1	350	650
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings		-	100
Current liabilities			
Current liabilities		<u>100</u>	<u>200</u>
		<u>500</u>	<u>1,000</u>

Notes to Accounts

		After Reconstruction	Before Reconstruction
1.	Other Equity		
	Other Equity	650	650
	Less: Loss on reconstruction	<u>(300)</u>	<u>—</u>
		<u>350</u>	<u>650</u>
2.	Property, Plant and Equipment	600	900
	Less: Depreciation	<u>(500)</u>	<u>(600)</u>
		<u>100</u>	<u>300</u>

Notes to Accounts: Consequent on reconstruction of the company and transfer of Mini division to newly incorporated company Mini Ltd., the members of the company have been allotted 5 crores equity shares of ₹ 10 each at part of Mini Ltd. The demerged entity and the resultant entity are common control and accordingly the transaction has been accounted at book values of the assets transferred in both the entity.

Mini Ltd.

Balance Sheet as at 1st November, 20X2

₹ in crore

ASSETS	Note No.	After reconstruction
Non-current assets		
Property, Plant and Equipment		200
Current assets		
Other current assets		<u>300</u>
		<u>500</u>
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		50
Other equity (capital reserve)		250
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings		100
Current liabilities		
Current liabilities		<u>100</u>
		<u>500</u>

Notes to Account

	(₹ in crores)
1. Share Capital:	
Issued and paid up:	
5 crores Equity shares of ₹ 10 each fully paid up	50
(All the above shares have been issued for consideration other than cash, to the members of Maxi Mini Ltd., on takeover of Mini division from Maxi Mini Ltd.)	

(b) Net asset value of an equity share

	Pre-demerger		Post-demerger
Maxi Mini Ltd. :	$\frac{₹ 700 \text{ crores}}{5 \text{ crores}}$	=	$\frac{₹ 400 \text{ crores}}{5 \text{ crores}} = ₹ 80$
Mini Ltd.:			$\frac{₹ 300 \text{ crores}}{5 \text{ crores}} = ₹ 60$

- (c) Demerger into two companies has had no impact on “net asset value” of shareholding. Pre-demerger, it was ₹ 140 per share. After demerger, it is ₹ 80 plus ₹ 60 i.e. ₹ 140 per original share.

It is only yield valuation that is expected to change because of separate focusing on two distinct businesses whereby profitability is likely to improve on account of demerger.

Illustration 38

AX Ltd. and BX Ltd. amalgamated from 1st January, 20X2. A new Company ABX Ltd. with shares of ₹ 10 each was formed to take over the businesses of the existing companies.

Summarized Balance Sheet as on 31-12-20X1

₹ in '000

ASSETS	Note No.	AX Ltd	BX Ltd
Non-current assets			
Property, Plant and Equipment		8,500	7,500
Financial assets			
Investment		1,050	550
Current assets			
Inventory		1,250	2,750
Financial assets			
Trade receivables		1,800	4,000
Cash and Cash equivalent		450	400
		<u>13,050</u>	<u>15,200</u>
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		6,000	7,000
Other equity	1	3,050	2,700
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings (12% Debentures)		3,000	4,000
Current liabilities			
Financial liabilities			
Trade payables		1,000	1,500
		<u>13,050</u>	<u>15,200</u>

Note:

1.	Other equity	AX Ltd	BX Ltd
	General Reserve	1,500	2,000
	Profit & Loss	1,000	500
	Investment Allowance Reserve	500	100
	Export Profit Reserve	<u>50</u>	<u>100</u>
		<u>3,050</u>	<u>2,700</u>

ABX Ltd. issued a requisite number of shares to discharge the claims of the equity shareholders of the transferor companies. Also new debentures were issued in exchange of the old series of both the companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd:

- Assuming that both the entities are under common control
- Assuming BX Ltd is a larger entity and their management will take control of the entity ABX Ltd.

The fair value of net assets of AX and BX limited are as follows:

Assets	AX Ltd. ('000)	BX Ltd. ('000)
Property, Plant and Equipment	9,500	1,000
Inventory	1,300	2,900
Fair value of the business	11,000	14,000

Solution**(a) 1. Calculation of Purchase Consideration**

	AX Ltd.	BX Ltd.
	₹ '000	₹ '000
Assets taken over:		
Property, Plant and Equipment	85,00	75,00
Investment	10,50	5,50
Inventory	12,50	27,50
Trade receivables	18,00	40,00
Cash & Cash equivalent	<u>4,50</u>	<u>4,00</u>

Gross Assets		130,50		152,00
<i>Less : Liabilities</i>				
12% Debentures	30,00		40,00	
Trade payables	<u>10,00</u>	<u>(40,00)</u>	<u>15,00</u>	<u>(55,00)</u>
Net Assets taken over		90,50		97,00
<i>Less: Other Equity:</i>				
General Reserve	15,00		20,00	
P & L A/c	10,00		5,00	
Investment Allowance Reserve	5,00		1,00	
Export Profit Reserve	<u>50</u>	<u>(30,50)</u>	<u>1,00</u>	<u>(27,00)</u>
Purchase Consideration		<u>60,00</u>		<u>70,00</u>

Total Purchase Consideration = 130,00 (60,00 of AX Ltd. & 70,00 of BX Ltd.)

2. Discharge of Purchase Consideration

No. of shares to be issued to AX Ltd =

$$\frac{\text{Net Assets taken over of AX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}} \times \text{Purchase Consideration}$$

No. of shares to be issued to BX Ltd =

$$\frac{\text{Net Assets taken over of BX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}} \times \text{Purchase Consideration}$$

	AX Ltd. ₹ '000	BX Ltd. ₹ '000
$130,00 \times \frac{90,50}{187,50} = 6,27,500$		
* Equity shares of ₹ 10 each	62,75	
$130,00 \times \frac{97,00}{187,50} = 6,72,500$		
Equity shares of ₹ 10 each		67,25

* The total purchase consideration is to be discharged by ABX Ltd. in such a way that the rights of the shareholders of AX Ltd. and BX Ltd. remain unaltered in the future profits of ABX Ltd.

Balance Sheet of ABX Ltd. as on 1.1.20X2

₹ in '000

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		16,000
Financial assets		
Investments		1,600
Current assets		
Inventory		4,000
Trade receivable		5,800
Cash and Cash equivalent		<u>850</u>
		<u>28,250</u>
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	13,000
Other equity	2	5,750
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings	3	7,000
Current liabilities		
Trade payable		<u>2,500</u>
		<u>28,250</u>

Notes to Accounts

		(₹ 000)	(₹ 000)
1.	Share Capital		
	13,00,000 Equity Shares of ₹ 10 each		130,00
2.	Other Equity		
	General Reserve (15,00 + 20,00)	35,00	
	Profit & Loss (10,00 + 5,00)	15,00	
	Investment Allowance Reserve (5,00 + 1,00)	6,00	
	Export Profit Reserve (50 + 1,00)	<u>1,50</u>	57,50
3.	Long Term Borrowings		
	12% Debentures		70,00

(b) Assuming BX Ltd is a larger entity and their management will take the control of the entity ABX Ltd.

In this case BX Ltd. and AX Ltd. are not under common control and hence accounting prescribed under Ind AS 103 for business combination will be applied. A question arises here is who is the accounting acquirer ABX Ltd which is issuing the shares or AX Ltd. or BX Ltd. As per the accounting guidance provided in Ind AS 103, sometimes the legal acquirer may not be the accounting acquirer. In the given scenario although ABX Ltd. is issuing the shares but BX Ltd. post-merger will have control and is bigger in size which is a clear indicator that BX Ltd. will be an accounting acquirer. This can be justified by the following table:

(In '000s)

	AX Ltd.	BX Ltd.
Fair Value	11,000	14,000
Value per share	10	10
No. of shares	1,100	1,400
i.e. Total No. of shares in ABX Ltd. = 2,500 thousand shares		
Thus, % Held by each Company in Combined Entity	44%	56%

Note: It is a case of Reverse Acquisition.

Accordingly, BX Ltd. assets will be recorded at historical cost in the merged financial statements.

(1) Calculation of Purchase Consideration (All figures are in thousands)

We need to calculate the number of shares to be issued by BX Ltd. to AX Ltd. to maintain the same percentage i.e. 56%:

Thus, 700 thousand shares of BX Ltd. (given in the balance sheet) represents 56%. This means that total no. of shares would be 1,250 thousand shares ie 700 thousand shares / 56%.

This implies BX Ltd. would need to issue 550 thousand shares (1,250 less 700) to AX Ltd.

Purchase Consideration = 550 thousand shares x ₹ 20 per share (ie. 14,000 thousand / 700 thousand shares) = ₹ 11,000 thousand.

Balance Sheet of ABX Ltd. as on 1.1.20X2

₹ in '000

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment (9,500 + 7,500)		17,000

Goodwill (Refer Working Note)		900
Financial assets		
Investment (1,050 + 550)		1,600
Current assets		
Inventory (1,300 + 2,750)		4,050
Trade receivables (1,800 + 4,000)		s 5,800
Cash and Cash equivalent (450 + 400)		<u>850</u>
		<u>30,200</u>
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	12,500
Other equity	2	8,200
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings (12% Debentures)	3	7,000
Current liabilities		
Trade payables		<u>2,500</u>
		<u>30,200</u>

Notes to Accounts

		(₹ 000)	(₹ 000)
1. Share Capital			
1,250,000 Equity Shares of ₹ 10 each (700,000 to BX Ltd and 550,000 as computed above to AX LTD)			1,25,00
2. Other Equity			
General reserve of BX Ltd	20,00		
P&L of BX Ltd	5,00		
Export Profit Reserve of BX Ltd	1,00		
Investment Allowance Reserve of BX Ltd	1,00		
Security Premium (550 shares x 10)	<u>5,500</u>		8,200
3. Long Term Borrowings			
12% Debentures			70,00

Working Note:**Goodwill Computation:**

Assets:	₹ in 000s
Property, Plant and Equipment	9,500
Investment	1,050
Inventory	1,300
Trade Receivable	1,800
Cash & Cash Equivalent	450
Total Assets	14,100
Less : Liabilities:	
Borrowings	3,000
Trade Payable	1,000
Net Assets	10,100
Purchase Consideration	11,000
Goodwill	900

Illustration 39

On 9th April, 20X2, Shyam Ltd. a listed company started to negotiate with Ram Ltd, which is an unlisted company about the possibility of merger. On 10th May, 20X2, the board of directors of Shyam Ltd. authorized their management to pursue the merger with Ram Ltd. On 15th May, 20X2, management of Shyam Ltd. offered management of Ram Ltd. 12,000 shares of Shyam Ltd. against their total share outstanding. On 31st May, 20X2, the board of directors of Ram Ltd accepted the offer subject to shareholder's vote. On 2nd June, 20X2 both the companies jointly made a press release about the proposed merger.

On 10th June, 20X2, the shareholders of Ram Ltd approved the terms of the merger. On 15th June, the shares were allotted to the shareholders of Ram Ltd.

The market price of the shares of Shyam Ltd was as follows:

Date	Price per share
9 th April	70
10 th May	75
15 th May	60
31 st May	70
2 nd June	80
10 th June	85
15 th June	90

What is the acquisition date and what is purchase consideration in the above scenario?

Solution

As per paragraph 8 of Ind AS 103, the acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree. In the above scenario, the acquisition date will be the date on which the shares were allotted to the shareholders of Ram Ltd. Although the shareholder approval was obtained on 10th June, 20X2 but the shares were issued only on 15th June, 20X2. Accordingly, the purchase consideration will be on the basis of ₹ 90 ie. the market price on that date. Hence total purchase consideration would be ₹ 10,80,000 (ie 12,000 shares x ₹ 90).

Illustration 40

The balance sheet of Professional Ltd. and Dynamic Ltd. as of 31st March, 20X2 is given below:

₹ in lakhs

Assets	Professional Ltd	Dynamic Ltd
Non-Current Assets:		
Property, plant and equipment	300	500
Investment	400	100
Current assets:		
Inventories	250	150
Financial assets		
Trade receivables	450	300
Cash and cash equivalents	200	100
Others	<u>400</u>	<u>230</u>
Total	<u>2,000</u>	<u>1,380</u>
Equity and Liabilities		
Equity		
Share capital- Equity shares of ₹ 100 each of Dynamic Ltd. and ₹ 10 each of Professional Ltd.	500	400
Other Equity	810	225
Non-Current liabilities:		
Financial liabilities		
Long term borrowings	250	200
Long term provisions	50	70
Deferred tax	40	35

Current Liabilities:		
<i>Financial liabilities</i>		
Short term borrowings	100	150
Trade payables	<u>250</u>	<u>300</u>
Total	<u>2,000</u>	<u>1,380</u>

Other information

- a. Professional Ltd. acquired 70% shares of Dynamic Ltd. on 1st April, 20X2 by issuing its own shares in the ratio of 1 share of Professional Ltd. for every 2 shares of Dynamic Ltd. The fair value of the shares of Professional Ltd was ₹ 40 per share.
- b. The fair value exercise resulted in the following: (all nos. in Lakh)
 - a. Fair value of PPE on 1st April, 20X2 was ₹ 350 lakhs.
 - b. Professional Ltd also agreed to pay an additional payment as consideration that is higher of ₹ 35 lakh and 25% of any excess profits in the first year, after acquisition, over its profits in the preceding 12 months made by Dynamic Ltd. This additional amount will be due after 2 years. Dynamic Ltd has earned ₹ 10 lakh profit in the preceding year and expects to earn another ₹ 20 Lakh.
 - c. In addition to the above, Professional Ltd also agreed to pay one of the founder shareholders a payment of ₹ 20 lakh provided he stays with the Company for two years after acquisition.
 - d. Dynamic Ltd had a certain equity settled share-based payment award (original award) which was replaced by the new awards issued by Professional Ltd. As per the original terms, the vesting period was 4 years and as of the acquisition date the employees of Dynamic Ltd have already served 2 years of service. As per the replaced awards the vesting period has been reduced to one year (one year from the acquisition date). The fair value of the award on the acquisition date was as follows:
 - i. Original award- ₹ 5 lakh
 - ii. Replacement award- ₹ 8 lakh.
 - e. Dynamic Ltd had a lawsuit pending with a customer who had made a claim of ₹ 50 lakh. Management reliably estimated the fair value of the liability to be ₹ 5 lakh.
 - f. The applicable tax rate for both entities is 30%.

You are required to prepare opening consolidated balance sheet of Professional Ltd as on 1st April, 20X2. Assume 10% discount rate.

Solution

Consolidated Balance Sheet of Professional Ltd as on 1st April, 20X2

(₹ in Lakhs)

	Amount
Assets	
Non-Current Assets:	
Property, plant and equipment	650
Investment	500
Current assets:	
Inventories	400
Financial assets:	
Trade receivables	750
Cash and cash equivalents	300
Others	630
Total	3,230
Equity and Liabilities	
Equity	
Share capital- Equity shares of ₹ 10 each	514
Other Equity	1,128.62
NCI	154.95
Non-Current liabilities:	
Long term borrowings	450
Long term provisions (50+70+28.93)	148.93
Deferred tax	28.5
Current Liabilities:	
Short term borrowings	250
Trade payables	550
Provision for Law suit Damages	5
Total	3,230

Notes:

- As per Ind AS 103, the acquirer is required to record the assets and liabilities acquired at their respective fair value. Accordingly, the PPE of Dynamic Ltd. will be recorded at ₹ 350 lakhs.
- The value of replacement award is allocated between consideration transferred and post combination expense. The portion attributable to purchase consideration is determined based on the fair value of the replacement award for the service rendered till the date of

the acquisition. Accordingly, ₹ 2.5 lakhs ($5 \times 2/4$) is considered as a part of purchase consideration and is credited to Professional Ltd equity as this will be settled in its own equity. Since the fair value of the award on the acquisition date is ₹ 8 lakhs, the balance of ₹ 5.5 lakhs ($8 - 2.5$) will be recorded as employee expense in the books of Dynamic Ltd over the remaining life, which is 1 year in this scenario. (Para B59 of Ind AS 103)

- c. There is a difference between contingent consideration and deferred consideration. In the given case, ₹ 35 lakhs is the minimum payment to be paid after 2 years and accordingly will be considered as deferred consideration. The other element is if a company meet certain target then they will get 25% of that or ₹ 35 lakhs whichever is higher. In the given case, the minimum what is expected to be paid has been considered and the fair value of the contingent consideration has been considered as zero. The impact of time value on deferred consideration has been given @ 10%.
- d. The additional consideration of ₹ 20 lakhs to be paid to the founder shareholder is contingent to him/her continuing in employment and hence this will be considered as employee compensation and will be recorded as post combination expenses in the income statement of Dynamic Ltd.

Working Notes:

1. Computation for Purchase consideration

Particulars		Amount
Share capital of Dynamic Ltd		<u>4,00,00,000</u>
Number of shares	4,00,000	
Shares to be issued 2:1	2,00,000	
Fair value ₹ per share		<u>40</u>
		₹ in lakhs
PC ($2,00,000 \times 70\% \times ₹ 40$ per share) (A)		56.00
Deferred consideration after discounting ₹ 35 lakhs for 2 years @ 10% (B)		28.93
Replacement award Market based measure of the acquiree award (5) x ratio of the portion of the vesting period completed (2) / greater of the total vesting period (3) or the original vesting period (4) of the acquiree award i.e. ($5 \times 2/4$) (C)		<u>2.50</u>
PC in lakhs (A+B+C)		<u>87.43</u>

2. Allocation of Purchase price

Particulars	Book value (A)	Fair value (B)	FV adjustment (A-B)
Property, plant and equipment	500	350	(150)
Investment	100	100	-
Inventories	150	150	-
Financial assets:			-
Trade receivables	300	300	-
Cash and cash equivalents	100	100	-
Others	230	230	-
Less: Long term borrowings	(200)	(200)	-
Long term provisions	(70)	(70)	-
Deferred tax	(35)	(35)	-
Short term borrowings	(150)	(150)	-
Trade payables	(300)	(300)	-
Contingent liability	-	(5)	(5)
Net assets (X)	625	470	(155)
Deferred tax Asset on FV adjustment (155 x 30%) (Y)		46.50	155
Net assets (X+Y)		516.5	
Non-controlling interest (516.50 x 30%) rounded off		154.95	
Purchase consideration (PC)		87.43	
Capital Reserve (Net assets – NCI – PC)		274.12	

3. Computation of consolidated amounts of Consolidated financial statements

	Professional Ltd.	Dynamic Ltd. (pre- acquisition)	PPA Allocation	Total
Assets				
Non-Current Assets:				
Property, plant and equipment	300	500	(150)	650
Investment	400	100		500

Current assets:				
Inventories	250	150		400
Financial assets:				
Trade receivables	450	300		750
Cash and cash equivalents	200	100		300
Others	<u>400</u>	<u>230</u>		<u>630</u>
Total	<u>2,000</u>	<u>1,380</u>	<u>(150)</u>	<u>3230</u>

Equity and Liabilities				
Equity				
Share capital- Equity shares of ₹ 10 each	500			
Shares allotted to Dynamic Ltd. (2,00,000 x 70% x ₹ 10 per share)			14	514
Other Equity	810			
Replacement award (W.N.1)			2.5	2.5
Security Premium (2,00,000 shares x 70% x ₹ 30) (W.N.1)			42	42
Capital Reserve (W.N.2)			274.12	274.12
Non-controlling interest (W.N.2)	0		154.95	154.95
Non-Current liabilities:				
Financial liabilities				
Long term borrowings	250	200		450
Long term provisions (W.N.1)	50	70	28.93	148.93
Deferred tax (W.N.2)	40	35	(46.5)	28.5
Current Liabilities:				
Financial liabilities				
Short term borrowings	100	150		250
Trade payable	250	300	0	550
Liability for lawsuit damages	<u> </u>	<u> </u>	<u>5</u>	<u>5</u>
Total	<u>2,000</u>	<u>755</u>	<u>475</u>	<u>3230</u>



14. EXTRACTS FROM THE FINANCIAL STATEMENTS OF LISTED ENTITIES

Relevant Extracts from Financial Statements of selected Listed Companies:

1. Annual Report of Hindustan Unilever Ltd. for the year ending 31 March 2021: Amalgamation of GlaxoSmithKline Consumer Healthcare Ltd.:

Disclosure in Standalone Financial Statements:

Amalgamation of GlaxoSmithKline Consumer Healthcare Limited

On 1st April, 2020, the Company completed the merger of GlaxoSmithKline Consumer Healthcare Limited ['GSK CH'] via an all-equity merger under which 4.39 shares of HUL (the Company) were allotted for every share of GSK CH. With this merger the Company acquired the business of GSK CH including the Right to Use asset of brand Horlicks and Intellectual property rights of brands like Boost, Maltova and Viva. The Company also acquired the Horlicks intellectual property rights, being the legal rights to the Horlicks brand for India from GlaxoSmithKline Plc.

The scheme of merger ("scheme") submitted by the Company was approved by Hon'ble National Company Law Tribunal by its order dated 24th September, 2019 (Mumbai bench) and 12th March, 2020 (Chandigarh bench). The Board of Directors approved the scheme between the Company and GSK CH, on 1st April, 2020. The scheme was filed with Registrar of Companies on the same date. Accordingly, 1st April, 2020 is considered as the acquisition date, i.e. the date on which control is transferred to the Company.

The merger was in line with HUL's strategy to build a sustainable and profitable Foods & Refreshment (F&R) business in India by leveraging the megatrend of health and wellness. GSK CH was one of the key players in this category with iconic brands such as 'Horlicks' and 'Boost' and comprised of a wide product portfolio.

The merger has been accounted for using the acquisition accounting method under Ind AS 103 – Business Combinations. All identified assets acquired, and liabilities assumed on the date of merger were recorded at their fair value.

(A) Purchase consideration transferred:

The total consideration paid was ₹40,242 crores which comprised of shares of the Company, valued based on the share price of the Company on the completion date. Refer to the details below:

As per the scheme, the Company issued its shares in favour of existing shareholders of GSK CH such that 4.39 of Company's shares were allotted for every share of GSK CH as below.

Total number of GSK CH shares outstanding	4,20,55,538
Total number of Company's shares issued to GSK CH shareholders i.e. 4.39 of Company's shares per share of GSK CH	18,46,23,812
Value of the Company share (closing price of the Company share on NSE as on 1st April, 2020)	2,179.65
Total consideration paid to acquire GSK CH (₹ crores)	40,242

- (a) Total costs relating to the issuance of shares amounting to ₹44 crores have been recognised against equity.
- (b) Transaction cost of ₹146 crores that were not directly attributable to the issue of shares are included under exceptional items in the standalone Statement of Profit and Loss.

(All amounts in ₹ crores, unless otherwise stated)

NOTE 40 BUSINESS COMBINATION (CONTINUED)**(B) Details of major assets acquired, and liabilities assumed:**

	Amount
Specified Tangible Asset	
Property, Plant and Equipment	
Owned Assets	1,133
Leased Assets	76
Capital Work-in-progress	30
Specified Intangibles Assets	
Right of Use Horlicks	19,274
Boost Trademark	4,800
Others	62
Other Assets	
Trade and other receivables	651
Inventories	470
Cash and cash equivalents	300
Bank Balances other than cash and cash equivalents	3,855
Indemnification asset	608
Tax assets	186
Total identifiable assets (A)	31,445
Specified liabilities	
Trade payables	533
Other liabilities	400
Provision for employee benefits	86
Other Provisions (including ₹64 crores provision created against contingent liabilities)	343
Direct Tax Provision against contingent liabilities	974
Deferred tax liabilities	6,132
Total identifiable liabilities (B)	8,468
Total identifiable net assets acquired (A) - (B)	22,977
Goodwill	17,265
Total Net Assets	40,242

The main assets acquired were Right to use Horlicks and Boost brand which were valued using the income approach model by estimating future cashflows generated by these assets and discounting them to present value using rates in line with a market participant expectation.

In addition, as applicable, Property plant & equipment have been valued using the market comparison technique and replacement cost method.

The gross contractual value and fair value of trade and other receivables as at the dates of acquisition amounted to ₹651 crores which is expected to be fully recoverable.

(All amounts in ₹ crores, unless otherwise stated)

(C) Acquisition of Horlicks Brand:

The Company also acquired the Horlicks intellectual property rights (IPR), being the legal rights to the Horlicks brand for India from GlaxoSmithKline Plc for a consideration of ₹3,045 crores. The transaction has been accounted as an asset acquisition in line with Ind AS 38 (Intangible asset).

The Company incurred transaction cost of ₹91 crores for the above asset acquisition which was capitalised along with Horlicks IPR. Total value of ₹3,136 crores is recognised under Intangible assets in the standalone financial statements.

(D) Goodwill:

Goodwill of ₹17,265 crores was recognised upon giving effect to the Scheme of Merger, which primarily can be attributable to the synergies expected to be achieved from integrating GSK CH into the Company's existing business and the value of GSK CH India's overlapping distribution network and assembled workforce i.e. the value of the acquired experienced and skilled employees, who have been instrumental to the GSK CH success.

Pursuant to amendment by Finance Act, 2021, Goodwill has been held as non-tax deductible asset effective 1st April, 2020.

(E) Details of contingent liabilities recognised:

GSK CH had direct/indirect tax related matters under litigation, for which contingent liability was determined amounting to ₹3,583 crores. Provision for these contingencies have been created at a fair value of ₹1,038 crores. There are several matters being disputed and, in each case, we believe that the likelihood that the Company will ultimately prevail is more likely than not. We expect that most of these disputes will not be resolved for several years. Further the Company has recognised Indemnification assets of ₹608 crores.

GlaxoSmithKline Plc, GlaxoSmithKline Pte. Ltd., Horlicks Ltd and the Company have entered into a contract to indemnify the Company for any exposure in relation to select taxation matters for a period of 10 years from date of acquisition i.e. till 31st March, 2030 and for a maximum value of USD 150 million.

(F) Analysis on cash flows of acquisition:

Purchase cost of Brand Horlicks of ₹3,045 crores and related transaction cost of ₹91 crores is included under Cash flow from investing activities.

Transaction cost attributable to issuance of equity shares ₹44 crores is included under cash flows from investing activities.

Transaction cost of ₹146 crores that were not directly attributable to the issue of shares are included under cash flow from operating activities.

(G) Impact of acquisition on the results

For the 12 months ended 31st March, 2021, GSK CH contributed revenue of ₹4,752 crores, EBITDA of ₹1,512 crores and EBIT of ₹1,406 crores to the Company's results.

Comparable period

The results for the year ended 31st March, 2021 include the impact of the acquisitions of VWash and GSK CH and accordingly are not comparable with previous year to that extent.

(Source: Annual report for 2020-2021 of Hindustan Unilever Ltd.)

2. Annual Report of Larsen and Toubro Ltd. for the year ending 31 March 2020: Acquisition of Majority Stake in Mindtree Ltd.:

Stake in Mindtree acquired through further acquisition: 28.86% existing stake + 31.20% acquired through open offer:

Notes forming part of the Consolidated Financial Statements (contd.)

NOTE [44]

Disclosure pursuant to Ind AS 103 "Business Combinations":

(a) Acquisition of Mindtree Limited:

- (i) Pursuant to completion of Open Offer on July 2, 2019, the Company acquired 60.06% stake in Mindtree Limited, which is a multinational information technology and outsourcing company headquartered in Bengaluru, India and New Jersey, USA. The stake was acquired in stages through direct share purchase, open market purchases and open offer.

The acquisition is in line with the Company's strategy of expanding its asset light services business portfolio.

- (ii) Assets acquired and liabilities recognised on the date of acquisition are as follows:

₹ crore

	Mindtree Limited	
Assets		
Non-current assets		
Customer relationships	2826.40	
Customer contracts	189.20	
Trade names	297.00	
Property, plant and equipment	377.70	
Fair value of land/building over book value	177.78	
Other non-current assets	974.95	4843.03
Current assets		
Trade receivables	1315.30	
Cash and bank balances	190.00	
Other current assets	1314.40	2819.70
Total Assets		7662.73
Liabilities		
Non-current liabilities		
Deferred tax liabilities	1126.18	
Other non-current liabilities	512.30	1638.48
Current Liabilities		
Trade payables	235.00	
Other current financial liabilities	294.10	
Other current liabilities	400.44	
Contingent liability taken over [Note(vi)]	26.85	956.39
Total Liabilities		2594.87
Net Assets acquired		5067.86

- (iii) Calculation of Goodwill:

₹ crore

	Mindtree Limited
Purchase consideration for 31.20% stake purchased in open offer (A)	5038.57
Fair valuation of existing 28.86% stake (B)	4333.96
Total consideration (C)=(A+B)	9372.53
Add: Non-controlling interest	2023.88
Less: Fair value of net assets acquired	5067.86
Goodwill	6328.55

Notes forming part of the Consolidated Financial Statements (contd.)**NOTE [44] (contd.)**

- (iv) Goodwill is attributable to future growth of business out of synergies from this acquisition and assembled workforce. The goodwill is not deductible for income tax purposes.
- (v) The transaction cost of ₹ 96.39 crore (including ₹ 12.12 crore in previous year) have been expensed in the Statement of Profit and Loss.
- (vi) Contingent liability of ₹ 26.85 crore has been recognised in respect of certain claims (mainly tax disputes) which have not been acknowledged as debt.
- (vii) The non-controlling interest (39.94% ownership in Mindtree Limited) recognised at the acquisition date was measured at proportionate share of Mindtree Limited's net assets.
- (viii) The Company fair valued its acquisition date stake of 28.86% as on July 2, 2019 and consequently, a loss of ₹ 329.89 crore was recognised in other comprehensive income.
- (ix) Mindtree Limited has reported revenue of ₹ 5917.18 crore and profit after tax of ₹ 538.17 crore from the date of acquisition till March 31, 2020. Had the entity been acquired from April 1, 2019, it would have reported revenue of ₹ 7764.25 crore and profit after tax of ₹ 630.87 crore during 2019-20.
- (x) Out of the ₹ 1315.30 crore trade receivables acquired, ₹ 1249.54 crore have been collected during the year.

(Source: Annual reports for 2020-2021 of Larsen and Turbo td.)

3. Annual Report of Larsen and Toubro Ltd. for the year ending 31 March 2020: Acquisition of Majority Stake in L&T Gulf Private Ltd.:

Notes forming part of the Consolidated Financial Statements (contd.)

NOTE [44] (contd.)

(d) Acquisition of further stake in L&T Gulf Private Limited

- (i) On November 20, 2019, the Group has acquired further 50% stake in L&T Gulf Private Limited. The entity has become a wholly owned subsidiary. It operates in the Hydrocarbon segment.
- (ii) Assets acquired and liabilities recognised on the date of acquisition are as follows:

₹ crore

	L&T Gulf Private Limited	
Assets		
Non-current assets		
Property, plant and equipment	0.41	
Deferred tax assets	0.48	
Other non-current assets	0.85	1.74
Current assets		
Trade receivables	4.66	
Cash and bank balances	19.76	
Other current assets	3.47	27.89
Total Assets		29.63
Liabilities		
Current liabilities		
Trade payables	3.43	
Other current liabilities	1.78	5.21
Total Liabilities		5.21
Net Assets acquired		24.42

(iii) Calculation of Goodwill:

₹ crore

	L&T Gulf Private Limited
Purchase consideration paid in cash for 50% stake (A)	25.00
Fair valuation of existing 50% stake (B)	25.00
Total (C=A+B)	50.00
Less: Fair value of net assets acquired	24.42
Goodwill	25.58

- (iv) Goodwill is attributable to future growth of business out of synergies from this acquisition and assembled workforce. The goodwill is not deductible for income tax purposes.
- (v) The entity has reported revenue of ₹ 12.13 crore and profit after tax of ₹ 8.65 crore from the date of acquisition till March 31, 2020. Had the entity been acquired from April 1, 2019, it would have reported revenue of ₹ 14.76 crore and profit after tax of ₹ 1.63 crore during 2019-20.
- (vi) Out of ₹ 4.66 crore of trade receivables acquired, ₹ 3.40 crore have been collected during the year.
- (e) The Hon'ble National Company Law Tribunal, Chennai Bench vide order dated March 10, 2020 and the Hon'ble National Company Law Tribunal, Mumbai Bench vide order dated April 24, 2020 have approved the scheme of amalgamation of L&T Shipbuilding Ltd (wholly-owned subsidiary) with the Company ('the Scheme'), the appointed date being April 1, 2019. Accordingly, the effect of the Scheme has been given in the standalone financials of the Company for the year 2019-20 and 2018-19.
- (f) The Hon'ble National Company Law Tribunal, Mumbai Bench vide its order dated April 23, 2020 approved the composite scheme of arrangement between L&T Realty Limited, L&T Construction Equipment Limited and L&T Construction Machinery Limited (all wholly-owned subsidiaries of the Company) and their respective shareholders and creditors ('the Scheme'), the appointed date being April 1, 2018. Accordingly, the effect of the Scheme has been given in the standalone financials of the respective companies for the year 2019-20 and 2018-19.

(Source: Annual reports for 2019-2020 of Larsen and Turbo Ltd.)



15. SIGNIFICANT DIFFERENCES BETWEEN IND AS 103 AND AS 14

- **Under the existing Indian GAAP**, there is no comprehensive standard that addresses accounting for acquisitions where one entity obtains control of another entity. The accounting for such transactions is largely dependent on the form of the acquisition. For example, the accounting treatment may differ depending on whether the acquired company is retained as a separate legal entity or whether it is legally merged with the acquirer.

To add to the complexity and confusion, if the acquired company is merged with the acquirer through a court-approved scheme, the scheme itself may prescribe an accounting treatment that is required to be followed, which may be in variation with the accounting standards. Indian GAAP still permits the use of the pooling-of-interest method whereby the entire transaction is accounted based on carrying values and no goodwill arises.

Further, the current principles (AS 21, Consolidated Financial Statements) provide guidance on accounting for acquisition of a subsidiary in the entity's consolidated financial statements by adding, on a line-by-line basis, all assets and liabilities of the acquiree at the carrying values as appearing in the acquiree's financial statement (subject to adjustment for alignment of accounting policies).

- **Under Ind AS 103**, Business Combination, is a more widely used term than just in relation to mergers and amalgamations and encompasses a wide range of arrangements (unless excluded from scope of Ind AS 103). Ind AS 103 provides principles for identifying what constitutes a business combination, prescribes the accounting treatment for business combinations with greater emphasis on the use of fair values in accounting for a business combination.

The core principle of Ind AS 103 requires an acquirer of a business to recognise the assets acquired and the liabilities assumed at their acquisition date fair values and to disclose information that enables users to evaluate the nature and financial effects of the acquisition.

S. No.	Basis	Ind AS	Accounting Standards
1.	Applicability	Ind AS 103 applies to all types of business combinations (as defined in the standard) except formation of joint venture and acquisition of assets which do not constitute business. Ind AS 103 is wider in scope	AS 14 deals with amalgamation and mergers.

2.		Ind AS 103 prescribes only the acquisition method for every business combination, except for business combinations involving entities or businesses under common control which shall be accounted for using the pooling of interests method.	Under AS 14, there are two methods of accounting for amalgamation viz the pooling of interest method and the purchase method. (Paragraph 7 of AS 14)
3.	Effective date	As per Ind AS 103, the date on which the acquirer obtains control of the acquiree is the acquisition date i.e. Effective date.	AS 14 mentions but does not define date of amalgamation. In practice generally the date of amalgamation / acquisition mentioned in the court scheme (the Appointed date) is considered as the acquisition date.
4.	Valuation base	Ind AS 103 requires the acquired identifiable assets liabilities and non-controlling interest to be recognised at fair value under acquisition method. (Paragraphs 18-19 of Ind AS 103)	Under AS 14, the acquired assets and liabilities are recognised at their existing book values or at fair values under the purchase method. (Paragraph 12 of AS 14)
5.	Accounting of non-controlling interest / minority interest	Ind AS 103 requires that for each business combination, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. (Paragraph 19 of Ind AS 103)	AS 21 states that the minority interest is the amount of equity attributable to minorities at the date on which investment in a subsidiary is made and it is shown outside shareholders' equity. (Paragraph 13(e) of AS 21)
6.	Amortisation of Goodwill	Under Ind AS 103, the goodwill is not amortised but tested for impairment on annual basis in accordance with Ind AS 36.	AS 14 requires that the goodwill arising on amalgamation in the nature of purchase is amortised over a period not exceeding five years.
7.	Reverse acquisition	Ind AS 103 provides guidance on accounting for reverse acquisitions.	AS 14 does not deal with the same.

8.	Contingent consideration	Ind AS 103 deals with the contingent consideration in case of business combination, i.e., an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met.	AS 14 does not provide specific guidance on this aspect.
9.	Bargain purchase gain / capital reserve and its presentation	Ind AS 103 requires bargain purchase gain arising on business combination to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. (Paragraph 34 of Ind AS 103)	Under AS 14, the excess amount is treated as capital reserve under the head reserves and surplus. (Paragraph 17 of AS 14)
	Accounting for common control transactions	Appendix C of Ind AS 103 deals with accounting for common control transactions, which prescribes pooling of interest method of accounting, which is different from accounting for other business combinations as prescribed under Ind AS 103.	AS 14 does not differentiate and prescribe accounting for such transactions different from other amalgamations.



16. CARVE OUT IN IND AS 103 FROM IFRS 3

As per IFRS: IFRS 3 requires bargain purchase gain arising from a business combination to be recognised in profit or loss as income.

Carve out: Ind AS 103 requires the bargain purchase gain to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. A similar carve-out is made in Ind AS 28, Investments in Associates and Joint Ventures.

Reasons: Since bargain purchase gain occurs at the time of acquiring a business, these are considered as capital reserve in continuation of the practice then prevailing in the Indian GAAP.



17. CARVE-IN IN IND AS 103 FROM IFRS 3

As per IFRS: IFRS 3 excludes from its scope business combinations of entities under common control.

Carve-in: Appendix C of Ind AS 103, *Business Combinations* gives guidance in this regard. Therefore, this is additional guidance under Ind AS that is not available under IFRS Standards.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Company A and Company B are in power business. Company A holds 25% of equity shares of Company B. On 1st November, Company A obtains control of Company B when it acquires a further 65% of Company B's shares, thereby resulting in a total holding of 90%. The acquisition had the following features:
 - ◆ **Consideration:** Company A transfers cash of ₹ 59,00,000 and issues 1,00,000 shares on 1st November. The market price of Company A's shares on the date of issue is ₹ 10 per share.
 - ◆ **Contingent consideration:** Company A agrees to pay additional consideration of ₹ 7,00,000 if the cumulative profits of Company B exceed ₹ 70,00,000 over the next two years. At the acquisition date, it is not considered probable that the extra consideration will be paid. The fair value of the contingent consideration is determined to be ₹ 3,00,000 at the acquisition date.
 - ◆ **Transaction costs:** Company A pays acquisition-related costs of ₹ 1,00,000.
 - ◆ **Non-controlling interests (NCI):** The fair value of the NCI is determined to be ₹ 7,50,000 at the acquisition date based on market prices. Company A elects to measure non-controlling interest at fair value for this transaction.
 - ◆ **Previously held non-controlling equity interest:** Company A has owned 25% of the shares in Company B for several years. At 1st November, the investment is included in Company A's consolidated balance sheets at ₹ 6,00,000, accounted for using the equity method; the fair value is ₹ 20,00,000.

The fair value of Company B's net identifiable assets at 1st November is ₹ 60,00,000, determined in accordance with Ind AS 103.

Determine the accounting under acquisition method for the business combination by Company A.

2. On 31st December, 20X1, Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

The fair value of each ordinary share of Entity B at 31st December, 20X1 is ₹ 40. The quoted market price of Entity A's ordinary shares at that date is ₹ 16.

The fair values of Entity A's identifiable assets and liabilities at 31st December, 20X1 are the same as their carrying amounts, except that the fair value of Entity A's non-current assets at 31st December, 20X1 is ₹ 1,500.

The balance sheets of Entity A and Entity B immediately before the business combination are:

	Entity A (legal parent, accounting acquiree)	Entity B (legal subsidiary, accounting acquirer)
Current assets	500	700
Non-current assets	<u>1,300</u>	<u>3,000</u>
Total assets	<u>1,800</u>	<u>3,700</u>
Current liabilities	300	600
Non-current liabilities	<u>400</u>	<u>1,100</u>
Total liabilities	<u>700</u>	<u>1,700</u>
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600
Total shareholders' equity	<u>1,100</u>	<u>2,000</u>
Total liabilities and shareholders' equity	<u>1,800</u>	<u>3,700</u>

Assume that Entity B's earnings for the annual period ended 31st March, 20X1 were ₹ 600 and that the consolidated earnings for the annual period ended 31st March, 20X2 were ₹ 800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the annual period ended 31st March, 20X1 and during the period from 1st January, 20X1 to the date of the reverse acquisition on 31st December, 20X1.

Calculate the fair value of the consideration transferred measure goodwill and prepare consolidated balance sheet as on 31st December, 20X1.

3. **Scenario 1: New information on the fair value of an acquired loan**

Bank F acquires Bank E in a business combination in October, 20X1. The loan by Bank E to Borrower B is recognised at its provisionally determined fair value. In December 20X1, F receives Borrower B's financial statements for the year ended 30th September, 20X1, which indicate significant decrease in Borrower B's income from operations. Basis this, the fair value of the loan to B at the acquisition date is determined to be less than the amount recognised earlier on a provisional basis.

Scenario 2: Decrease in fair value of acquired loan resulting from an event occurring during the measurement period.

Bank F acquires Bank E in a business combination in October, 20X1. The loan by Bank E to Borrower B is recognised at its provisionally determined fair value. In December 20X1, F receives information that Borrower B has lost its major customer earlier that month and this is expected to have a significant negative effect on B's operations.

Comment on the treatment done by Bank F.

4. Company A acquired 90% equity interest in Company B on 1st April, 20X1 for a consideration of ₹ 85 crores in a distress sale. Company B did not have any instrument recognised in equity. The Company appointed a registered valuer with whose assistance, the Company valued the fair value of NCI and the fair value identifiable net assets at ₹ 15 crores and ₹ 100 crores respectively.

Find the value at which NCI has to be shown in the financial statements.

5. On 1st April, 20X1, Company A acquired 5% of the equity share capital of Company B for 1,00,000. A accounts for its investment in B at Fair Value through OCI (FVOCI) under Ind AS 109, *Financial Instruments: Recognition and Measurement*. At 31st March, 20X2, A carried its investment in B at fair value and reported an unrealised gain of ₹ 5,000 in other comprehensive income, which was presented as a separate component of equity. On 1st April, 20X2, A obtains control of B by acquiring the remaining 95 percent of B.

Comment on the treatment to be done based on the facts given in the question.

6. Company A acquires 70 percent of Company S on 1st January, 20X1 for consideration transferred of ₹ 5 million. Company A intends to recognise the NCI at proportionate share of fair value of identifiable net assets. With the assistance of a suitably qualified valuation professional, A measures the identifiable net assets of B at ₹ 10 million. A performs a review and determines that the business combination did not include any transactions that should be accounted for separately from the business combination.

State whether the procedures followed by A and the resulting measurements are appropriate or not. Also calculate the bargain purchase gain in the process

7. Entity A and entity B provide construction services in India. Entity A is owned by a group of individuals, none of whom has control and does not have a collective control agreement. Entity B is owned by a single individual, Mr. Ram. The owners of entities A and B have decided to combine their businesses. The consideration will be settled in shares of entity B. Entity B issues new shares, amounting to 40% of its issued share capital, to its controlling shareholder, Mr. Ram. Mr. Ram then transfers the shares to the owners of entity A in exchange for their interest in entity A. At this point Mr. Ram controls both entities A and B, owning 100% of entity A and 71.42% of entity B. Mr. Ram had a controlling interest in both entity A and entity B before and after the contribution.

Is the combination of entities A and B a combination of entities under common control?

8. On 1 April 20X1, Alpha Ltd. acquires 80 percent of the equity interest of Beta Pvt. Ltd. in exchange for cash of ₹ 300. Due to legal compulsion, Beta Pvt. Ltd. had to dispose of their investments by a specified date. Therefore, they did not have sufficient time to market Beta Pvt. Ltd. to multiple potential buyers. The management of Alpha Ltd. initially measures the separately recognizable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirement of Ind AS 103. The identifiable assets are measured at ₹ 500 and the liabilities assumed are measured at ₹ 100. Alpha Ltd. engages an independent consultant, who determined that the fair value of 20 per cent non-controlling interest in Beta Pvt. Ltd. is ₹ 84.

Alpha Ltd. reviewed the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest in Beta Pvt. Ltd. and the consideration transferred. After the review, it decided that the procedures and resulting measures were appropriate.

Calculate the gain or loss on acquisition of Beta Pvt. Ltd. and also show the journal entries for accounting of its acquisition. Also calculate the value of the non-controlling interest in Beta Pvt. Ltd. on the basis of proportionate interest method, if alternatively applied?

9. ABC Ltd. prepares consolidated financial statements upto 31st March each year. On 1st July 20X1, ABC Ltd. acquired 75% of the equity shares of JKL Ltd. and gained control of JKL Ltd. the issued shares of JKL Ltd. is 1,20,00,000 equity shares. Details of the purchase consideration are as follows:
- On 1st July, 20X1, ABC Ltd. issued two shares for every three shares acquired in JKL Ltd. On 1st July, 20X1, the market value of an equity share in ABC Ltd. was ₹ 6.50 and the market value of an equity share in JKL Ltd. was ₹ 6.
 - On 30th June, 20X2, ABC Ltd. will make a cash payment of ₹ 71,50,000 to the former shareholders of JKL Ltd. who sold their shares to ABC Ltd. on 1st July, 20X1. On 1st July, 20X1, ABC Ltd. would have to pay interest at an annual rate of 10% on borrowings.

- On 30th June, 20X3, ABC Ltd. may make a cash payment of ₹ 3,00,00,000 to the former shareholders of JKL Ltd. who sold their shares to ABC Ltd. on 1st July, 20X1. This payment is contingent upon the revenues of ABC Ltd. growing by 15% over the two-year period from 1st July, 20X1 to 30th June, 20X3. On 1st July, 20X1, the fair value of this contingent consideration was ₹ 2,50,00,000. On 31st March, 20X2, the fair value of the contingent consideration was ₹ 2,20,00,000.

On 1st July, 20X1, the carrying values of the identifiable net assets of JKL Ltd. in the books of that company was ₹ 6,00,00,000. On 1st July, 20X1, the fair values of these net assets was ₹ 7,00,00,000. The rate of deferred tax to apply to temporary differences is 20%.

During the nine months ended on 31st March, 20X2, JKL Ltd. had a poorer than expected operating performance. Therefore, on 31st March, 20X2 it was necessary for ABC Ltd. to recognise an impairment of the goodwill arising on acquisition of JKL Ltd., amounting to 10% of its total computed value.

Compute the impairment of goodwill in the consolidated financial statements of ABC Ltd. under both the methods permitted by Ind AS 103 for the initial computation of the non-controlling interest in JKL Ltd. at the acquisition date.

10. How should contingent consideration payable in relation to a business combination be accounted for on initial recognition and at the subsequent measurement as per Ind AS in the following cases:

On 1st April 20X1, A Ltd. acquires 100% interest in B Ltd. As per the terms of agreement the purchase consideration is payable in the following 2 tranches:

- a. an immediate issuance of 10 lakhs shares of A Ltd. having face value of ₹ 10 per share;
- b. a further issuance of 2 lakhs shares after one year if the profit before interest and tax of B Ltd. for the first year following acquisition exceeds ₹ 1 crore.
 - i. The fair value of the shares of A Ltd. on the date of acquisition is ₹ 20 per share. Further, the management has estimated that on the date of acquisition, the fair value of contingent consideration is ₹ 25 lakhs.
 - ii. During the year ended 31st March 20X2, the profit before interest and tax of B Ltd. exceeded ₹ 1 crore. As on 31st March 20X2, the fair value of shares of A Ltd. is ₹ 25 per share.
 - iii. Continuing with the fact pattern in (a) above except for:
- c. The number of shares to be issued after one year is not fixed.
- d. Rather, A Ltd. agreed to issue variable number of shares having a fair value equal to ₹ 40 lakhs after one year, if the profit before interest and tax for the first year following acquisition exceeds ₹ 1 crore. A Ltd. issued shares with ₹ 40 lakhs after a year.

11. As part of its business expansion strategy, KK Ltd. is in process of setting up a pharma intermediates business which is at very initial stage. For this purpose, KK Ltd. has acquired on 1st April, 20X1, 100% shares of ABR Ltd. that manufactures pharma intermediates. The purchase consideration for the same was by way of a share exchange valued at ₹ 35 crores. The fair value of ABR Ltd.'s net assets was ₹ 15 crores, but does not include:

- (i) A patent owned by ABR Ltd. for an established successful intermediate drug that has a remaining life of 8 years. A consultant has estimated the value of this patent to be ₹ 10 crores. However, the outcome of clinical trials for the same are awaited. If the trials are successful, the value of the drug would fetch the estimated ₹ 15 crores.
- (ii) ABR Ltd. has developed and patented a new drug which has been approved for clinical use. The cost of developing the drug was ₹ 12 crores. Based on early assessment of its sales success, the valuer has estimated its market value at ₹ 20 crores.
- (iii) ABR Ltd.'s manufacturing facilities have received a favourable inspection by a government department. As a result of this, the Company has been granted an exclusive five-year license to manufacture and distribute a new vaccine. Although the license has no direct cost to the Company, its directors believe that obtaining the license is a valuable asset which assures guaranteed sales and the value for the same is estimated at ₹ 10 crores.

KK Ltd. has requested you to suggest the accounting treatment of the above transaction under applicable Ind AS.

12. H Ltd. acquired equity shares of S Ltd., a listed company, in two tranches as mentioned in the below table:

Date	Equity stake purchased	Remarks
1 st November, 20X6	15%	The shares were purchased based on the quoted price on the stock exchange on the relevant dates.
1 st January, 20X7	45%	

Both the above-mentioned companies have Rupees as their functional currency. Consequently, H Ltd. acquired control over S Ltd. on 1st January, 20X7. Following is the Balance Sheet of S Ltd. as on that date:

Particulars	Carrying value (₹ in crore)	Fair value (₹ in crore)
ASSETS:		
<u>Non-current assets</u>		

(a) Property, plant and equipment	40.0	90.0
(b) Intangible assets	20.0	30.0
(c) Financial assets		
- Investments	100.0	350.0
<u>Current assets</u>		
(a) Inventories	20.0	20.0
(b) Financial assets		
- Trade receivables	20.0	20.0
- Cash held in functional currency	4.0	4.0
(c) Other current assets		
Non-current asset held for sale	4.0	4.5
TOTAL ASSETS	208	
EQUITY AND LIABILITIES:		
<u>Equity</u>		
(a) Share capital (face value ₹ 100)	12.0	50.4
(b) Other equity	141.0	Not applicable
<u>Non-current liabilities</u>		
(a) Financial liabilities		
- Borrowings	20.0	20.0
<u>Current liabilities</u>		
(a) Financial liabilities		
- Trade payables	28.0	28.0
(b) Provision for warranties	3.0	3.0
(c) Current tax liabilities	4.0	4.0
TOTAL EQUITY AND LIABILITIES	208.0	

Other information:

Following is the statement of contingent liabilities of S Ltd. as on 1st January, 20X7:

Particulars	Fair value (₹ in crore)	Remarks
Law suit filed by a customer for a claim of ₹ 2 crore	0.5	It is not probable that an outflow of resources embodying economic benefits will be required to settle the claim. Any amount which would be paid

		in respect of law suit will be tax deductible.
Income tax demand of ₹ 7 crore raised by tax authorities; S Ltd. has challenged the demand in the court.	2.0	It is not probable that an outflow of resources embodying economic benefits will be required to settle the claim.

In relation to the above-mentioned contingent liabilities, S Ltd. has given an indemnification undertaking to H Ltd. up to a maximum of ₹ 1 crore.

₹ 1 crore represents the acquisition date fair value of the indemnification undertaking.

Any amount which would be received in respect of the above undertaking shall not be taxable.

The tax bases of the assets and liabilities of S Ltd. is equal to their respective carrying values being recognised in its Balance Sheet.

Carrying value of non-current asset held for sale of ₹ 4 crore represents its fair value less cost to sell in accordance with the relevant Ind AS.

In consideration of the additional stake purchased by H Ltd. on 1st January, 20X7, it has issued to the selling shareholders of S Ltd. 1 equity share of H Ltd. for every 2 shares held in S Ltd. Fair value of equity shares of H Ltd. as on 1st January, 20X7 is ₹ 10,000 per share.

On 1st January, 20X7, H Ltd. has paid ₹ 50 crore in cash to the selling shareholders of S Ltd. Additionally, on 31st March, 20X9, H Ltd. will pay ₹ 30 crore to the selling shareholders of S Ltd. if return on equity of S Ltd. for the year ended 31st March, 20X9 is more than 25% per annum. H Ltd. has estimated the fair value of this obligation as on 1st January, 20X7 and 31st March, 20X7 as ₹ 22 crore and ₹ 23 crore respectively. The change in fair value of the obligation is attributable to the change in facts and circumstances after the acquisition date.

Quoted price of equity shares of S Ltd. as on various dates is as follows:

As on November, 20X6 ₹ 350 per share

As on 1st January, 20X7 ₹ 395 per share

As on 31st March, 20X7 ₹ 420 per share

On 31st May, 20X7, H Ltd. learned that certain customer relationships existing as on 1st January, 20X7, which met the recognition criteria of an intangible asset as on that date, were not considered during the accounting of business combination for the year ended 31st March, 20X7. The fair value of such customer relationships as on 1st January, 20X7

was ₹ 3.5 crore (assume that there are no temporary differences associated with customer relations; consequently, there is no impact of income taxes on customer relations).

On 31st May, 20X7 itself, H Ltd. further learned that due to additional customer relationships being developed during the period 1st January, 20X7 to 31st March, 20X7, the fair value of such customer relationships has increased to ₹ 4 crore as on 31st March, 20X7.

On 31st December, 20X7, H Ltd. has established that it has obtained all the information necessary for the accounting of the business combination and that more information is not obtainable.

H Ltd. and S Ltd. are not related parties and follow Ind AS for financial reporting. Income tax rate applicable is 30%.

You are required to provide your detailed responses to the following, along with reasoning and computation notes:

- (a) What should be the goodwill or bargain purchase gain to be recognised by H Ltd. in its financial statements for the year ended 31st March, 20X7. For this purpose, measure non-controlling interest using proportionate share of the fair value of the identifiable net assets of S Ltd.
 - (b) Will the amount of non-controlling interest, goodwill, or bargain purchase gain so recognised in (a) above change subsequent to 31st March, 20X7? If yes, provide relevant journal entries.
 - (c) What should be the accounting treatment of the contingent consideration as on 31st March, 20X7?
13. Company X is engaged in the business of exploration & development of Oil & Gas Blocks.

Company X currently holds participating interest (PI) in below mentioned producing Block as follows:

Block Name	Company X	Company Y	Company Z	Total
AWM/01	30%	60%	10%	100%

For the above Block, Company X, Y & Z has entered into unincorporated Joint Arrangement.

Company Y is the Operator of the Block AWM/01. Company X & Company Z are the Joint Operators. Company Y incurs all the expenditure on behalf of Joint Venture and raise cash call to Company X & Company Z at each month end in respect of their share of expenditure incurred in Joint Venture. All the manpower and requisite facilities / machineries owned by the Joint venture and thereby owned by all the Joint Operators.

For past few months, due to liquidity issues, Company Z defaulted in payment of cash calls to operators. Therefore, company Y (Operator) has issued notice to company Z for withdrawal of their participating right from on 01.04.20X1. However, company Z has filed the appeal with arbitrator on 30.04.20X1.

Financial performance of company Z did not improve in subsequent months and therefore company Z decided to withdraw participating interest rights from Block AWM/01 and entered into sale agreement with Company X & Company Y. As per the terms of the agreement, dated 31.5.20X1, Company X will receive 33.33% share & Company Y will receive 66.67% share of PI rights owned by Company Z.

Company X is required to pay ₹ 1 Lacs against 33.33% share of PI rights owned by Company Z.

After signing of sale agreement, Operator (company Y) approach government of India for modification in PSC (Production Sharing Contract) i.e. removal of Company Z from PSC of AWM/01 and government has approved this transaction on 30.6.20X1. Government approval for the modification in PSC is essential, given the industry in which the joint operators operate.

Balance sheet of Company X & Company Z are as follows:

Particulars	Company X		Company Z	
	31.5.20X1 ₹	30.6.20X1 ₹	31.5.20X1 ₹	30.6.20X1 ₹
Assets				
Non-Current Assets				
Property, Plant & Equipment	5,00,000	10,00,000	1,50,000	3,00,000
Right of Use Asset	1,00,000	2,00,000	10,000	20,000
Development CWIP	50,000	1,00,000	50,000	1,00,000
Financial Assets				
Loan receivable	<u>25,000</u>	<u>50,000</u>	<u>25,000</u>	<u>50,000</u>
Total Non-Current Assets	<u>6,75,000</u>	<u>13,50,000</u>	<u>2,35,000</u>	<u>4,70,000</u>
Current assets				
Inventories	1,00,000	2,00,000	15,000	30,000
Financial Assets				
Trade receivables	1,50,000	3,00,000	50,000	1,00,000
Cash and cash equivalents	2,00,000	4,00,000	1,00,000	2,00,000
Other Current Assets	<u>2,25,000</u>	<u>50,000</u>	<u>25,000</u>	<u>50,000</u>
Total Current Assets	<u>6,75,000</u>	<u>9,50,000</u>	<u>1,90,000</u>	<u>3,80,000</u>
Total Assets	<u>13,50,000</u>	<u>23,00,000</u>	<u>4,25,000</u>	<u>8,50,000</u>

Equity and Liabilities				
Equity				
Equity share capital	3,00,000	3,00,000	1,00,000	1,00,000
Other equity	<u>2,00,000</u>	<u>3,00,000</u>	<u>75,000</u>	<u>2,50,000</u>
Total Equity	<u>5,00,000</u>	<u>6,00,000</u>	<u>1,75,000</u>	<u>3,50,000</u>
Liabilities				
Non-Current Liabilities				
Provisions	4,00,000	8,00,000	1,00,000	2,00,000
Other Liabilities	<u>1,50,000</u>	<u>3,00,000</u>	<u>50,000</u>	<u>1,00,000</u>
Total Non-Current Liabilities	<u>5,50,000</u>	<u>11,00,000</u>	<u>1,50,000</u>	<u>3,00,000</u>
Current Liabilities				
Financial Liabilities				
Trade Payables	<u>3,00,000</u>	<u>6,00,000</u>	<u>1,00,000</u>	<u>2,00,000</u>
Total Current Liabilities	<u>3,00,000</u>	<u>6,00,000</u>	<u>1,00,000</u>	<u>2,00,000</u>
Total Liabilities	<u>13,50,000</u>	<u>23,00,000</u>	<u>4,25,000</u>	<u>8,50,000</u>

Additional Information:

1. Fair Value of PPE & Development CWIP owned by Company Z as per Market participant approach is ₹ 5,00,000 & ₹ 2,00,000 respectively.
2. Fair Value of all the other assets and liabilities acquired are assumed to be at their carrying values (except cash & cash equivalent). Cash and cash equivalents of Company Z are not to be acquired by Company X as per the terms of agreement.
3. Tax rate is assumed to be 30%.
4. As per Ind AS 111, it is a joint operation whereby every operator records their share of assets and liabilities in their books.

You need to determine the following:

1. Whether the above acquisition falls under business or asset acquisition as defined under business combination standard Ind AS 103?
2. Determine the acquisition date in the above transaction?
3. Prepare Journal entries for the above-mentioned transaction?
4. Draft the Balance Sheet for Company X based on your analysis in Part 1 above as at acquisition date.

14. Entity X acquired entity Y in a business combination as per Ind AS 103. There is an existing share-based plan in entity Y with a vesting condition for 3 years in which 2 years have already lapsed at the date of such business acquisition. Entity X agreed to replace the existing award for the employees of combined entity. The details are as below –

Acquisition date fair value of share-based payment plan	₹ 300
Number of years to vest after acquisition	1 year
Fair Value of award which replaces existing plan	₹ 400

Calculate the share-based payment values?

Answers

1. *Identify the acquirer*

In this case, Company A has paid cash consideration to shareholders of Company B. Further, the shares issued to Company B pursuant to the acquisition do not transfer control of Company A to erstwhile shareholders of Company B. Therefore, Company A is the acquirer and Company B is the acquiree.

Determine acquisition date

As the control over the business of Company B is transferred to Company A on 1st November, that date is considered as the acquisition date.

Determine the purchase consideration

The purchase consideration in this case will comprise the following:

Cash consideration	₹ 59,00,000
Equity shares issued (1,00,000 x 10 i.e., at fair value)	₹ 10,00,000
Contingent consideration (at fair value)	₹ 3,00,000
Fair value of previously held interest	₹ 20,00,000

As such, the total purchase consideration is ₹ 92,00,000.

Acquisition cost incurred by and on behalf of the Company A for acquisition of Company B should be recognised in the Statement of profit and loss. As such, an amount of ₹ 1,00,000 should be recognised in Statement of profit and loss.

Determine fair value of identifiable assets and liabilities

The fair value of identifiable net assets is determined at ₹ 60,00,000.

Measure NCI

The management has decided to recognise the NCI at its fair value. As such, the NCI will be recognised at ₹ 7,50,000.

Re-measure previously held interests in case business combination is achieved in stages

In this case, the control has been acquired in stages i.e., before acquisition to control, the Company A exercised significant influence over Company B. As such, the previously held interest should be measured at fair value and the difference between the fair value and the carrying amount as at the acquisition date should be recognised in Statement of Profit and Loss. As such, an amount of ₹ 14,00,000 (i.e., 20,00,000 less 6,00,000) will be recognised in Statement of profit and loss.

Determination of goodwill or gain on bargain purchase

Goodwill should be calculated as follows:

	(₹)
Total consideration	92,00,000
Recognised amount of any non-controlling interest	7,50,000
Less: Fair value of Company B's net identifiable assets	<u>(60,00,000)</u>
Goodwill	<u>39,50,000</u>

2. Identifying the acquirer

As a result of Entity A issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (i.e., 150 of the 250 total issued shares). The remaining 40 per cent are owned by Entity A's shareholders. Thus, the transaction is determined to be a reverse acquisition in which Entity B is identified as the accounting acquirer while Entity A is the legal acquirer.

Calculating the fair value of the consideration transferred

If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B — 60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is ₹ 1,600 (40 shares with a fair value per share of ₹ 40).

The fair value of the consideration effectively transferred should be based on the most reliable measure. Here, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair

value of the shares in Entity B, and the consideration is measured using the market price of Entity A's 100 shares with a fair value per share of ₹ 16.

Measuring goodwill

Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognised identifiable assets and liabilities, as follows:

	₹	₹
Consideration effectively transferred		1,600
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	<u>(400)</u>	<u>(1,300)</u>
Goodwill		<u>300</u>

Consolidated balance sheet at 31st December, 20X1

The consolidated balance sheet immediately after the business combination is:

	₹
Non-current assets [3,000 + 1,500]	4,500
Goodwill	300
Current assets [700 + 500]	<u>1,200</u>
Total assets	<u>6,000</u>
Shareholders' equity	
Issued equity 250 ordinary shares [600 + 1,600]	2,200
Retained earnings	<u>1,400</u>
Total shareholders' equity	<u>3,600</u>
Non-current liabilities [1,100 + 400]	1,500
Current liabilities [600 + 300]	<u>900</u>
Total liabilities	<u>2,400</u>
Total liabilities and shareholders' equity	<u>6,000</u>

The amount recognised as issued equity interests in the consolidated financial statements (₹ 2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (600) and the fair value of the consideration effectively transferred (₹ 1,600). However, the equity structure appearing in the consolidated financial statements (i.e., the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to affect the combination.

3. **Scenario 1:** The new information obtained by F subsequent to the acquisition relates to facts and circumstances that existed at the acquisition date. Accordingly, an adjustment (i.e., decrease) to in the provisional amount should be recognised for loan to B with a corresponding increase in goodwill.

Scenario 2: Basis this, the fair value of the loan to B will be less than the amount recognised earlier at the acquisition date. The new information resulting in the change in the estimated fair value of the loan to B does not relate to facts and circumstances that existed at the acquisition date, but rather is due to a new event i.e., the loss of a major customer subsequent to the acquisition date. Therefore, based on the new information, F should determine and recognise an allowance for loss on the loan in accordance with Ind AS 109, *Financial Instruments: Recognition and Measurement*, with a corresponding charge to profit or loss; goodwill is not adjusted.

4. In this case, Company A has the option to measure NCI as follows:
- ◆ Option 1: Measure NCI at fair value i.e., ₹ 15 crores as derived by the valuer;
 - ◆ Option 2: Measure NCI as proportion of fair value of identifiable net assets i.e., ₹ 10 crores (100 crores x 10%)
5. At the acquisition date A recognises the gain of ₹ 5,000 in OCI as the gain or loss is not allowed to be recycled to income statement as per the requirement of Ind AS 109. A's investment in B would be at fair value and therefore does not require remeasurement as a result of the business combination. The fair value of the 5 percent investment (1,05,000) plus the fair value of the consideration for the 95 percent newly acquired interest is included in the acquisition accounting.
6. The amount of B's identifiable net assets exceeds the fair value of the consideration transferred plus the fair value of the NCI in B, resulting in an initial indication of a gain on a bargain purchase. Accordingly, A reviews the procedures it used to identify and measure the identifiable net assets acquired, to measure the fair value of both the NCI and the consideration transferred, and to identify transactions that were not part of the business combination.

Following that review, A concludes that the procedures followed and the resulting measurements were appropriate.

	(₹)
Identifiable net assets	1,00,00,000
Less: Consideration transferred	(50,00,000)
NCI (10 million x 30%)	<u>(30,00,000)</u>
Gain on bargain purchase	<u>20,00,000</u>

7. No. This is not a business combination of entities under common control. Mr. Ram's control of both entities before the business combination was transitory. The substance of the transaction is that entity B has obtained control of entity A. Entity B accounts for this transaction as a business combination under Ind AS 103 using acquisition accounting.
8. The amount of Beta Pvt. Ltd. identifiable net assets [₹ 400, calculated as ₹ 500 - ₹ 100] exceeds the fair value of the consideration transferred plus the fair value of the non controlling interest in Beta Pvt. Ltd. [₹ 384 calculated as 300 + 84]. Alpha Ltd. measures the gain on its purchase of the 80 per cent interest as follows:

		₹ in lakh
Amount of the identifiable net assets acquired (₹ 500 - ₹ 100)		400
Less: Fair value of the consideration transferred for Alpha Ltd. 80 per cent interest in Beta Pvt. Ltd.	300	
Add: Fair value of non controlling interest in Beta Pvt. Ltd.	<u>84</u>	<u>(384)</u>
Gain on bargain purchase of 80 per cent interest		<u>16</u>

Journal Entry

	₹ in lakh	₹ in lakh
Identifiable assets acquired Dr.	500	
To Cash		300
To Liabilities assumed		100
To OCI/Equity-Gain on the bargain purchase		16
To Equity-non controlling interest in Beta Pvt Ltd.		84

If the acquirer chose to measure the non controlling interest in Beta Pvt. Ltd. on the basis of its proportionate interest in the identifiable net assets of the acquire, the recognized

amount of the non controlling interest would be ₹ 80 ($₹ 400 \times 0.20$). The gain on the bargain purchase then would be ₹ 20 ($₹ 400 - (₹ 300 + ₹ 80)$)

9. Computation of goodwill impairment

	NCI at fair value	NCI at of net assets
	₹ in '000	₹ in '000
Cost of investment		
Share exchange ($12,000 \times 75\% \times 2/3 \times ₹ 6.50$)	39,000	39,000
Deferred consideration ($7,150 / 1.10$)	6,500	6,500
Contingent consideration	25,000	25,000
Non-controlling interest at date of acquisition:		
Fair value – $3000 \times ₹ 6$	18,000	
% of net assets – 68,000 (Refer W.N.) $\times 25\%$		17,000
Net assets on the acquisition date (Refer W.N.)	(68,000)	(68,000)
Goodwill on acquisition	20,500	19,500
Impairment @ 10%	2,050	1,950

Working Note:

Net assets on the acquisition date	₹ '000
Fair value at acquisition date	70,000
Deferred tax on fair value adjustments [$20\% \times (70,000 - 60,000)$]	(2,000)
	<u>68,000</u>

10. Paragraph 37 of Ind AS 103, inter alia, provides that the consideration transferred in a business combination should be measured at fair value, which should be calculated as the sum of (a) the acquisition-date fair values of the assets transferred by the acquirer, (b) the liabilities incurred by the acquirer to former owners of the acquiree and (c) the equity interests issued by the acquirer.

Further, paragraph 39 of Ind AS 103 provides that the consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

With respect to contingent consideration, obligations of an acquirer under contingent consideration arrangements are classified as equity or a liability in accordance with

Ind AS 32 or other applicable Ind AS, i.e., for the rare case of non-financial contingent consideration. Paragraph 40 provides that the acquirer shall classify an obligation to pay contingent consideration that meets the definition of a financial instrument as a financial liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of Ind AS 32, Financial Instruments: Presentation. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met. Paragraph 58 of Ind AS 103 provides guidance on the subsequent accounting for contingent consideration.

- (i) In the given case the amount of purchase consideration to be recognized **on initial recognition** shall be as follows:

	₹
Fair value of shares issued (10,00,000 x ₹20)	2,00,00,000
Fair value of contingent consideration	<u>25,00,000</u>
Total purchase consideration	<u>2,25,00,000</u>

Subsequent measurement of contingent consideration payable for business combination

In general, an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Ind AS 32 describes an equity instrument as one that meets both of the following conditions:

- (a) There is no contractual obligation to deliver cash or another financial asset to another party, or to exchange financial assets or financial liabilities with another party under potentially unfavorable conditions (for the issuer of the instrument).
- (b) If the instrument will or may be settled in the issuer's own equity instruments, then it is:
 - (i) a non-derivative that comprises an obligation for the issuer to deliver a fixed number of its own equity instruments; or
 - (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or other financial assets for a fixed number of its own equity instruments.

In the given case, given that the acquirer has an obligation to issue fixed number of shares on fulfilment of the contingency, the contingent consideration will be classified as equity as per the requirements of Ind AS 32.

As per paragraph 58 of Ind AS 103, contingent consideration classified as equity should not be re-measured and its subsequent settlement should be accounted for within equity.

Here, the obligation to pay contingent consideration amounting to ₹ 25,00,000 is recognized as a part of equity and therefore not re-measured subsequently or on issuance of shares.

- (ii) The amount of purchase consideration to be recognized on initial recognition shall be as follows:

	₹
Fair value of shares issued (10,00,000 x ₹20)	2,00,00,000
Fair value of contingent consideration	<u>25,00,000</u>
Total purchase consideration	<u>2,25,00,000</u>

Subsequent measurement of contingent consideration payable for business combination

The contingent consideration will be classified as liability as per Ind AS 32.

As per paragraph 58 of Ind AS 103, contingent consideration not classified as equity should be measured at fair value at each reporting date and changes in fair value should be recognized in profit or loss.

As at 31 March 20X2, (being the date of settlement of contingent consideration), the liability would be measured at its fair value and the resulting loss of ₹ 15,00,000 (₹ 40,00,000 – ₹ 25,00,000) should be recognized in the profit or loss for the period. A Ltd. would recognize issuance of 160,000 (40,00,000/25) shares at a premium of ₹ 15 per share.

11. As per para 13 of Ind AS 103 'Business Combination', the acquirer's application of the recognition principle and conditions may result in recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements. This may be the case when the asset is developed by the entity internally and charged the related costs to expense.

Based on the above, the company can recognise following Intangible assets while determining Goodwill / Bargain Purchase for the transaction:

- (i) **Patent owned by ABR Ltd.:** The patent owned will be recognised at fair value by KK Ltd. even though it was not recognised by ABR Ltd. in its financial statements. The patent will be amortised over the remaining useful life of the asset i.e. 8 years. Since the company is awaiting the outcome of the trials, the value of the patent cannot be estimated at ₹ 15 crore and the extra ₹ 5 crore should only be disclosed as a Contingent Asset and not recognised.
- (ii) **Patent internally developed by ABR Ltd.:** As per para 18 of Ind AS 103 'Business Combination', the acquirer shall measure the identifiable assets acquired and the

liabilities assumed at their acquisition date fair values. Since the patent developed has been approved for clinical use, it is an identifiable asset, hence the same will be measured at fair value ie ₹ 20 crore on the acquisition date.

- (iii) **Grant of Licence to ABR Ltd. by the Government:** As regards to the five-year license, applying para 18 of Ind AS 103, grant asset will be recognised at fair value on the acquisition date by KK Ltd. On acquisition date, the fair value of the license is ₹ 10 crore. However, since the question does not mention about the fair value of the identifiable liability with respect to grant of license for the acquirer, it is assumed that no conditions with respect to compliance of grant (if any) have been passed to the acquirer. Hence, the fair value of the liability with respect to grant, for acquirer would be nil. Only, the grant asset (license) would be recognised at ₹ 10 crore in the books of acquirer KK Ltd.

Hence the revised working would be as follows:

	₹
Fair value of net assets of ABR Ltd.	15 crore
Add: Patent (10 + 20)	30 crore
Add: License	10 crore
Less: Grant for License	<u>(Nil)</u>
	55 crores
Purchase Consideration	<u>(35 crores)</u>
Bargain purchase	<u>20 crore</u>

12. (i) As an only exception to the principle of classification or designation of assets as they exist at the acquisition date is that for lease contract and insurance contracts classification which will be based on the basis of the conditions existing at inception and not on acquisition date.

Therefore, H Ltd. would be required to retain the original lease classification of the lease arrangements and thereby recognise the lease arrangements as finance lease.

- (ii) The requirements in Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', do not apply in determining which contingent liabilities to recognise as of the acquisition date as per Ind AS 103 'Business Combination'. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to Ind AS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be

required to settle the obligation. Hence H Ltd. will recognize contingent liability of ₹ 2.5 cr.

Since S Ltd. has indemnified for ₹ 1 cr., H Ltd. shall recognise an indemnification asset at the same time for ₹ 1 cr.

As per the information given in the question, this indemnified asset is not taxable. Hence, its tax base will be equal to its carrying amount. No deferred tax will arise on it.

- (iii) As per Ind AS 103, non-current assets held for sale should be measured at fair value less cost to sell in accordance with Ind AS 105 'Non-current Assets Held for Sale and Discontinued Operations'. Therefore, its carrying value as per balance sheet has been considered in the calculation of net assets.
- (iv) Any equity interest in S Ltd. held by H Ltd. immediately before obtaining control over S Ltd. is adjusted to acquisition-date fair value. Any resulting gain or loss is recognised in the profit or loss of H Ltd.

Calculation of purchase consideration as per Ind AS 103

₹ in crore

Investment in S Ltd.			
On 1 st Nov. 20X6	15%	$[(12/100) \times ₹ 395 \times 15\%]$	7.11
On 1 st Jan. 20X7	45%		
Own equity given		$12 \times 100 \times ₹ 10,000 \times 45\% \times 1/2$	270.00
Cash			50.00
Contingent consideration			<u>22.00</u>
			<u>349.11</u>

- (v) Calculation of deferred tax on assets and liabilities acquired as part of the business combination, including current tax and goodwill.

Item	₹ in crore				
	Book value	Fair value	Tax base	Taxable (deductible) temporary difference	Deferred tax assets (liability) @ 30%
Property, plant and equipment	40	90	40	50	(15)
Intangible assets	20	30	20	10	(3)
Investments	100	350	100	250	(75)

Inventories	20	20	20	-	-
Trade receivables	20	20	20	-	-
Cash held in functional currency	4	4	4	-	-
Non-current asset held for sale	4	4	4	-	-
Indemnified asset	-	1	-	-	-
Borrowings	20	20	20	-	-
Trade payables	28	28	28	-	-
Provision for warranties	3	3	3	-	-
Current tax liabilities	4	4	4	-	-
Contingent liability		0.5	-	(0.5)	0.15
Deferred tax Liability					(92.85)

(vi) Calculation of identifiable net assets acquired

	₹ in crore	₹ in crore
Property, plant and equipment	90	
Intangible assets	30	
Investments	350	
Inventories	20	
Trade receivables	20	
Cash held in functional currency	4	
Non-current asset held for sale	4	
Indemnified asset	<u>1</u>	
Total asset		519
Less: Borrowings	20	
Trade payables	28	
Provision for warranties	3	
Current tax liabilities	4	
Contingent liability (2 + 0.5)	2.50	
Deferred tax liability (W.N.2)	<u>92.85</u>	<u>(150.35)</u>
Net identifiable assets		<u>368.65</u>

(a) Calculation of NCI by proportionate share of net assets

Net identifiable assets of S Ltd. on 1.1.20X7 (Refer W.N.(vi)) = 368.65 crore

NCI on 1.1.20X7 = 368.65 crore x 40% = 147.46 crore

Calculation of Goodwill as per Ind AS 103

Goodwill on 1.1.20X7 = Purchase consideration + NCI – Net assets
 = 349.11 + 147.46 – 368.65 = 127.92 crore

- (b)** As per para 45 of Ind AS 103 'Business Combination', if the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete.

During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

Further, as per para 46 of Ind AS 103, the measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognised for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this Ind AS:

- (a) the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;
- (b)
- (c); and
- (d) the resulting goodwill or gain on a bargain purchase.

Para 48 states that the acquirer recognises an increase (decrease) in the provisional amount recognised for an identifiable asset (liability) by means of a decrease (increase) in goodwill.

Para 49 states that during the measurement period, the acquirer shall recognise adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date.

Para 50 states that after the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with Ind AS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

On 31st December, 20X7, H Ltd. has established that it has obtained all the information necessary for the accounting of the business combination and the more information is not obtainable. Therefore, the measurement period for acquisition of S Ltd. ends on 31st December, 20X7.

On 31st May, 20X7 (ie within the measurement period), H Ltd. learned that certain customer relationships existing as on 1st January, 20X7 which met the recognition criteria of an intangible asset as on that date were not considered during the accounting of business combination for the year ended 31st March, 20X7. Therefore, H Ltd. shall account for the acquisition date fair value of customer relations existing on 1st January, 20X7 as an identifiable intangible asset. The corresponding adjustment shall be made in the amount of goodwill.

Accordingly, the amount of goodwill will be changed due to identification of new asset from retrospective date for changes in fair value of assets and liabilities earlier recognised on provisional amount (subject to meeting the condition above for measurement period). NCI changes would impact the consolidated retained earnings (parent's share). Also NCI will be increased or decreased based on the profit during the post-acquisition period.

Journal Entry

Customer relationship	Dr. 3.5 crore	
To NCI		1.4 crore
To Goodwill		2.1 crore

However, the increase in the value of customer relations after the acquisition date shall not be accounted by H Ltd., as the customer relations developed after 1st January, 20X7 represents internally generated intangible assets which are not eligible for recognition on the balance sheet.

- (c) Since the contingent considerations payable by H Ltd is not classified as equity and is within the scope of Ind AS 109 'Financial Instruments', the changes in the fair value

shall be recognised in profit or loss. Change in Fair value of contingent consideration (23-22) ₹ 1 crore will be recognized in the Statement of Profit and Loss.

13. (1) Ind AS 103 defines business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

For a transaction to meet the definition of a business combination (and for the acquisition method of accounting to apply), the entity must gain control of an integrated set of assets and activities that is more than a collection of assets or a combination of assets and liabilities.

To be capable of being conducted and managed for the purpose identified in the definition of a business, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs.

Therefore, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output.

In the aforesaid transaction, Company X acquired share of participating rights owned by Company Z for the producing Block (AWM/01). The output exist in this transaction (Considering AWM/01) is a producing block. Also all the manpower and requisite facilities / machineries are owned by Joint venture and thereby all the Joint Operators. Hence, acquiring participating rights tantamount to acquire inputs (Expertise Manpower & Machinery) and it is critical to the ability to continue producing outputs. Thus, the said acquisition will fall under the Business Acquisition and hence standard Ind AS 103 is to be applied for the same.

- (2) As per paragraph 8 of Ind AS 103, acquisition date is the date on which the acquirer obtains control of the acquiree. Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date. Since government of India (GOI) approval is a substantive approval for Company X to acquire control of Company Z's operations, the date of acquisition cannot be earlier than the date on which approval is obtained from GOI. This is pertinent given that the approval from GOI is considered to be a substantive process and accordingly, the acquisition is considered to be completed only on receipt of such approval. Hence acquisition date in the above scenario is 30.6.20X1.

(3) Journal entry for acquisition

Particulars		Amount (₹)	Amount (₹)
Property Plant & Equipment	Dr.	1,66,650	
Right-of-use Asset	Dr.	6,666	
Development CWIP	Dr.	66,660	
Financial Assets - Loan Receivables	Dr.	16,665	
Inventories	Dr.	9,999	
Trade Receivables	Dr.	33,330	
Other Current Assets	Dr.	16,665	
To Provisions			66,660
To Other Liabilities			33,330
To Trade Payables			66,660
To Deferred Tax Liability			29,997
To Cash & Cash Equivalent (purchase consideration)			1,00,000
To Gain on bargain purchase (Other Comprehensive Income)			19,988
(Being assets acquired and liabilities assumed from Company Z recorded at fair value along gain on bargain purchase)			

(4) Balance Sheet of Company X as at 30.6.20X1

(Pre & Post Acquisition of PI rights pertaining to Company Z)

Particulars	Pre-Acquisition	Adjustments	Post-Acquisition
	30.6.20X1		30.6.20X1
Assets			
Non - Current Assets			
Property Plant & Equipment	10,00,000	1,66,650	11,66,650
Right of Use Asset	2,00,000	6,666	2,06,666
Development CWIP	1,00,000	33,330	1,66,660
Financial Assets			
Loan receivable	<u>50,000</u>	16,665	<u>66,665</u>
Total Non-Current Assets	<u>13,50,000</u>		<u>16,06,641</u>

Current assets			
Inventories	2,00,000	9,999	2,09,999
Financial Assets			
Trade receivables	3,00,000	33,330	3,33,330
Cash and cash equivalents	4,00,000	(1,00,000)	3,00,000
Other Current Assets	50,000	16,665	66,665
Total Current Assets	<u>9,50,000</u>		<u>9,09,994</u>
Total Assets	<u>23,00,000</u>		<u>25,16,635</u>
Equity and Liabilities			
Equity			
Equity share capital	3,00,000		3,00,000
Other equity	3,00,000		3,00,000
Capital Reserve (OCI)	<u> </u>	19,988	<u>19,988</u>
Total Equity	<u>6,00,000</u>		<u>6,19,988</u>
Liabilities			
Non-Current Liabilities			
Provisions	8,00,000	66,660	8,66,660
Other Liabilities	3,00,000	33,330	3,33,330
Deferred Tax Liability	<u> </u>	29,997	<u>29,997</u>
Total Non-Current Liabilities	<u>11,00,000</u>		<u>12,29,987</u>
Current Liabilities			
Financial liabilities			
Trade Payables	<u>6,00,000</u>	66,660	<u>6,66,660</u>
Total Current Liabilities	<u>6,00,000</u>		<u>6,66,660</u>
Total Equity and Liabilities	<u>23,00,000</u>		<u>25,16,635</u>

Working Notes

1. Determination of Company Z's balance acquired by Company X on 30.6.20X1 (Acquisition Date)

Particulars	As per Company Z Books 30.6.20X1	Carrying Value 33.33% Share	Acquisition Date Value	Remarks
	₹	₹	₹	
Assets				
Non-Current Assets				
Property Plant & Equipment	3,00,000	99,990	1,66,650	Note 1
Right of Use Asset	20,000	6,666	6,666	
Development CWIP	1,00,000	33,330	66,660	Note 2
Financial Assets				
Loan receivable	<u>50,000</u>	<u>16,665</u>	<u>16,665</u>	
Total Non-Current Assets	<u>4,70,000</u>	<u>1,56,651</u>	<u>2,56,641</u>	
Current assets				
Inventories	30,000	9,999	9,999	
Financial Assets				
Trade receivables	1,00,000	33,330	33,330	
Cash and cash equivalents	2,00,000	66,660	66,660	
Other Current Assets	<u>50,000</u>	<u>16,665</u>	<u>16,665</u>	
Total Current Assets	<u>3,80,000</u>	<u>1,26,654</u>	<u>1,26,654</u>	
Liabilities				
Non-Current Liabilities				
Provisions	2,00,000	66,660	66,660	
Other Liabilities	<u>1,00,000</u>	<u>33,330</u>	<u>33,330</u>	
Total Non-Current Liabilities	<u>3,00,000</u>	<u>99,990</u>	<u>99,990</u>	
Current Liabilities				
Financial liabilities				
Trade Payables	<u>2,00,000</u>	<u>66,660</u>	<u>66,660</u>	
Total Current Liabilities	<u>2,00,000</u>	<u>66,660</u>	<u>66,660</u>	

Note 1: Fair Value of PPE:

Fair Value of PPE in Company Z Books	₹ 5,00,000
33.33% Share acquired by Company X	₹ 1,66,650

Note 2: Fair Value of Development CWIP:

Fair Value of PPE in Company Z Books	₹ 2,00,000
33.33% Share acquired by Company X	₹ 66,660

2. Computation Goodwill/Bargain Purchase Gain

Particulars	As at 30.6.20X1 (₹)
Total Non - Current Assets	2,56,641
Total Current Assets (Except Cash & Cash Equivalent of ₹ 66,660) (1,26,654 – 66,660)	59,994
Total Non-Current Liabilities	(99,990)
Total Current Liabilities	(66,660)
Total Deferred Tax Liability (Refer Working note 3)	<u>(29,997)</u>
Net Assets Acquired	1,19,988
Less: Consideration Paid	<u>(1,00,000)</u>
Gain on Bargain Purchase (To be transferred to OCI)	<u>19,988</u>

*In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the value of net assets acquired in a business combination exceeds the purchase consideration. The acquirer shall recognise the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve, if the reason for bargain purchase gain is clear and evidence exist. If there does not exist clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, then the gain shall be recognised directly in equity as capital reserve. Since in above scenario it is clearly evident that due to liquidity issues, Company Z has to withdraw their participating right from AWM/01. The said bargain purchase gain should be transferred to other comprehensive income on the acquisition date.

3. Computation of Deferred Tax Liability arising on Business Combination

Particulars	Acquisition Date Value (₹)
Total Non - Current Assets	2,56,641
Total Current Assets (Except Cash & Cash Equivalent of ₹ 66,660)	59,994
Total Non-Current Liabilities	(99,990)
Total Current Liabilities	<u>(66,660)</u>
Net Assets Acquired at Fair Value	1,49,985
Book value of Net Assets Acquired	<u>(49,995)</u>
Temporary Difference	<u>99,990</u>
DTL @ 30% on Temporary Difference	29,997

Note: As per Ind AS 103, in case an entity acquires another entity step by step through series of purchase then the acquisition date will be the date on which the acquirer obtains control. Till the time the control is obtained the investment will be accounted as per the requirements of other Ind AS 109, if the investments are covered under that standard or as per Ind AS 28, if the investments are in Associates or Joint Ventures.

If a business combination is achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

Since in the above transaction, company X does not hold any prior interest in Company Z & company holds only 30% PI rights in Block AWM/01 through unincorporated joint arrangement, this is not a case of step acquisition.

14. Pre-acquisition period = 2
 Post-acquisition period = 1
 Total fair value at acquisition date = ₹ 300
 Value to be recorded as per business combination under Ind AS 103 = ₹ 300/3 x 2 = ₹ 200
 Value to be recorded as per Ind AS 102 (A) = ₹ 300/3 x 1 = ₹ 100
 Fair value of the replacement of such award = ₹ 400
 Difference from acquisition date fair value (B) = ₹ 400 – ₹ 300 = ₹ 100
 Total value to be accounted over vesting period as per Ind AS 102 = A + B
 = ₹ 100 + ₹ 100 = ₹ 200

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CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS OF GROUP ENTITIES

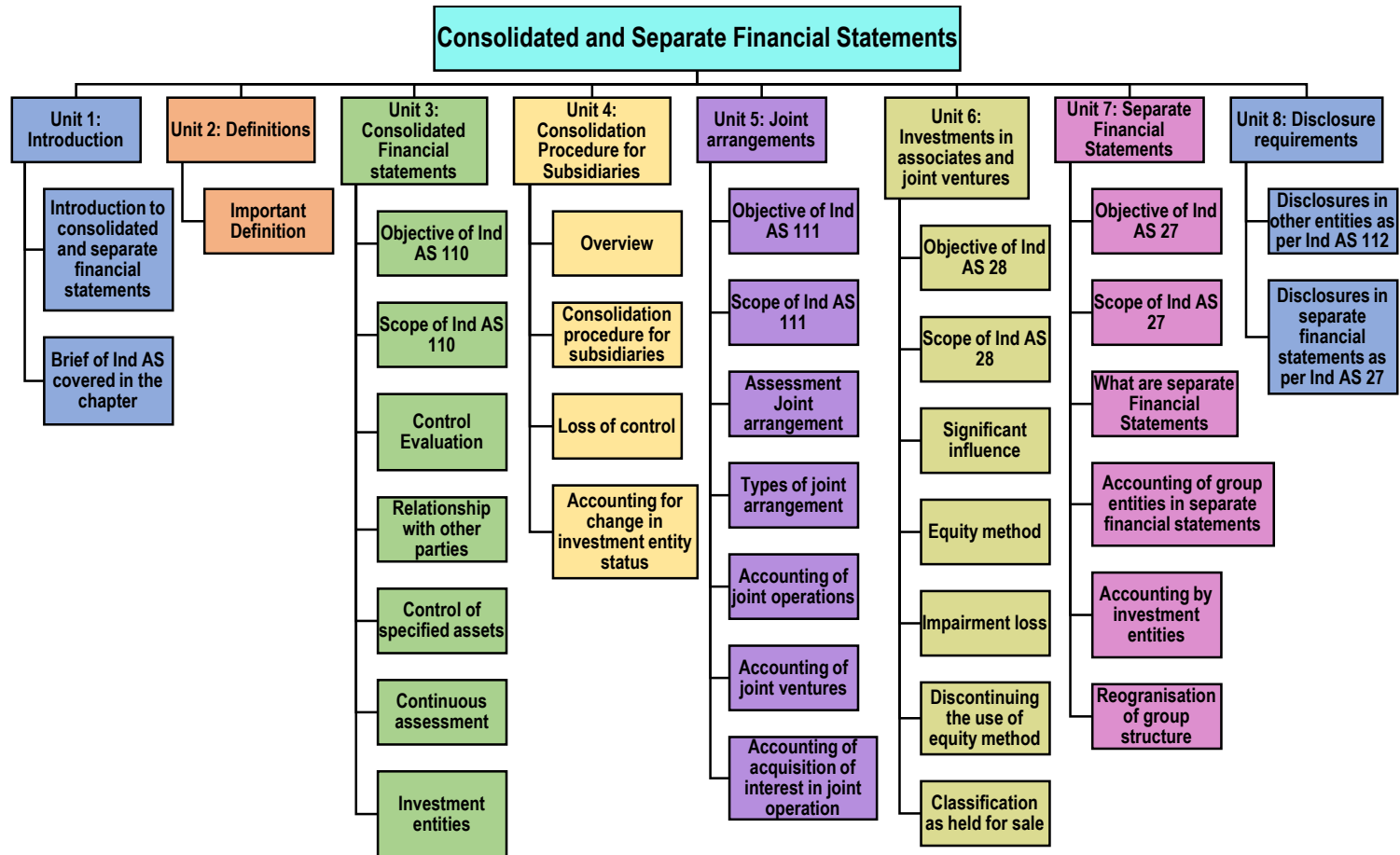


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the scope and objective of various Ind AS related to preparation of consolidated and separate financial statements
- ❑ Comprehend the concepts of control evaluation over an investee
- ❑ Analyse whether an entity is an investment entity
- ❑ Learn consolidation procedure for subsidiaries and accounting of non-controlling interests
- ❑ Determine whether an entity is a joint arrangement and if yes then whether that joint arrangement is a joint operation or joint venture
- ❑ Assess whether an investor has significant influence over an investee to treat that investee as an associate
- ❑ Learn what is the equity method of accounting and how it is applied in accounting of associates and joint ventures in the consolidated financial statements
- ❑ Gain knowledge of what are separate financial statements and how to account for the investments in subsidiaries, associates and joint ventures in separate financial statements of the investor
- ❑ Understand the disclosure requirements with respect to interests in other entities in the consolidated and separate financial statements.

CHAPTER OVERVIEW



UNIT 1: INTRODUCTION TO CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS



1.1 INTRODUCTION

Consolidated and Separate Financial Statements of Group Entities

Consolidated financial statements present the financial position of an entire group including the parent and its group companies. Whereas the separate financial statements present the financial position of a single entity for which the financial statements are prepared.

Various stakeholders such as investors, promoters, lenders, government authorities, etc. are more interested in referring to the consolidated financial statements for their decision-making purpose as consolidated financial statements provide a complete overview of the operations and profitability of the entire group which is controlled by the parent rather than just looking at the separate financial statements of the parent. Also, in current business scenario, various large corporates frequently do business restructuring or expansion by creating more group companies in order to achieve benefits like tax savings, operational efficiency, etc. Hence, in such circumstances the consolidated financial statements are imperative to have a complete understanding of the profitability and financial position of the entire group.

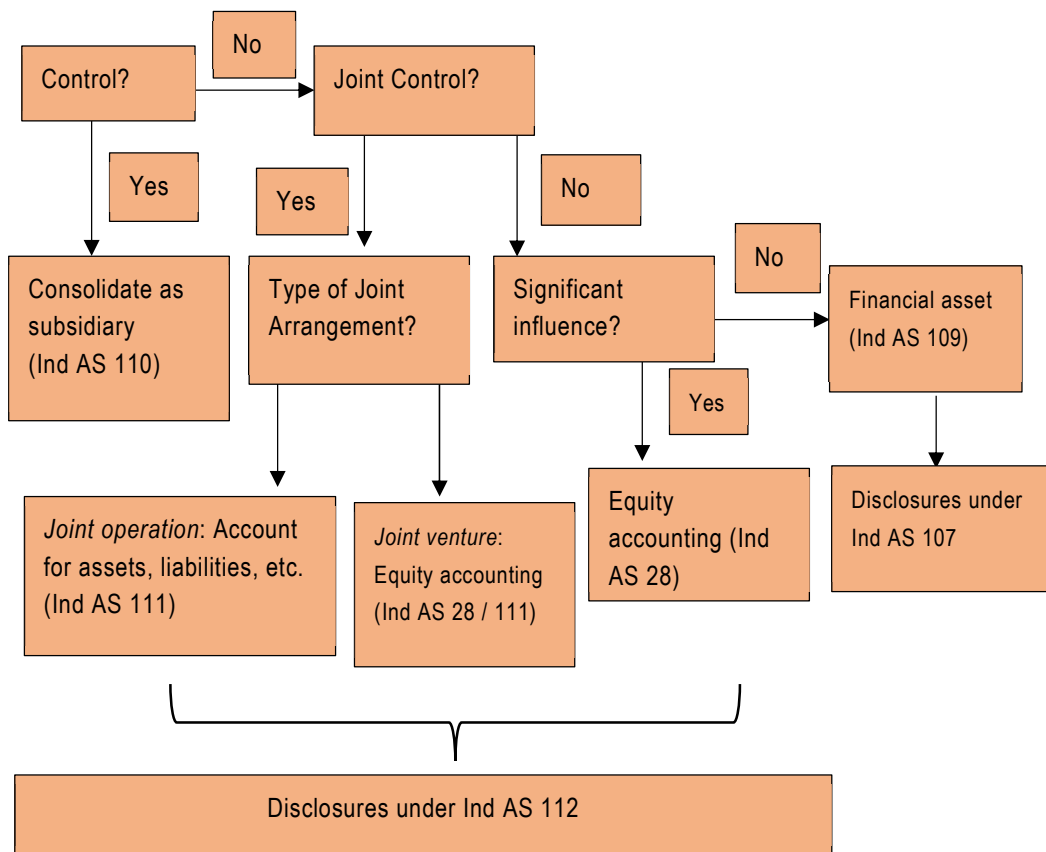


1.2 IND AS COVERED IN THE CHAPTER

In this study material, following Ind AS are covered related to the preparation of consolidated and separate financial statements of group entities:

- Ind AS 110 '*Consolidated Financial Statements*': This Ind AS provides the criteria for evaluation of whether an entity controls one or more other entities to treat them as subsidiaries of the entity. It also explains the procedures for preparation of consolidated financial statements including the requirements for elimination of inter-company transactions, accounting of non-controlling interests, accounting of loss of control over subsidiaries and many more. The principles of control evaluation are covered in unit 3 of this chapter and principles of consolidation procedures are covered in unit 4 of this chapter.
- Ind AS 111 '*Joint Arrangements*': This Ind AS explains the principles of determining whether an investment by an entity in an arrangement with one or more other parties can be treated as a joint arrangement or not. Also, it explains how to classify such joint arrangement between joint operation and joint venture. The principles of this Ind AS are covered in unit 5 of this chapter.

- Ind AS 28 '*Investments in Associates and Joint Ventures*': This Ind AS describes the principles of determining whether an investor has significant influence over an investee whereby the investee will be treated as an associate of the investor. Further, this Ind AS explains the principles of application of equity method of accounting for accounting of investments in associates and joint ventures in the consolidated financial statements. The principles of this Ind AS are covered in unit 6 of this chapter.
- Ind AS 27 '*Separate Financial Statements*': This Ind AS prescribes the principles of accounting and disclosure of investment in subsidiaries, associates and joint ventures in the separate financial statements of an entity. The principles of accounting of investments in subsidiaries, associates and joint ventures are covered in unit 7 of this chapter and principles of disclosures of investments in subsidiaries, associates and joint ventures are covered in unit 8 of this chapter.
- Ind AS 112 '*Disclosures of Interests in Other entities*': This Ind AS provides the requirements for an entity to disclose certain information in its financial statements with respect to its interests in other entities. The requirements of this Ind AS are covered in unit 8 of this chapter.



UNIT 2: IMPORTANT DEFINITIONS

Following are the definitions of some of the important terms used across the chapter.

- **Associate:** An associate is an entity over which the investor has significant influence.
- **Consolidated Financial Statements:** The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.
- **Control over an investee:** An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
- **Group:** A parent and its subsidiaries.
- **Joint arrangement:** A joint arrangement is an arrangement of which two or more parties have joint control.
- **Joint control:** Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
- **Joint operation:** A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
- **Joint venture:** A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
- **Non-controlling interest:** Equity in a subsidiary not attributable, directly or indirectly, to a parent.
- **Parent:** An entity that controls one or more entities.
- **Power:** Existing rights that give the current ability to direct the relevant activities.
- **Separate financial statements:** Separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with Ind AS 109 '*Financial Instruments*'.
- **Significant influence:** Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
- **Subsidiary:** An entity that is controlled by another entity.

UNIT 3:

IND AS 110: CONSOLIDATED FINANCIAL STATEMENTS



3.1 OBJECTIVE OF IND AS 110

The objective of Ind AS 110 is to provide principles of when an entity should prepare consolidated financial statements and how those consolidated financial statements should be prepared. In particular, Ind AS 110 provides following principles for presentation and preparation of consolidated financial statements:

- A parent that controls one or more subsidiaries should prepare consolidated financial statements
- Guidance on how to apply the principles of control evaluation to determine whether an investor has control over an investee to be able to consolidate that investee
- Principles around accounting requirements for consolidated financial statements
- Definition of an investment entity and consolidation exemptions applicable to them

The principles mentioned above are discussed in this unit except the accounting requirements for consolidated financial statements which is discussed in Unit 4.

Further, Ind AS 110 does not deal with the accounting requirements for business combinations and their effects on consolidation, including goodwill arising on a business combination. Hence, such requirements are also not discussed in this study material. Refer study material 'Business Combination and Corporate Restructuring' for discussion on the same.



3.2 SCOPE OF IND AS 110

Ind AS 110 requires that an entity that is a parent should prepare consolidated financial statements. However, there are certain exemptions and exceptions to this as follows:

Exemption

As per paragraph 4(a) of Ind AS 110, a parent entity that meets **all** of the following conditions need **not present** consolidated financial statements:

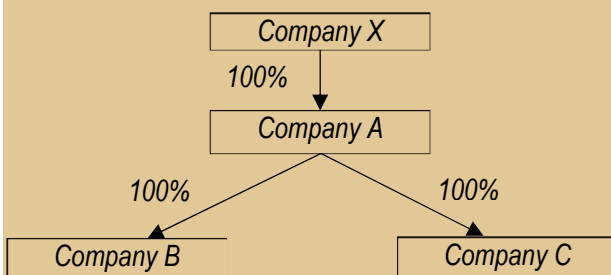
- (i) The entity is a wholly owned or partly owned subsidiary of another entity and all the owners of the entity are informed, and they do not object to the entity not preparing consolidated financial statements

- (ii) The debt or equity instruments of the entity are not traded in a public market (whether domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)
- (iii) The entity has not filed nor is it in the process of filing its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market
- (iv) The entity's ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110

Illustration 1: Exception to prepare consolidated financial statements

Scenario A:

Following is the structure of a group headed by Company X:



Company X is a listed entity in India and prepares consolidated financial statements as per the requirements of Ind AS. Company A is an unlisted entity and it is not in the process of listing any of its instruments in public market. Company X does not object to Company A not preparing consolidated financial statements.

Whether Company A is required to prepare consolidated financial statements as per the requirements of Ind AS 110?

Scenario B:

Assume the same facts as per Scenario A except, Company X is a foreign entity and is listed in stock exchange of a foreign country and it prepares its financial statements as per the generally accepted accounting principles (GAAP) applicable to that country.

Will your answer be different in this case?

Scenario C:

Assume the same facts as per Scenario A except, 100% of the investment in Company A is held by Mr. X (an individual) instead of Company X.

Will your answer be different in this case?

Solution:**Scenario A:**

In this case, Company A satisfies all the conditions for not preparing consolidated financial statements i.e. it is not a listed entity nor it is in the process of listing, the parent of Company A prepares consolidated financial statements as per Ind AS which is available for public use and parent of Company A does not object Company A not preparing consolidated financial statements.

Hence, Company A is not required to prepare consolidated financial statements.

Scenario B:

In this case, the consolidated financial statements of parent of Company A are not prepared under Ind AS. Hence Company A cannot avail the exemption from preparation of consolidated financial statements.

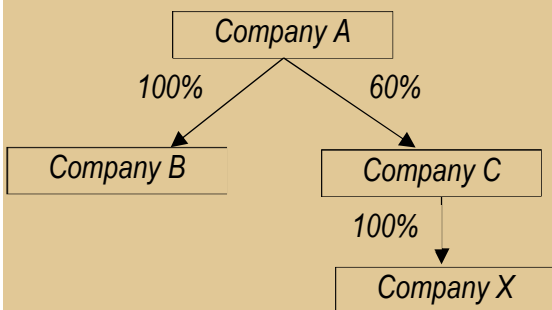
Scenario C:

In this case, Mr. X (an individual) would not be preparing its financial statements as per the requirements of Ind AS which is available for public use.

Hence Company A cannot avail the exemption from preparation of consolidated financial statements.

Illustration 2: Exception to prepare consolidated financial statements**Scenario A:**

Following is the structure of a group headed by Company A.



Company A is a listed entity in India and prepares consolidated financial statements as per the requirements of Ind AS. Company C is an unlisted entity and it is not in the process of listing any of its instruments in public market. 60% of the equity share capital of Company C is held by Company A and balance 40% equity share capital is held by other outside investors. Company A does not object to Company C not preparing consolidated financial statements.

Whether Company C is required to prepare consolidated financial statements as per the requirements of Ind AS 110?

Scenario B:

Assume the same facts as per Scenario A except, the balance 40% of the equity share capital of Company C is held by Company B.

State whether C Limited is required to inform its other owner B Limited (owning 40%) of its intention to not prepare consolidated financial statements as mentioned in paragraph 4(a)(i)?

Solution:

Scenario A:

Company C is a partly owned subsidiary of Company A. In such case, Company C should inform the other 40% equity shareholders about Company C not preparing consolidated financial statements and if they do not object then only Company C can avail the exemption from preparing consolidated financial statements.

Scenario B:

In this scenario, Company C is 100% held by Company A (60% direct investment and 40% investment through Company B). Hence, Company C is not required to inform to Company B of not preparing consolidated financial statements and can avail the exemption from preparing the consolidated financial statements.

Exception 1

Ind AS 110 does not apply to post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19 'Employee Benefits' applies. Therefore, an entity which has set up such plans should not consolidate them.

Example 1

Company A has set up an Employee Gratuity Plan trust for the purpose of giving gratuity benefits to its employees. The gratuity benefit given by the company is a post-employee benefit plan which is accounted as per Ind AS 19 (refer Unit 1 of Chapter 9 for the accounting of employee benefit plans as per Ind AS 19). So, Company A is not required to evaluate whether it controls the trust and should not consolidate it.

Exception 2

An investment entity (explained in section 3.7 of this Unit) that is required to measure all of its subsidiaries at fair value through profit or loss need not present consolidated financial statements. This exception is further explained subsequently in this unit.

Note:

It may be noted that the Indian GAAP (i.e. the accounting standards under The Companies (Accounting Standards) Rules, 2021) contained two exceptions from consolidation, which **are no longer applicable under Ind AS**:

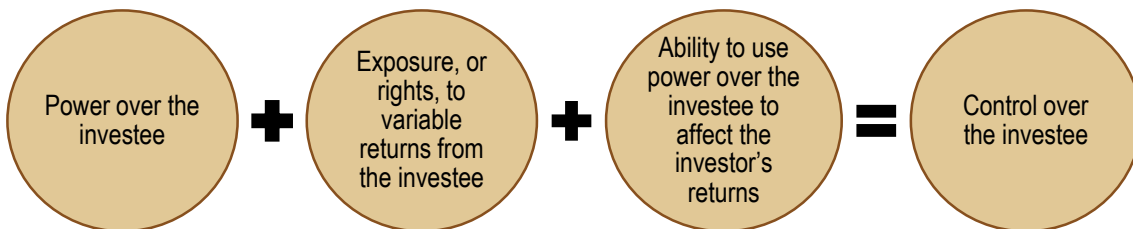
- When control is intended to be temporary; or
- When the subsidiary operates under severe long-term restrictions



3.3 CONTROL EVALUATION

As per Ind AS 110, an investor needs to determine whether it controls an investee and if yes then the investor would be treated as a parent and the investee would be treated as a subsidiary of the parent.

An investor controls an investee if and only if the investor has **all of the following three elements**:



After doing an initial assessment of control over an investee, the investor should reassess the control over the investee when there are changes to one or more of the three elements of control mentioned above.

Further, there may be situations where the investor is not the only one who control the investee and it may need to act in co-operation with any other entity. There may also be a situation where there is no investor who individually controls the investee. In such scenario, the investor would account for the interest in such investees in accordance with other applicable Ind AS such as Ind AS 111 for joint arrangement (discussed in Unit 5 of this Chapter), Ind AS 28 for investments in associates (discussed in Unit 6 of this Chapter) or Ind AS 109 for financial instruments (discussed in Chapter 12).

Each of the elements of control evaluation are explained below.

3.3.1 Power

What is power?

The first criterion of control evaluation is to determine whether the investor has power over the investee. An investor gets power over an investee if it has three elements:

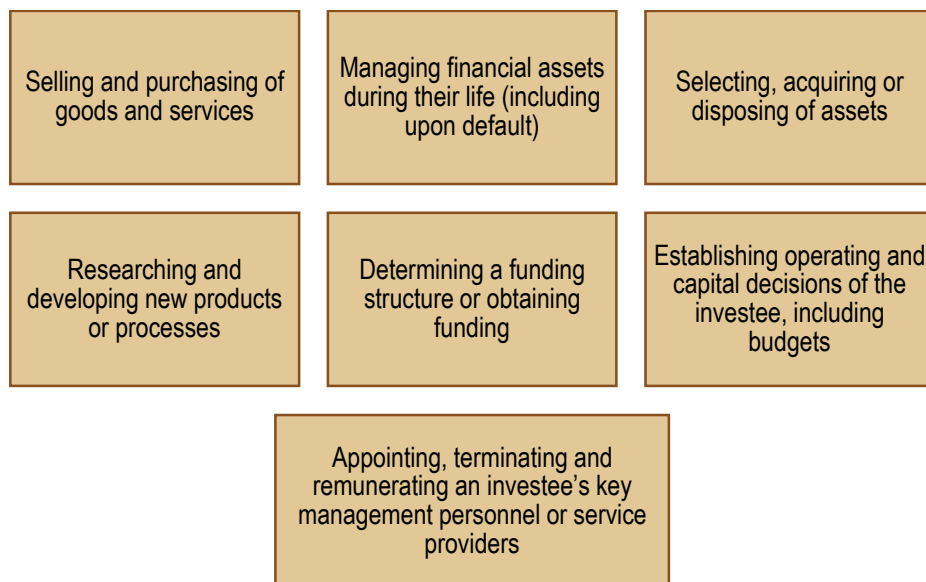
- A. existing rights that give it
- B. the current ability
- C. to direct the relevant activities of the investee.

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change. We will move in a reverse order to understand the meaning of 'power' in the context of Ind AS 110. In other words, we will first learn what are 'relevant activities', then we will move to understand what is intended to be covered within the scope of 'current ability' and finally, we will link this understanding with the concept of 'rights'.

How to identify the relevant activities and how the decisions about those activities are made?

Relevant activities are the activities of investee that significantly affect the investee's returns. For a detailed understanding of what encompasses 'returns', please refer to section 3.3.2.

There may be range of operating and financing activities that would significantly affect the returns of an investee. Examples of activities related to operating and financing activities that can be relevant activities include, but not limited to:



The power to direct the relevant activities can be shared by multiple parties but those rights may not meet the definition of joint control.

Example 2

Five parties each own 20 per cent of entity Z, and each has one seat on entity Z's board of directors. All strategic operating and financing decisions (ie decisions in respect of the activities that significantly affect the returns of entity Z) require the consent of any four of the five directors. The five parties do not jointly control entity Z because unanimous consent is not required for decisions relating to the activities of entity Z that significantly affect its returns. Nevertheless, it is clear that the power to direct the activities of entity Z is shared and no single party controls entity Z.

There may be another situation where two or more investors have the rights to unilaterally direct different relevant activities of an investee. In such situation, one has to decide which activities can most significantly affect the returns of the investee and the investor having the ability to direct those activities would be considered to have power over the investee. The investors shall reconsider this assessment in case there is change in the facts or circumstances.

Illustration 3: Different investors have ability to direct different relevant activities

A Ltd. and B Ltd. set up a new company C Ltd. to construct and operate a toll road. A Ltd. is responsible for the construction of the toll road, which is expected to take two years. Thereafter, B Ltd. has authority on all matters related to toll road operation.

Is it possible for B Ltd. to have power over C Ltd. during the construction phase, even though A Ltd. is responsible for construction and has authority to make decisions that need to be made during the construction phase?

Solution

B Ltd. may power during the construction phase, even though it cannot yet exercise its decision-making rights during construction. The investor that has the ability to direct the activities that most significantly affect the returns of the investee has power over the investee. Consideration should be given to the factors that determine profit margin, revenue and valuation of C Ltd. For example, the construction of the road may be under the strict supervision and precise requirements of the regulator say State Road Transport Corporation (SRTC).

A Ltd. will recover its costs plus a fixed percentage of margin. That margin will be returned through adjustment of the amount of tolls that will flow to A Ltd., so that A Ltd. has first call on the cash flows generated by tolls. B Ltd. will manage the toll road operations, including maintenance, and will be able to claim a management fee equivalent to any residual cash in the entity after all operating expenses have been paid, including payments to A Ltd.

Assume that B Ltd. has the ability to set tolls (and not SRTC). In this scenario, A Ltd. merely works like a contractor, earning a fixed margin, and probably a financing income for financing the construction. A Ltd. does not take much of a risk on the cash flows, because the residual risks and rewards belong to B Ltd. Consequently, B Ltd. controls C Ltd. from its inception.

Illustration 4: Determining the relevant activities

A Ltd. is an asset manager of a venture capital fund i.e. Fund X. Out of the total outstanding units of the fund, 10% units are held by A Ltd. and balance 90% units are held by other investors. Majority of the unitholders of the fund have right to appoint a committee which will manage the day-to-day administrative activities of the fund. However, the decisions related to the investments / divestments to be done by Fund X is taken by asset manager i.e. A Ltd. Based on above, who has power over Fund X?

Solution:

In this case, A Ltd. is able to direct the activities that can most significantly affect the returns of Fund X. Hence, A Ltd. has power over the investee. However, this does not mean that A Ltd. has control over the fund and consideration will have to be given to other elements of control evaluation as well i.e. exposure to variable returns and link between power and exposure to variable returns.

Current ability to direct relevant activities

An investor would have current ability to direct relevant activities if that investor were able to make decisions at the time those decisions need to be taken. An investor can have the current ability to direct the activities of an investee even if it does not actively direct the activities of the investee.

Having the current ability to direct the activities of an investee is not limited to being able to act today. There may be steps to be taken in order to act - for example, an investor may need to initiate a meeting before it can exercise its voting or other rights that give it power. However, such a delay would not prevent the investor from having power, assuming that there are no other barriers that would prevent the investor from exercising its rights when it chooses to do so.

For some investees, particularly those with most of their operating and financing decisions predetermined, decisions that significantly affect the returns of the investee are not made continuously. Such decisions may be made only if particular events occur or circumstances arise. For such investees, having the ability to make those decisions if and when they arise is a source of a current ability to direct the relevant activities.

It must be borne in mind that the current ability to direct the activities of an investee would, in all cases, arise from rights (voting rights, potential voting rights, rights within other arrangements or a combination of these).

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with

the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

Illustration 5: Current ability to direct the relevant activities

An investment vehicle (the investee) is created and financed with a debt instrument held by an investor (the debt investor) and equity instruments held by a number of other investors. The equity tranche is designed to absorb the first losses and to receive any residual return from the investee. One of the equity investors who holds 30 per cent of the equity is also the asset manager.

The investee uses its proceeds to purchase a portfolio of financial assets, exposing the investee to the credit risk associated with the possible default of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee.

The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (ie when the value of the portfolio is such that the equity tranche of the investee has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor.

Based on the above, who has power over the investment vehicle?

Solution:

Managing the investee's asset portfolio is the relevant activity of the investee.

The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value.

The asset manager and the debt investor each need to determine whether they are able to direct the activities that most significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

3.3.1.1 Rights that give power to an investor

Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities.

The rights that give an investor power over an investee can differ investee by investee. Following are some of the examples (not an exhaustive list) of various forms of rights that, either individually or in combination with other rights, can give power to an investor:

Form of right	Illustration
Voting rights or potential voting rights of an investee (this is further explained subsequently in this unit).	An investor holding majority of the equity share capital of an investee. Concepts of power through voting or potential voting rights are further discussed in detail in section 3.3.1.3 of this unit.
Rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities.	An investor having right to appoint majority of the members of the Board of Director who have power to take decisions related to relevant activities.
Rights to appoint or remove another entity that directs the relevant activities.	Right with an investor to appoint or remove an asset manager who takes decisions related to investments / divestments by a venture capital fund.
Rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor.	Right with an investor to direct the investee to sell all of its outputs to a group company of the investor at the price determined by investor
Other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.	Right related to relevant activities given to a single investor by all other investors through a shareholders' agreement

In most of the case where the investee has a range of relevant activities and decisions are required to be taken on a continuous basis for those activities then it will be voting or similar rights that give an investor power over the investee.

3.3.1.1A Substantive rights vs Protective Rights

For the purpose of determination of power over an investee, an investor shall consider only those rights which are substantive. Protective rights are not considered for the determination of power. Below table summarises the difference between substantive rights and protective rights:

Substantive rights	Protective rights
Substantive rights can give the investor power over the investee.	Protective rights do not give investor power over the investee.

Substantive rights relate to the relevant activities of the investee.	Protective rights relate to protect the interest of the party holding those rights without giving the holder the right over the relevant activities of the investee.

Both the above rights are discussed below in detail.

1. Substantive rights

For a right to be substantive, the holder must have the practical ability to exercise that right.

Assessment of whether the rights are substantive requires judgement taking into consideration all the facts and circumstances. Following are some of the factors (not an exhaustive list) that should be considered while assessing whether the rights are substantive or not:

a) Whether there are any **barriers** that prevent the holder from exercising the rights. Example of such barriers (not an exhaustive list) can be as follows:

- Financial penalties and incentives
- High exercise or conversion price
- Terms and conditions that make it unlikely that the rights would be exercised, like, conditions that narrowly limit the timing of their exercise
- The absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights.
- The inability of the holder of the rights to obtain the information necessary to exercise its rights.
- Operational barriers or incentives. For example, in case of a venture capital fund managed by an asset manager, there is absence of other managers willing or able to provide specialised services or provide the services and take on other interests held by the existing manager.
- legal or regulatory requirements. For example, where a foreign investor is prohibited from exercising its rights

b) When the exercise of rights requires **agreement of more than one party**, or when the rights are **held by more than one party**, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive.

An independent board of directors may serve as a mechanism for numerous investors to act collectively in exercising their rights.

c) Whether the party or parties that hold the rights would **benefit from the exercise of those rights**. For example, the holder of potential voting rights in an investee shall consider the

exercise or conversion price of the instrument. The potential voting rights are more likely to be substantive when the exercise price is lower than the market price or when there are other synergies anticipated between the investor and the investee.

Below are some illustrations that explain the above factors of determining whether the rights held by investors are substantive or not:

Illustration 5: Voting rights are substantive or not

Scenario A:

Following is the voting power holding pattern of B Ltd.

- 10% voting power held by A Ltd.
- 90% voting power held by 9 other investor each holding 10%

All the investors have entered into a management agreement whereby they have granted the decision-making powers related to the relevant activities of B Ltd. to A Ltd. for a period of 5 years.

After 2 years of the agreement, the investors holding 90% of the voting powers have some disputes with A Ltd. and they want to take back the decision-making rights from A Ltd. This can be done by passing a resolution with majority of the investors voting in favour of the removal of rights from A Ltd. However, as per the termination clause of the management agreement, B Ltd. will have to pay a huge penalty to A Ltd. for terminating the agreement before its stated term.

Whether the rights held by investors holding 90% voting power are substantive?

Scenario B:

Assume the same facts as per Scenario A except, there is no penalty required to be paid by B Ltd. for termination of agreement before its stated term. However, instead of all other investors, there are only 4 investors holding total 40% voting power that have disputes with A Ltd. and want to take back decision-making rights from A Ltd.

Whether the rights held by investors holding 40% voting power are substantive?

Solution:

Scenario A:

If the investors holding 90% of the voting power exercise their right to terminate the management agreement, then it will result in B Ltd. having to pay huge penalty which will affect the returns of B Ltd. This is a barrier that prevents such investors from exercising their rights and hence such rights are not substantive.

Scenario B:

To take back the decision-making rights from A Ltd., investors holding majority of the voting power need to vote in favour of removal of rights from A Ltd. However, the investors having disputes with A Ltd. do not have majority voting power and hence the rights held by them are not substantive.

Illustration 6: Potential voting rights are substantive or not**Scenario A:**

An investor is holding 30% of the voting power in ABC Ltd. The investor has been granted an option to purchase 30% more voting power from other investors. However, the exercise price of the option is too high compared to the current market price of ABC Ltd. because ABC Ltd. is incurring losses since last 2 years and it is expected to continue to incur losses in future period as well. Whether the right held by the investor to exercise purchase option is substantive?

Scenario B:

Assume the same facts as per Scenario A except, the option price is in line with the current market price of ABC Ltd. and ABC Ltd. is making profits. However, the option can be exercised in next 1 month only and the investor is not in a position to arrange for the required amount in 1 month's time to exercise the option. Whether the right held by the investor to exercise purchase option is substantive?

Scenario C:

Assume the same facts as per Scenario A except, ABC Ltd. is making profits. However, the current market price of ABC Ltd. is not known since the ABC Ltd. is a relatively new company, business of the company is unique and there are no other companies in the market doing similar business. Hence the investor is not sure whether to exercise the purchase option. Whether the right held by the investor to exercise purchase option is substantive?

Solution:**Scenario A:**

The right to exercise purchase option is not substantive since the option exercise price is too high as compared to current market price of ABC Ltd.

Scenario B:

The right to exercise purchase option is not substantive since the time period for the investor to arrange for the requisite amount for exercising the option is too narrow.

Scenario C:

The right to exercise purchase option is not substantive. This is because the investor is not able to obtain information about the market value of ABC Ltd. which is necessary in order to compare the option exercise price with market price so that it can decide whether the exercise of purchase option would be beneficial or not.

Illustration 7: Removal rights are substantive or not

A venture capital fund is managed by an asset manager who has right to take the investment and divestments decisions related to the fund corpus. The asset manager is also holding some stake in the fund. The other investors of the fund have right to remove the asset manager.

However, in the present scenario, there is absence of other managers who are willing or able to provide specialised services that the current asset manager is providing and purchase the stake that the current asset manager is holding in the fund. Whether the removal rights available with other investors are substantive?

Solution:

If the other investors exercise their removal rights, then it will impact the operations of the fund and ultimately the returns of the fund since there is no substitute of the current asset manager available who can manage the corpus of the fund. Hence the removal rights held by other investors are not substantive.

For a right to be substantive, it should be exercisable when decisions about the direction of the relevant activities need to be made. In most of the cases a right, to be a substantive right, rights need to be currently exercisable. However, there may be some situations where a right can be substantive, even though it may not be currently exercisable.

Example 3

In case of an investor currently holding only 30% voting rights in a company has an option to purchase additional 40% voting rights to increase its voting rights to 70%. The option can be exercised within next 25 days. Also, there is a meeting of shareholding scheduled to be held after 30 days to take decision about relevant activities of the company. In such case, even though the

investor is not currently holding majority voting power, it can exercise the purchase option and increase its voting power to 70% by the time when the decisions about the relevant activities are to be made. Hence such rights are substantive rights.

An investor may be directing relevant activities of an investee and the evidence of that can help determine whether the investor has power. However, such evidence is not, in itself, conclusive in determining whether the investor has power over an investee.

While assessing the power, an investor should also consider the substantive rights held by other investors. The other investors may not be able to initiate the decisions about relevant activities on their own, but the rights held by them to approve or block any decision may prevent the investor from taking decision about relevant activities.

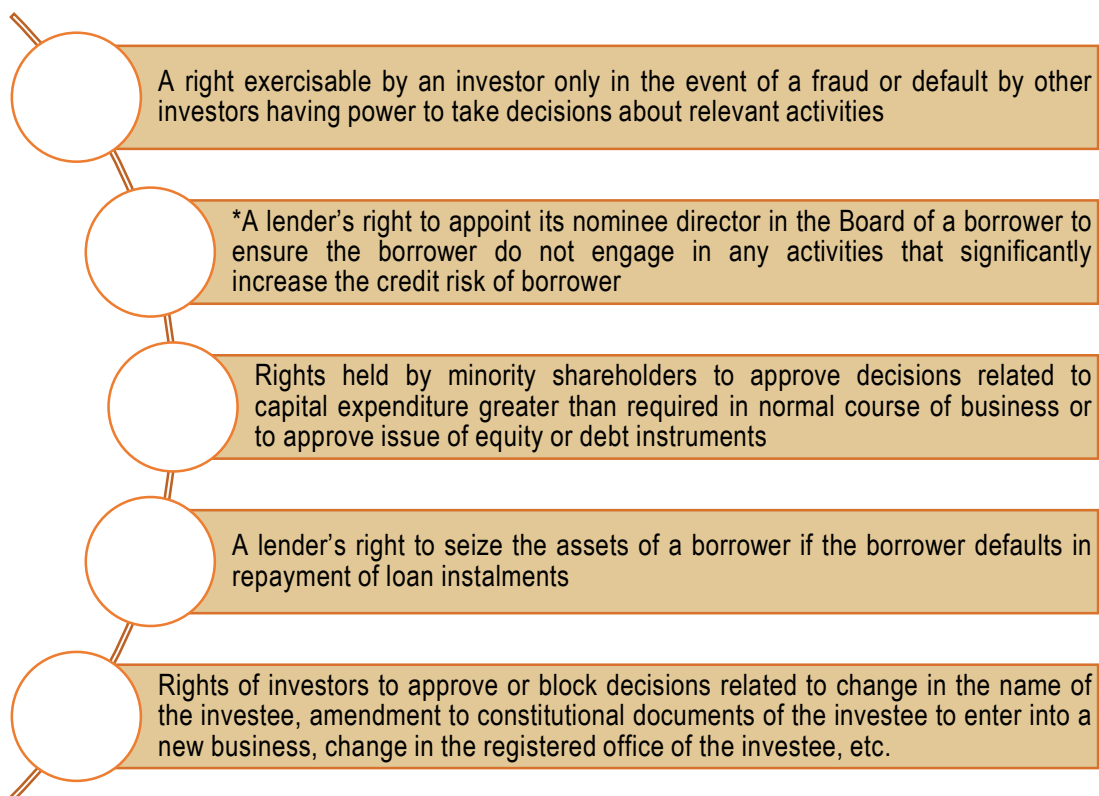
Example 4

In case of a company with 5 investors, a meeting of the investors to take decisions about relevant activities can be called if at least 2 members are in favour of calling the meeting. However, to pass any decision in the meeting, unanimous consent of all investors is required. Hence, in such case a single investor may not be able to initiate the meeting, but his consent is required to pass any decision in the meeting.

2. Protective rights

Protective rights are the rights designed to **protect the interest of the party** holding those rights **without giving that party power** over the entity to which those rights relate.

Such rights mainly **relate to fundamental changes** to the activities of an investee or apply in exceptional circumstances. However, not all the rights that apply in exceptional circumstances or are contingent on future events are protective rights. Protective rights do not give its holder power or prevent another party from having power over an investee. The examples of protective rights include, but not limited to, following:



***Note:** The 2nd right (illustrated above) is not protective in all circumstances. So far as the nomination doesn't result in majority control over the Board, it can be considered protective.

The effect of substantive and protective rights is summarised below:

Type of rights held by investor	Type of rights held by other parties	Conclusion on 'power'?
Substantive	Protective	Investor has power
Protective	Substantive	Other parties have power
Substantive	Substantive	Further evaluation needed

Franchises

Apart from the examples of protective rights mentioned above, one more example can be of rights of a franchisor in a franchise agreement. In a franchise agreement, the investee i.e. the franchisee usually give the franchisor the rights that are related to protect the franchise brand. Following are some of the salient features of a franchise arrangement which indicates that the rights of a franchisor in a franchise agreement are protective rights:

Salient features of a franchise agreement that indicate that rights of franchisor are protective rights			
Franchisor's right do not give it ability to direct the relevant activities of franchisee	Other parties have current ability to direct the relevant activities of the franchisee	Franchisor's rights do not affect the rights of others to take decisions about relevant activities	Franchisee operates the business for its own account

Note: Control over fundamental decisions as the legal form of the franchisee and its funding structure may be determined by parties other than the franchisor and may significantly affect the returns of the franchisee. The lower the level of financial support provided by the franchisor and the lower the franchisor's exposure to variability of returns from the franchisee the more likely it is that the franchisor has only protective rights.

Illustration 8: Protective rights of a franchisor

ABC Ltd. is a manufacturer of branded garments and is the owner of Brand X. PQR Ltd. has entered into a franchise agreement with ABC Ltd. to allow PQR Ltd. to set up a retail outlet to sell the products of Brand X.

As per the agreement, PQR Ltd. will set up the retail outlet from its own funds, decide the capital structure of the entity, hire employees and their remuneration, select vendors for acquiring capital items, etc. However, ABC Ltd. will give certain operating guidelines like the interior of the retail outlet, uniform of the employees and other such guidelines to protect the brand name of ABC Ltd.

Whether the rights held by ABC Ltd. protective or substantive?

Solution:

The activities that most significantly affect the returns of PQR Ltd. are the funding and capital structure of PQR Ltd., hiring of employees and their remuneration, vendors for capital items, etc. which are exercisable by PQR Ltd. Further, the retail outlet is being set up by PQR Ltd. without

any financial support from ABC Ltd. The rights available with ABC Ltd. are to protect the brand name of ABC Ltd. and such rights do not affect the ability of PQR Ltd. to take decisions about relevant activities. Hence, the rights held by ABC Ltd. are protective rights.

3.3.1.3 Voting rights

Generally, an investor gets power over an investee by way of voting rights that allow it to direct the relevant activities.

However, there can be situations where voting rights (even if the investor holds majority of them) do not give investor power over the investee. This can be in the following situations:

- Voting rights are not substantive (as discussed above).
- If another entity has existing rights that provide that entity with the right to direct the relevant activities and that entity is not an agent of the investor, the investor does not have power over the investee

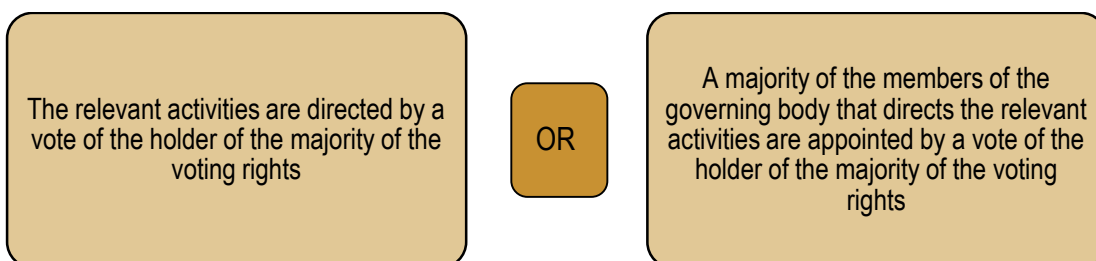
Even if the voting rights do not give power to an investor, there can be other rights which would give an entity power over the investee. In this section we will discuss various scenarios of power through voting rights and power other than through voting rights.

3.3.1.3.1 Power through voting rights

In the most straightforward cases, the investor that holds a majority of voting rights has power over an investee. However, there can be certain cases where an investor can have power even if it holds less than a majority of the voting rights of an investee.

A. Power with a majority of the voting rights

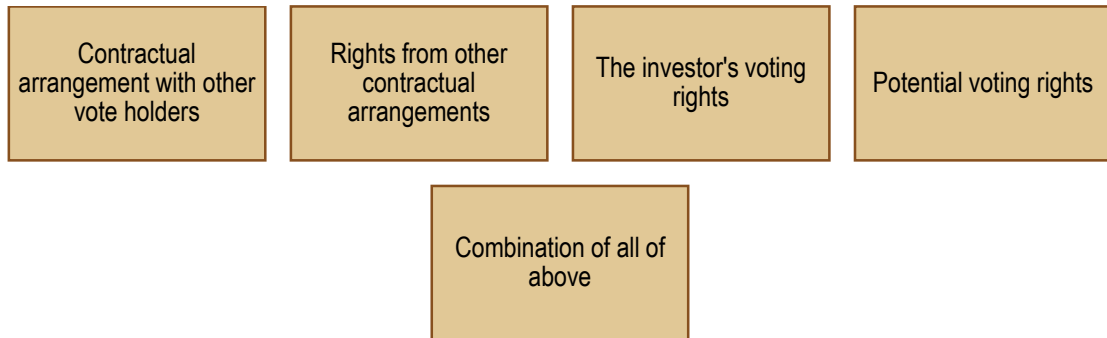
An investor that holds more than half of the voting rights of an investee has power in the following situations:



For example, in case of a company where the decisions related to relevant activities are taken by Board of Directors of the company and the Board members are appointed by shareholder holding majority of the voting rights. Then the shareholder holding majority of the voting rights has power over the company.

B. Power without a majority of voting rights

There can be certain cases where an investor can have power even if it holds less than a majority of the voting rights of an investee. Following are the examples of power without majority voting rights:



Contractual arrangement with other vote holders

An investor, who is not holding voting rights that are sufficient to give it power over the investee, may enter into a contract with other vote holders to give the investor rights to exercise voting rights which are **sufficient to have power over the investee**. In such case, the investor would direct the other vote holders on how they should vote whereby the investor gets power to direct the decision related to relevant activities.

Rights from other contractual arrangements

Apart from holding voting rights, an investor might be having decisions-making rights related to relevant activities of the investee pursuant to a contractual arrangement. Such **contractual rights in combination with voting rights** may give investor power to direct the relevant activities like manufacturing process of the investee or other operating and financing activities of the investee.

However, in the absence of any other rights, economic dependence of an investee on the investor (such as relations of a supplier with its main customer) does not lead to the investor having power over the investee.

The investor's voting rights

There may be certain situations where even though an investor is not holding majority of the voting rights, but the voting rights held by it are **sufficient to give it practical ability** to have power over the investee unilaterally. Generally, this is termed as de-facto control.

In assessing the sufficiency of the voting rights of an investor, one should consider the **size of the investor's holding of voting rights** relative to the size and dispersion of holdings of the other vote holders. This is interpreted as follows:

Particulars	Higher number or size	Lower number or size
Number of voting rights held by investor	More likely to have power	Less likely to have power
Size of investor's voting rights relative to voting rights held by other holders	More likely to have power	Less likely to have power
Number of parties required to outvote the investor	More likely to have power	Less likely to have power

Illustration 9: Voting rights of investor are sufficient to give it power

An investor holds 45% of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. Whether the investor holding 45% voting right have power over the investee?

Solution:

On the basis of the absolute size of its holding by the investor and the relative size of the voting rights held by other shareholders, it is more likely that the investor would have power over the investee.

Illustration 10: Voting rights of investor are sufficient to give it power

ABC Ltd. holds 40% of the voting rights of XYZ Ltd. The remaining voting rights are held by 6 other shareholders, each individually holding 10% each. Whether the investor holding 40% voting right have power over the investee?

Solution:

In this case, it is less likely that ABC Ltd. will have power over XYZ Ltd. since the size of the number of shareholders required to outvote ABC Ltd. is not so high. Additional facts and circumstances should also be considered to determine whether ABC Ltd. has power or not.

Apart from the size of the investor's voting rights, one should also consider the i) potential voting rights held by investor or other vote holders or parties (discussed subsequently in this section) and ii) rights arising from other contractual arrangements (already discussed above) to determine whether the investor's voting rights are sufficient to give it power over the investee.

Ind AS 110 provides that when the decisions related to relevant activities of an investee are taken by **majority vote holders** and the investor holds sufficiently more voting rights compared to other vote holders and the other shareholdings are widely dispersed then it may be clear from the above

factors i.e. i) size of the investor's voting rights, ii) potential voting rights and iii) other contractual arrangements that investor has power over the investee. In such case, there is no need to consider other factors to evaluate who has power over the investee.

- For examples, in the illustration 9 discussed above, the investor holding 45% of voting rights may, on the basis of the absolute size of its holding and the relative size of the other shareholdings, conclude it has power over the investee without the need to consider any other evidence of power.
- However, in illustration 10 above, the absolute size of the ABC Ltd.'s holding and the relative size of the other shareholdings alone are not conclusive in determining whether ABC Ltd. has power over the investee and hence additional facts and circumstances need to be considered.

When it is not clear from the three factors of sufficiency of voting rights of an investor discussed above, the investor should consider additional facts and circumstances such as the **voting patterns at previous shareholders' meetings** to determine whether investor has power over the investee.

Illustration 11: Voting patterns at previous shareholders' meetings

An investor holds 35% of the voting rights of an investee. Three other shareholders each hold 5% of the voting rights of the investee. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders' meetings — 75% of the voting rights of the investee have been cast at recent relevant shareholders' meetings.

Whether the investor's voting rights are sufficient to give it power to direct the relevant activities of the investee?

Solution:

In this case, the active participation of the other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

Ind AS 110 provides that if it is not clear from the above factors of sufficiency of voting rights of an investor that investor has power then the investor does not control the investee.

Potential voting rights

Potential voting rights are rights to obtain voting rights of an investee, such as those arising from **convertible instruments or options or forward contracts**. Those potential voting rights are considered only if the rights are substantive as per the guidance discussed earlier.

When considering potential voting rights, an investor shall consider the purpose and design of the instrument giving those rights as well as any other benefits that the investor would get from the exercise of those rights.

Potential voting rights are to be considered in combination with voting or other decisions-making rights that the investor might have to assess whether investor has power or not.

Illustration 12: Potential voting rights

Investor A and two other investors each hold a third of the voting rights of an investee. The investee's business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price. The conversion rights are substantive. If the debt were converted, investor A would hold 60% of the voting rights of the investee. Investor A would benefit from realising synergies if the debt instruments were converted into ordinary shares. Whether investor A has power over the investee?

Solution:

Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities.

3.3.1.3.2 Power other than through voting rights

When voting rights cannot have a significant effect on an investee's returns, such as when voting rights relate to administrative tasks only the investor shall consider following factors to determine whether it has power over the investee:

- Purpose and design of the investee
- Contractual arrangements
- Special relation between investor and investee

Purpose and design of the investee

Evaluation of purpose and design of the investee helps in:

- identification of relevant activities of the investee,
- how decisions about the relevant activities are made,
- who has the current ability to direct those activities, and
- who receives returns from those activities.

In assessing the purpose and design of an investee, an investor shall consider its **involvement and decisions made at the time of design of the investee** and evaluate whether such involvement provide the investor with rights that are sufficient to give it power. Being involved in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee.

Illustration 13: Purpose and design of the investee

PQR Ltd. has entered into a contract with a state government to construct a power plant and distribute the electricity generated from the plant to the households of the state. For this, PQR Ltd. has set up a new entity XYZ Ltd. PQR Ltd. was involved in the design of XYZ Ltd. The decisions related to the relevant activities of XYZ Ltd. i.e. how much electricity to generate or the price at which units of electricity to be sold to customers, etc. are not determined by the voting rights. Whether PQR Ltd. has power over XYZ Ltd.?

Solution:

PQR Ltd. was involved in the design of XYZ Ltd. Accordingly, its involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee. However, being involved in the design of XYZ Ltd. alone is not sufficient to give PQR Ltd. control over XYZ Ltd. and hence other facts and circumstances, such as other contractual arrangements, should also be considered.

Contractual arrangements

An investor shall consider contractual arrangements such as call rights, put rights and liquidation rights that give it explicit or implicit decision-making rights that are closely related to the relevant activities of the investee even though they may occur outside the legal boundaries of the investee.

For some investees, decisions about relevant activities are required to be taken only when particular circumstances arise or events occur. The investee may be designed so that the direction of its activities and its returns are predetermined unless and until those particular circumstances arise or events occur. In this case, only those decisions that are required to be taken when those circumstances or events occur would significantly affect its returns and thus be relevant activities. However, it is not necessary for those circumstance or events to actually occur to establish that investor has power over the investee. The fact that the investor has rights to take those decisions whenever required is sufficient to establish power.

Illustration 14: Rights contingent upon future events

An investee's only business activity, as specified in its founding documents, is to purchase receivables and service them on a day-to-day basis for its investors. Following is the relevant fact pattern:

- *The servicing on a day-to-day basis includes the collection and passing on of principal and interest payments as they fall due.*
- *Upon default of a receivable the investee automatically puts the receivable to an investor as agreed separately in an agreement between the investee and the investor.*
- *The only relevant activity is managing the receivables upon default because it is the only activity that can significantly affect the investee's returns.*
- *Managing the receivables before default is not a relevant activity because the activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them on to investors.*

Whether the investor has power over the investee?

Solution:

In this question, the design of the investee ensures that the investor has decision-making power only in case of default of a receivable. The terms of the agreement between investee and investor are integral to the overall transaction and the establishment of the investee. Therefore, the terms of the agreement together with the founding documents of the investee lead to the conclusion that the investor has power over the investee even though the investor takes ownership of the receivables only upon default and manages the defaulted receivables outside the legal boundaries of the investee.

An investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to variability of returns and thus increase the incentive for the investor to obtain rights sufficient to give it power. Therefore, a commitment to ensure that an investee operates as designed may be an indicator that the investor has power, but does not, by itself, give an investor power, nor does it prevent another party from having power.

Illustration 15: Commitment to ensure that an investee operates as designed

A Ltd. is a manufacturer of pharmaceutical products. A Ltd. has invested in share capital of B Ltd. which is a manufacturer of packing material for pharmaceutical products. A Ltd.'s requirements of packing materials for its products are entirely supplied by B Ltd. A Ltd. is not purchasing the packing materials from any other vendors because the materials supplied by other vendors are of inferior quality. Whether A Ltd. has power over B Ltd.?

Solution:

A Ltd. would be the most affected by the operations of B Ltd. since it is dependent on B Ltd. for the supply of packing materials. Therefore A Ltd. would be committed to ensure that B Ltd. operates as designed. This can be an indicator of A Ltd. having power over B Ltd. But it has to consider other facts and circumstances as well to conclude whether it control B Ltd. or not.

Special relation between investor and investee

Ind AS 110 recognises that the control assessment process described above will not always yield a clear conclusion. To assist in reaching a conclusion in marginal situations, the Standard includes guidance on:

- Evidence of possible power
- Indicators of possible power
- Incentives to obtain power

In some circumstances it may be difficult to determine whether an investor's rights are sufficient to give it power over an investee. In such cases, paragraph B18 of Ind AS 110 provides guidance to enable the assessment of power whereby the investor shall consider **evidence** of whether it has the **practical ability to direct** the relevant activities unilaterally. Following are some of the examples of such evidences:

Evidence	Illustration
The investor can appoint or approve the investee's key management personnel who can direct the relevant activities	An investor holds 40% of the voting rights of an investor. However, the investor has right to appoint majority of the board members of investee and the decisions of relevant activities of investee are taken by its board.
The investor can direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor	A Ltd. and B Ltd. both holds 50% each of voting rights of an investee and also have right to appoint 2 members each in board of investee. The decision of relevant activities of investee are taken in board meetings by majority members. A Ltd. also has right to appoint a chairman of the board who will have a casting vote in case of a deadlock situation.
The investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights.	X Ltd. has invested in the share capital of P Ltd. Apart from A Ltd. there are 4 other investors in P Ltd. Each investor has right to appoint one member on the board of P Ltd. who will have right to direct the relevant activities of P Ltd. Out of the 4 other investors, 2 investors are related parties of X Ltd. and hence X Ltd. can direct them to appoint their representative on the board as per X Ltd.'s choice. Accordingly, X Ltd. can appoint majority of the members of the board of P Ltd.

The investee's key management personnel are related parties of the investor	The chief executive officer of the investee and the chief executive officer of the investor are the same person.
The majority of the members of the investee's governing body are related parties of the investor.	The majority of the board members of the investee are also the board members of the investor.

As per paragraph B19 of Ind AS 110, sometimes there will be **indications** that the investor has a special relationship with the investee, which suggests that the **investor has more than a passive interest in the investee**. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that investor has power over an investee. However, having more than a passive interest in the investee may indicate that the investor has other related rights sufficient to give it power over an investee. For example, the following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate power:

Investee's key management personnel who can direct the relevant activities are current or previous employees of the investor

Investee's operations are dependent on the investor such as in following situations:

- Dependence to fund a significant portion of its operations.
- Guarantee a significant portion of the investee's obligations.
- Dependence for critical services, technology, supplies or raw materials.
- Assets such as licences or trademarks that are critical to investee's operations are controlled by investor
- Dependence on for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations.

A significant portion of the investee's activities either involve or are conducted on behalf of the investor

Investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights.

- For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.

Further, paragraph B20 of Ind AS 110 provides that the greater an investor's exposure, or rights, to variability of returns from its involvement with an investee, the greater is the **incentive** for the investor to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of returns is an indicator that the investor may have power. However, the extent of the investor's exposure does not, in itself, determine whether an investor has power over the investee.

When the factors set out in paragraph B18 and the indicators set out in paragraphs B19 and B20 of Ind AS 110 are considered together with an investor's rights, greater weight shall be given to the evidence of power described in paragraph B18.

3.3.2 Exposure, or rights, to variable returns from an investee

When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to 'variable returns' from its involvement with the investee.

Variable returns are returns that are not fixed and have the **potential to vary as a result of the performance of an investee**. Variable returns can be only positive, only negative or both positive and negative. It should be noted that the term used is 'returns' and not 'benefits' which are often interpreted as implying only positive returns.

An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the **substance of the arrangement** and regardless of the legal form of the returns.

- For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of control evaluation because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (i.e. how variable those returns are) depends on the credit risk of the bond.
- Similarly, fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee.
- However, a non-refundable income received from the investee which is not impacted by the credit risk or performance of the investee can be considered as a fixed return.

It must also be noted that the term 'returns' includes within its scope both (a) direct returns (which are mostly financial returns), as well as (b) synergistic returns, which are more indirect.

Following are some of the examples of variable returns:

Variable returns from an investee		
Dividends, other distributions of economic benefits from an investee (eg interest from debt securities) Changes in the value of the investor's investment in that investee.	- Remuneration for servicing an investee's assets or liabilities - Fees and exposure to loss from providing credit or liquidity support - Residual interests in the investee's assets and liabilities on liquidation - Tax benefits - Access to future liquidity	Returns that are not available to other interest holders For example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other

Exposure to variable returns is not in itself enough to conclude the assessment of control. An investor should have power over the investee and the ability to use its power to affect the amount of the investor's returns from its involvement with the investee. For example, it is common for a lender to have an exposure to variable returns from a borrower through interest payments that it receives from the borrower, that are subject to credit risk. However, the lender would not control the borrower if it does not have the ability to affect those interest payments (which is frequently the case).

Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, holders of non-controlling interests can share in the profits or distributions of an investee.

Reputational risk

During the financial crisis, some financial institutions provided funding or other support to securitisation or investment vehicles because they established or promoted those vehicles. Rather than allowing them to fail and facing a loss of reputation, the financial institutions stepped in, and in some cases took control of the vehicles. Having reputational risk in isolation is not an appropriate basis for consolidation. The term 'reputational risk' relates to the risk that failure of an investee would damage an investee's reputation and, therefore, that of an investor or sponsor, compelling the investor or sponsor to provide support to an investee in order to protect its reputation, even though the investor or sponsor has no legal or contractual requirement to do so.

Reputational risk is part of an investor's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. Therefore, when assessing control, reputational risk is a factor to consider along with other facts and circumstances. It is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor power over an investee.

3.3.3 Link between power and returns

An investor controls an investee if the investor not only has **power** over the investee and **exposure or rights to variable returns** from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.

Thus, an investor with decision-making rights shall **determine whether it is a principal or an agent**. An investor shall also determine whether another entity with decision-making rights is acting as an agent for the investor. An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)). An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

An investor may delegate its decision-making authority to an agent on some specific issues or on all relevant activities. When assessing whether it controls an investee, the investor shall treat the decision-making rights delegated to its agent as held by the investor directly.

A decision maker shall consider the overall **relationship between itself, the investee being managed and other parties involved** with the investee, in particular all the factors below, in determining whether it is an agent:

The scope of the decision-making authority	Rights held by other parties	Remuneration from the investee	Exposure to variable returns from other interests in the investee

Different weightings shall be applied to each of the factors on the basis of particular facts and circumstances.

The scope of the decision-making authority

The scope of a decision maker's decision-making authority is evaluated by considering:

- the activities that are permitted according to the decision-making agreement(s) and specified by law, and
- the discretion that the decision maker has when making decisions about those activities.

A decision maker shall consider the purpose and design of the investee, the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved and the level of involvement the decision maker had in the design of an investee. For example, if a decision maker is significantly involved in the design of the investee (including in determining the scope of decision-making authority), that involvement may indicate that the decision maker had the opportunity and incentive to obtain rights that result in the decision maker having the ability to direct the relevant activities.

Rights held by other parties

Substantive removal or other rights may indicate that the decision maker is an agent.

Removal rights

Removal rights are rights to deprive the decision-maker of its decision-making authority.

The removal rights held by other should be considered as follows:

Single party holds substantive removal rights and can remove the decision maker **without cause**, this, in isolation, is **sufficient to conclude** that the decision maker is an **agent**.

If **more than one party holds such rights** (and no individual party can remove the decision maker without the agreement of other parties) those rights are **not, in isolation, conclusive** in determining that a decision maker is an agent.

The **greater the number of parties** required to act together to exercise removal rights and the **greater the magnitude** of, and variability associated with, the decision maker's **other economic interests** (ie remuneration and other interests), the **less the weighting** that shall be placed on removal rights.

Other substantive rights

If other parties hold substantive rights that can restrict the decision maker from exercising its discretion shall be considered in similar manner to removal right when evaluating whether the decision maker is an agent.

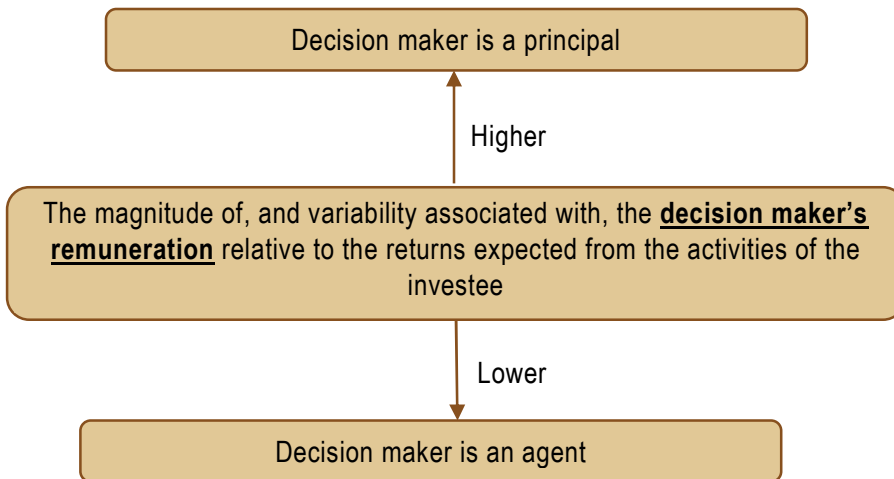
For example, a decision maker that is required to obtain approval from a small number of other parties for its actions is generally an agent.

Consideration of the rights held by other parties shall include an assessment of any rights exercisable by an investee's board of directors (or other governing body) and their effect on the decision-making authority.

For example, if board of directors (which is appointed by other investors) of an investee has right to remove the decision maker without cause than the decision maker is an agent.

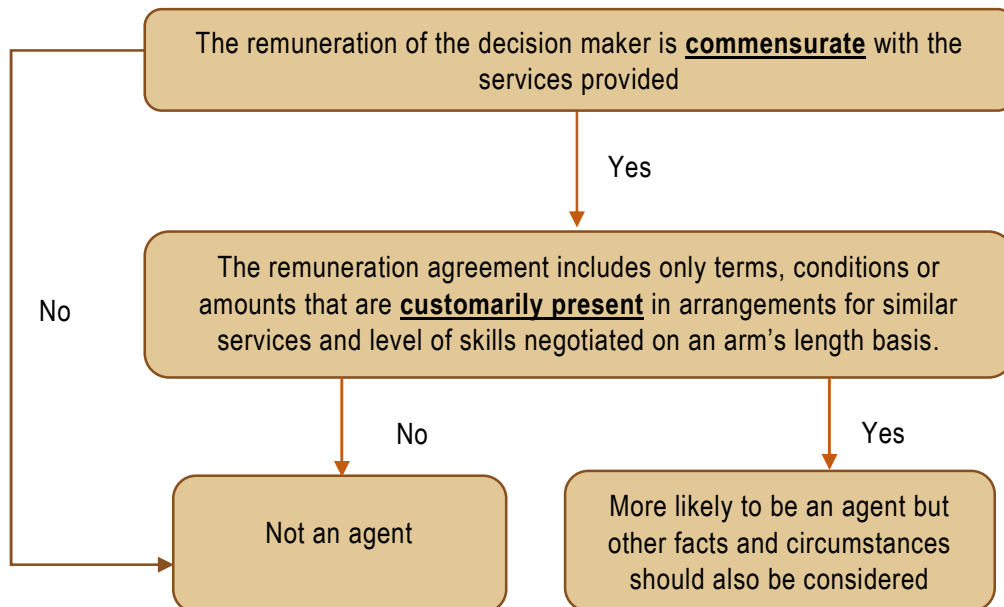
Remuneration from the investee

The relationship between the remuneration of a decision maker and it being an agent is explained below:



For example, if a variation in investee's returns by 1% causes variation in decision maker's remuneration from investee by less than 1% then the decision maker can be an agent. However, if a variation in investee's returns by 1% causes variation in decision maker's remuneration from investee by more than 1% then the decision maker can be a principal.

Further, in determining whether it is a principal or an agent the decision maker shall also consider following conditions:

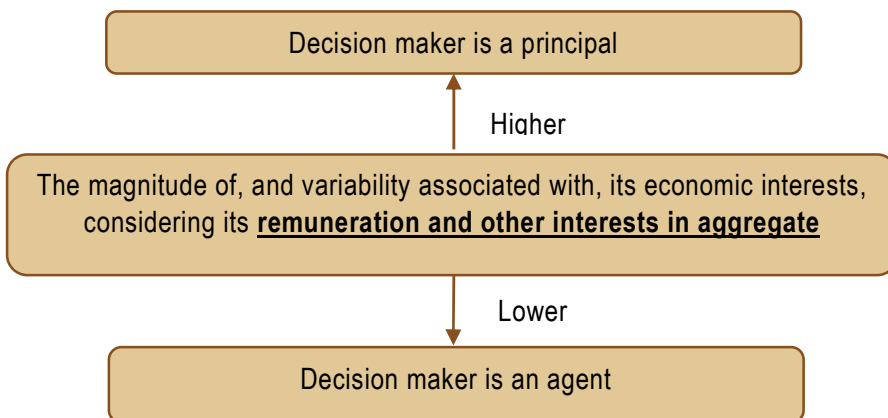


Exposure to variable returns from other interests in the investee

A decision maker that holds other interests in an investee (like investments in the investee or provides guarantees with respect to the performance of the investee), shall consider its exposure

to variability of returns from those interests in assessing whether it is an agent. **Holding other interests in an investee indicates that the decision maker may be a principal.**

In evaluating the exposure to variability of returns, the decision maker shall consider the magnitude of variability as follows:



It is to be noted that here the decision maker needs to consider the remuneration and other interests in aggregate. Hence, even though in case the decision maker had concluded in the initial assessment about remuneration that it is an agent, it needs to again consider remuneration in the assessment of exposure to variable returns.

Apart from the magnitude of exposure to variable returns, decision maker shall also consider whether its exposure to **variability of returns is different from that of the other investors**. If yes, then whether this might influence its actions. **For example**, this might be the case when a decision maker holds subordinated interests in, or provides other forms of credit enhancement to, an investee.

The decision maker shall evaluate its **exposure relative to the total variability** of returns of the investee. This evaluation is made primarily on the basis of returns expected from the activities of the investee but **shall not ignore** the decision maker's **maximum exposure to variability** of returns of the investee through other interests that the decision maker holds.

For example, if a variation in investee's returns by 1% causes variation in decision maker's returns from investee by less than 1%. However, a variation in investee's returns by ₹ 100 causes variation in decision maker's returns from investee by ₹ 150 because of significant variation in the market price of the equity shares of the investee.

Illustration 16: Link between power and returns

A decision maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to investors as an investment in a

diversified portfolio of equity securities of publicly traded entities. Following is the relevant fact pattern related to fund manager:

- *Within the defined parameters, the fund manager has discretion about the assets in which to invest.*
- *The fund manager has made a 10% pro rata investment in the fund and receives a market-based fee for its services equal to 1% of the net asset value of the fund.*
- *The fees are commensurate with the services provided.*
- *The fund manager does not have any obligation to fund losses beyond its 10% investment.*

The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that would affect the decision-making authority of the fund manager but can redeem their interests within particular limits set by the fund.

Whether the fund manager controls the fund?

Solution:

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund — the investors do not hold substantive rights that could affect the fund manager's decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a pro rata investment in the fund. The remuneration and its investment expose the fund manager to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

In this case, consideration of the fund manager's exposure to variability of returns from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Illustration 17: Link between power and returns

A decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided.

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager

is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal.

The above fact pattern and analysis applies to various scenarios described below. Each scenario is considered in isolation. Determine whether the fund manager control the fund?

Scenario A

The fund manager also has a 2% investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2% investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Scenario B

The fund manager has a more substantial pro rata investment in the fund but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Scenario C

The fund manager has a 20% pro rata investment in the fund but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Solution:

Scenario A

The fund manager's 2% investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. In this example, although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Scenario B

In this scenario, the other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund

manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal.

For example, having considered its remuneration and the other factors, the fund manager might consider a 20% investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e. if the remuneration or other factors are different), control may arise when the level of investment is different.

Scenario C

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20% investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager — the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In this scenario, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Illustration 18: Link between power and returns

An investee is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual returns of the investee.

The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio.

On formation, the equity instruments represent 10% of the value of the assets purchased. A decision maker (the asset manager) manages the active asset portfolio by making investment decisions within the parameters set out in the investee's prospectus. For those services, the asset manager receives a market-based fixed fee (i.e. 1% of assets under management) and performance-related fees (i.e. 10% of profits) if the investee's profits exceed a specified level.

The fees are commensurate with the services provided. The asset manager holds 35% of the equity in the investee. The remaining 65% of the equity, and all the debt instruments, are held by a large number of widely dispersed unrelated third-party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

Does the asset manager control the investee?

Solution:

The asset manager is paid fixed and performance-related fees that are commensurate with the services provided. The remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund. The asset manager has exposure to variability of returns from the activities of the fund because it holds 35% of the equity and from its remuneration.

Although operating within the parameters set out in the investee's prospectus, the asset manager has the current ability to make investment decisions that significantly affect the investee's returns -the removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the fund from its equity interest, which is subordinate to the debt instruments. Holding 35% of the equity creates subordinated exposure to losses and rights to returns of the investee, which are of such significance that it indicates that the asset manager is a principal. Thus, the asset manager concludes that it controls the investee.

Following table summarises the above illustrations on link between power and returns by highlighting each of the factors for evaluating link between power and returns:

Illustration	Scope of the decision-making authority	Removal rights held by others	Remuneration from the investee	Variable returns from other interests	Conclusion
16	Narrowly defined	No such rights	1% of the net asset value of the fund	10% investment in the fund	Agent
17 (A)	Extensive decision-making authority	Removal for cause by simple majority	1% of assets under management and 20% of all the fund's	2% investment in the fund	Agent
17 (B)				20% investment in the fund	Principal

17 (C)		Removal without cause by board	profits if a specified profit level is achieved	20% investment in the fund	Agent
18	Decisions within the parameters set out in the investee's prospectus	Removal without cause by simple majority of widely dispersed investors	1% of assets under management and 10% of profits if the profits exceed a specified level	35% of equity in the investee	Principal

Illustration 19: Link between power and returns

A decision maker (the sponsor) sponsors a fund, which issues short-term debt instruments to unrelated third-party investors. The transaction was marketed to potential investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. Various transferors sell high quality medium-term asset portfolios to the fund. Each transferor services the portfolio of assets that it sells to the fund and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralisation of the assets transferred to the fund. The sponsor establishes the terms of the fund and manages the operations of the fund for a market-based fee. The fee is commensurate with the services provided. The sponsor approves the sellers permitted to sell to the fund, approves the assets to be purchased by the fund and makes decisions about the funding of the fund. The sponsor must act in the best interests of all investors.

The sponsor is entitled to any residual return of the fund and also provides credit enhancement and liquidity facilities to the fund. The credit enhancement provided by the sponsor absorbs losses of up to 5% of all of the fund's assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor. Whether the sponsor has control over the fund?

Solution:

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of returns from the activities of the fund because of its rights to any residual returns of the fund and the provision of credit enhancement and liquidity facilities (i.e. the fund is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the fund, the sponsor has extensive decision-

making authority that gives it the current ability to direct the activities that most significantly affect the fund's returns (i.e. the sponsor established the terms of the fund, has the right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the fund (for which new investment must be found on a regular basis)). The right to residual returns of the fund and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of returns from the activities of the fund that is different from that of the other investors. Accordingly, that exposure indicates that the sponsor is a principal and thus the sponsor concludes that it controls the fund. The sponsor's obligation to act in the best interest of all investors does not prevent the sponsor from being a principal.



3.4 RELATIONSHIP WITH OTHER PARTIES

When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor's behalf i.e. they are '**de facto agents**' of the investor. The determination of whether other parties are acting as de facto agents requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor.

A de facto agent relationship **does not require a contractual arrangement** between the investor and the de facto agent.

A party is a de facto agent when the investor has, or those that direct the activities of the investor have, the **ability to direct that party** to act on the investor's behalf.

An investor shall consider its de facto agent's decision-making rights and its indirect exposure, or rights, to variable returns through the de facto agent **together with its own** when assessing control of an investee.

Further, having a de facto agent does not necessarily mean that the investor controls the investee. The investor still needs to perform the control evaluation as per the detailed guidance discussed above.

When assessing control, an investor would consider its de facto agent's decision-making rights and exposure (or rights) to variable returns together with its own as if the rights were held by the investor directly.

Example 5

An investor holds 30% voting powers in an investee. One of the fellow subsidiaries of the investor also holds 30% voting powers of the investee. If the investor believes that it has the ability to direct the fellow subsidiary to act on behalf of the investor while exercising its voting rights, then the investor may conclude that the fellow subsidiary is a de facto agent of the investor. Accordingly, investor would be able to control the investee with ability to use 60% of the voting

rights. However, in case the fellow subsidiary holds just 10% voting rights of the investee then the investor would not be able to control the investee with just 40% voting rights (30% held by investor itself and 10% owned by de facto agent).

Following are the examples of other parties that, by the nature of their relationship, might act as de facto agents for the investor:

Investor's related parties

A party that received its interest in the investee as a contribution or loan from the investor

A party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except in case investor and other party have right of prior approval and rights are based on mutually agreed terms)

A party that cannot finance its operations without subordinated financial support from the investor

Investee for which the majority of the members of board or similar body are the same as those of the investor

A party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

Parties mentioned above are not necessarily de facto agents of the investor. However, the investor needs to evaluate whether the parties following in the above categories are the de facto agents or not.



3.5 CONTROL OF SPECIFIED ASSETS

An investor shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity. A deemed separate entity is often called a 'silo'.

An investor shall treat a portion of an investee as a deemed separate entity if and only if the following condition is satisfied:

Determination of whether a portion of an investee is a deemed separate entity

Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee.	Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets.	In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

Thus, in substance, all the assets, liabilities and equity of that deemed separate entity are **ring-fenced** from the overall investee.

For example, an investee is a mutual fund and under the investee there are multiple sub-funds established with different investment objectives like debt-oriented funds, equity-oriented funds, etc. In such case, an assessment should be made as to whether the sub-funds are deemed separate entities as per the conditions mentioned above.

When the conditions mentioned above are satisfied, an investor shall assess **whether it controls the silo** by applying the guidance of control evaluation i.e. whether the investor has power over the silo, exposure or rights to variable returns from involvement with silo and whether it can use that power to affect the returns of the silo.

If the investor controls the silo, the investor shall consolidate that silo. In that case, other parties exclude that silo when assessing control of, and in consolidating, the investee.

For example, continuing with the above example on identification of a silo, if one of the sub-funds is treated as a silo then the investor that controls that silo will consolidate that sub-fund. Other parties who control other sub-funds will exclude the sub-fund controlled by the investor in their control evaluation and consolidation.



3.6 CONTINUOUS ASSESSMENT

An investor shall reassess whether it controls an investee **if facts and circumstances indicate that there are changes** to one or more of the three elements of control i.e. power, exposure or rights to variable returns and link between power and variable returns.

An investor should reassess the control over an investee in following situations:

Situation	Example
A change in how power over an investee can be exercised	Changes to decision-making rights whereby the relevant activities are no longer directed through voting rights, but instead other agreements, like contracts, give another party or parties power over the investee
An event can cause an investor to gain or lose power over an investee without the investor being involved in that event	An investor can gain power over an investee because decision-making rights held by another party or parties that previously prevented the investor from controlling an investee have lapsed
Changes affecting exposure, or rights, to variable returns from involvement with an investee	An investor that has power over an investee can lose control of an investee if the investor ceases to be entitled to receive variable returns or to be exposed to obligations (e.g. if a contract to receive performance-related fees is terminated).
Assessment to act as an agent or principal has changed. Changes in the overall relationship between the investor and other parties can mean that an investor no longer acts as an agent, even though it has previously acted as an agent, and vice versa.	If changes to the rights of the investor, or of other parties, occur, the investor shall reconsider its status as a principal or an agent.

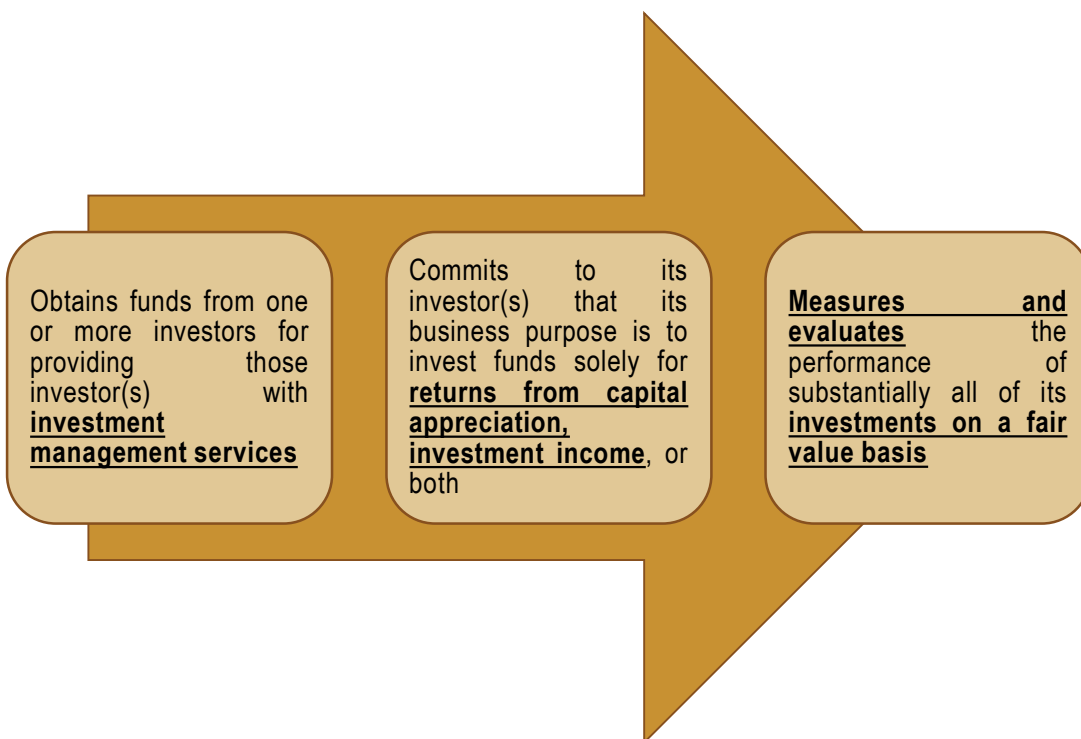
An investor's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (e.g. a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control or changes the overall relationship between a principal and an agent.



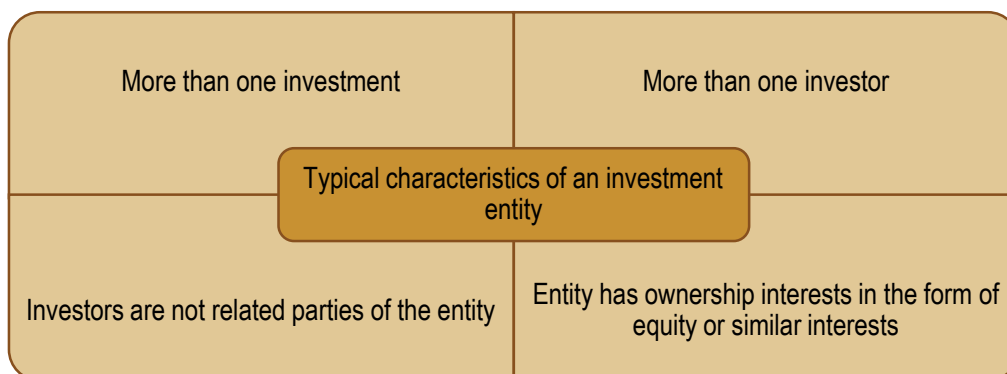
3.7 INVESTMENT ENTITIES

3.7.1 Determining whether an entity is an investment entity

A parent shall determine whether it is an investment entity. An entity is an investment entity if it fulfils **all the following conditions**:



In assessing whether an entity meets the definition of investment entity as above, the entity shall consider whether it has the following typical characteristics of an investment entity:



The absence of one or more of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity but indicates that additional judgement is required in determining whether the entity is an investment entity.

If facts and circumstances indicate that there are **changes** to one or more of the three elements that make up the definition of an investment entity or the typical characteristics of an investment entity, a parent shall **reassess whether it is an investment entity**.

Following is the detailed discussion on two of the three elements of the definition of an investment entity (business purpose and fair value measurement) and the typical characteristics of an investment entity. As regards the first element, i.e. provision of investment management services, that essentially differentiates an investment entity from other entities.

3.7.1.1 Business Purpose

The definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both.

Documents or other evidence that indicate the entity's investment objectives are include:

- offering memorandum of the entity
- publications distributed by the entity and other corporate
- partnership documents of the entity
- manner in which the entity presents itself to other parties (such as potential investors or potential investees)

For example, an entity may present its business as providing medium-term investment for capital appreciation. In contrast, an entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees has a business purpose that is inconsistent with the business purpose of an investment entity, because the entity will earn returns from the development, production or marketing activity as well as from its investments.

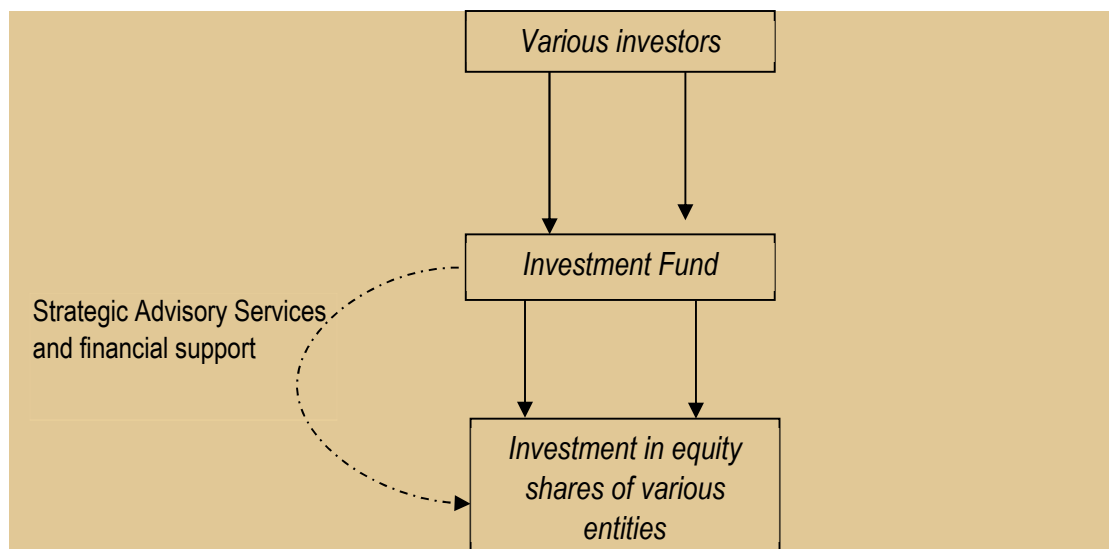
Apart from the business purpose of investing for capital appreciation and investment income, an **investment entity may provide investment-related services** (e.g. investment advisory services, investment management, investment support and administrative services), to third parties as well as to its investors, even if those activities are substantial to the entity, subject to the entity continuing to meet the definition of an investment entity.

An investment entity may also participate in the following **investment-related activities** if these activities are **undertaken to maximise the investment return** (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity:

- a) providing management services and strategic advice to an investee; and
- b) providing financial support to an investee, such as a loan, capital commitment or guarantee.

Illustration 20: Business purpose of an investment entity

An asset manager has set up an investment fund for the purpose of acquiring capital contributions from various investors (by issuing them units in the fund) and investing those contributions in the equity share capital of various entities for the purpose of earning capital appreciation on those investments. Following is the existing structure of the fund.



Apart from the investments in various entities, the investment fund also provides its investee the strategic advisory services so that it can result in increase in the capital appreciation from investments in those investees. It also provides its investees financial support in the form of loan to provide them with funds for acquiring capital assets. The investment fund does not hold such investments for a period longer than 5 years. The investment fund measures and evaluate the performance of the investments on fair value basis.

Whether the investment fund can be treated as an investment entity?

Solution:

Out of the three elements of the definition of an investment entity, the investment fund fulfils the two elements very clearly i.e. it obtains fund from more than one investor for providing investment management services and measures and evaluates its investments on fair value basis.

The typical characteristics of an investment entity are also present in the structure of the investment fund i.e. more than one investment, more than one investor, investors are unrelated and investment fund issues units in the fund to the investors.

With respect to the business objective of the investment fund, the objective is to earn capital appreciation from its investments. The strategic advisory services and financial support provided to investees are extended with the intention of earning higher capital appreciation from the investees. However, judgement should to be applied that these do not represent substantial business activity or a separate substantial source of income for the investment fund. If the investment fund concludes that these services and financial support to investees are not substantial business activity and substantial source of income for the investment fund, then only the investment fund can be treated as an investment entity.

3.7.1.2 Exit strategies

One feature that differentiates an investment entity from other entities is that an **investment entity does not plan to hold its investments indefinitely**; it holds them for a limited period. Because equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity **shall have an exit strategy** documenting how the entity plans to realise capital appreciation from substantially all of its equity investments and non-financial asset investments.

An investment entity shall also have an exit strategy for any debt instruments that have the potential to be held indefinitely, for example perpetual debt investments. The entity need not document specific exit strategies for each individual investment but shall identify different **potential strategies for different types or portfolios of investments**, including a substantive time frame for exiting the investments. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.

Exit strategies can vary by type of investment.

- **For investments in private equity securities**, examples of exit strategies include an initial public offering, a private placement, a trade sale of a business, distributions (to investors) of ownership interests in investees and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee).
- **For equity investments that are traded in a public market**, examples of exit strategies include selling the investment in a private placement or in a public market.
- **For real estate investments**, an example of an exit strategy includes the sale of the real estate through specialized property dealers or the open market.

An investment entity may have an **investment in another investment entity** that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the **investment entity investor need not have an exit strategy** for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.

Illustration 21: Exit strategies of an investment entity

ABC Ltd. is established with primary objective of investing in the equity shares of various entities across various industries based on the detailed research about each industry and entities within that industry being done by the investment manager of the company.

The investment manager decides the timing as to when the investments should be made considering the current market situation. Sometimes, the investment manager decides to invest the idle funds into short-term to medium-term debt instruments with fixed maturity. The exit strategies are in place for the investments done in equity shares but the same is not there for investments done in debt instruments.

Determine whether the entity fulfils the exit strategy condition of being classified as investment entity?

Solution:

The exit strategies are in place for investments done in equity shares. But not in place for investments done in debt instruments. However, it should be noted that the debt instruments have fixed maturity period and they cannot be held for indefinite period. Hence, there is no need for having exit strategies for such instruments. Accordingly, the exit strategy condition is fulfilled for being classified as investment entity.

3.7.1.3 Earnings from investments

To be an investment entity, an entity must commit to its investors that its business purpose is to invest funds solely for **returns from capital appreciation, investment income**, or both.

An entity is **not an investment entity if** the entity, or another member of the group containing the entity **obtains**, or has the objective of obtaining, **other benefits from the entity's investments** that are not available to other parties unrelated to the investee.

Such other benefits include following:

Acquisition, use, exchange or exploitation of the **processes, assets or technology of an investee**. This would include the entity or another group member having disproportionate, or exclusive, rights to acquire assets, technology, etc. of any investee

Joint arrangements or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services;

Financial guarantees or assets provided by an investee for borrowing arrangements of the entity or another group member (however, an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings)

An **option held by a related party** of the entity **to purchase**, from that entity or another group member, an **ownership interest** in an investee of the entity;

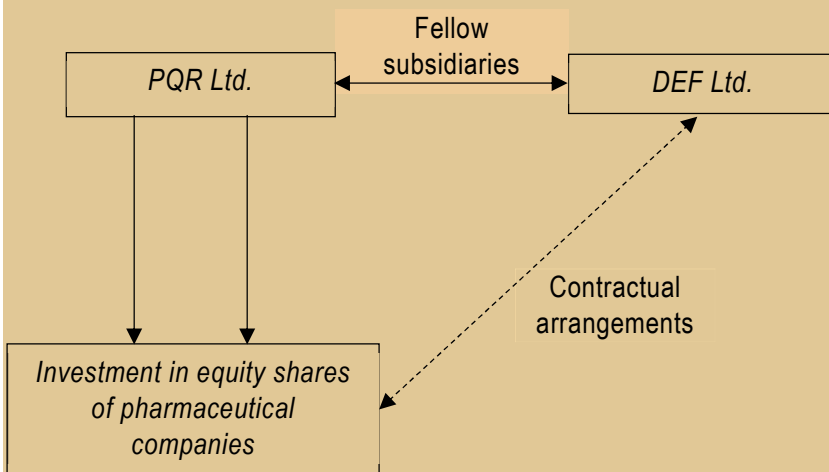
Transactions (except as mentioned in next paragraph) between the entity or another group member and an investee that are

- on terms that are unavailable to unrelated parties; or
- not at fair value; or
- represent a substantial portion of the investee's or the entity's or other group entities' business

An investment entity may have a strategy to invest in more than one investee in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income from those investees. An entity is not disqualified from being classified as an investment entity merely because such investees trade with each other.

Illustration 22: Earnings from investments of an investment entity

PQR Ltd. is established with primary objective of investing in the equity shares of various pharmaceutical companies which are involved in the research and development of medicine for a critical illness. DEF Ltd. is a fellow subsidiary of PQR Ltd. and DEF Ltd. has entered into contractual arrangements with all the investees of PQR Ltd. that in case they are successful in developing the medicine then they will transfer the patent and distribution rights for that medicine to DEF Ltd. at less than market price. This arrangement is explained in following diagram:



Determine whether PQR Ltd. can be classified as investment entity?

Solution:

PQR Ltd. and DEF Ltd. are part of same group. Further, DEF Ltd. have exclusive right to acquire the patent and distributions rights from the investees of PQR Ltd. and that too at less than the market price. Hence, the related party of PQR Ltd. is in position to obtain benefits other than capital appreciation and investment income from the investees that are not available to other parties unrelated to the investee. Accordingly, PQR Ltd. cannot be classified as investment entity.

3.7.1.4 Fair value measurement

An essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis, because **using fair value results in more relevant information** than, for example, consolidating its subsidiaries or

using the equity method for its interests in associates or joint ventures. In order to demonstrate that it meets this element of the definition, an investment entity:

Provides investors with **fair value information and measures substantially all of its investments at fair value** whenever fair value is required or permitted in accordance with Ind ASs

AND

Reports fair value information internally to the entity's key management personnel, who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

In order to meet the requirement of measuring investments at fair value, an investment entity would:

- a) elect the exemption from applying the equity method in Ind AS 28 for its investments in associates and joint ventures (exemptions from applying the equity method is discussed in detail in unit 6); and
- b) measure its financial assets at fair value using the requirements in Ind AS 109.

An investment entity may have some non-investment assets, such as a head office property and related equipment, and may also have financial liabilities. The fair value measurement element of the definition of an investment entity applies to an investment entity's investments. Accordingly, an investment entity **need not measure its non-investment assets or its liabilities at fair value.**

3.7.1.5 More than one investment

An investment entity **typically holds several investments** to diversify its risk and maximise its returns. An entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments.

There may be times when the entity holds a single investment. However, **holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity.** For example, an investment entity may hold only a single investment when the entity:

is in its **start-up period** and has not yet identified suitable investments and, therefore, has not yet executed its investment plan

has **not yet** made other investments to **replace those it has disposed of**

is **established to pool investors' funds** to invest in a single investment when that investment is unobtainable by individual investors (e.g. when the required minimum investment is too high for an individual investor)

is in the process of **liquidation**

3.7.1.6 More than one investor

An investment entity would have **several investors who pool their funds** to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income.

Alternatively, an investment entity may be formed by, or for, a **single investor that represents or supports the interests of a wider group of investors** (e.g. a pension fund, government investment fund or family trust).

There may also be times when the entity temporarily has a single investor. For example, an **investment entity may have only a single investor** when the entity:

- (a) is within its **initial offering period**, which has not expired and the entity is actively identifying suitable investors;
- (b) has not yet **identified suitable investors to replace ownership interests** that have been redeemed; or
- (c) is in the process of **liquidation**

3.7.1.7 Unrelated investors

An investment entity has **several investors that are not related parties** of the entity or other members of the group containing the entity. Having unrelated investors would make it **less likely** that the entity, or other members of the group containing the entity, would **obtain benefits other than capital appreciation or investment income**.

However, an entity may still qualify as an investment entity even though its investors are related to the entity.

For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

3.7.1.8 Ownership interests

An investment entity is typically, but is not required to be, a separate legal entity. Ownership interests in an investment entity are typically in the form of **equity or similar interests** (e.g. partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. However, **having different classes of investors**, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, **does not preclude an entity from being an investment entity**.

Example 6

An entity has issued two types of equity shares to its investors i.e. class A shares and class B shares. Holders of class A shares are entitled to receive 10% of the profits of the entity at the end of each year. After distribution of such amount, the balance amount is distributed proportionately between holders of class A shares and class B shares. Such method of distribution of profits to shareholders would not preclude the entity from being an investment entity if other conditions are satisfied.

In addition, an entity that has significant **ownership interests in the form of debt** that, in accordance with other applicable Ind AS, does not meet the definition of equity, may still qualify as an investment entity, **provided that the debt holders are exposed to variable** returns from changes in the fair value of the entity's net assets.

Example 7

An entity has issued compulsorily convertible bonds with fixed interest payments to the investors. Such bonds are convertible into variable numbers of equity shares and hence classified as financial liability in accordance with Ind AS 32 '*Financial Instruments: Presentation*'. The compulsorily convertible bonds expose the investors to variable returns because after conversion, the investors will have rights in the net assets of the entity which is dependent on the fair value of investments done by the entity.

3.7.2 Exemptions to investment entities

An investment entity **shall**

- **not consolidate its subsidiaries** or apply Ind AS 103 '*Business Combinations*' when it obtains control of another entity; **and**
- **measure an investment in a subsidiary at fair value through profit or loss** in accordance with Ind AS 109.

If an investment entity has a subsidiary **that is not itself an investment entity** and whose main purpose and activities are **providing services related** to the investment entity's **investment activities**, it shall **consolidate that subsidiary** and apply the requirements of Ind AS 103 to the acquisition of any such subsidiary. If the subsidiary that provides the investment-related services or activities is itself an investment entity then the investment entity parent shall measure that subsidiary at fair value through profit or loss.

A **parent of an investment entity shall consolidate** all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity. This is explained in following diagram form:

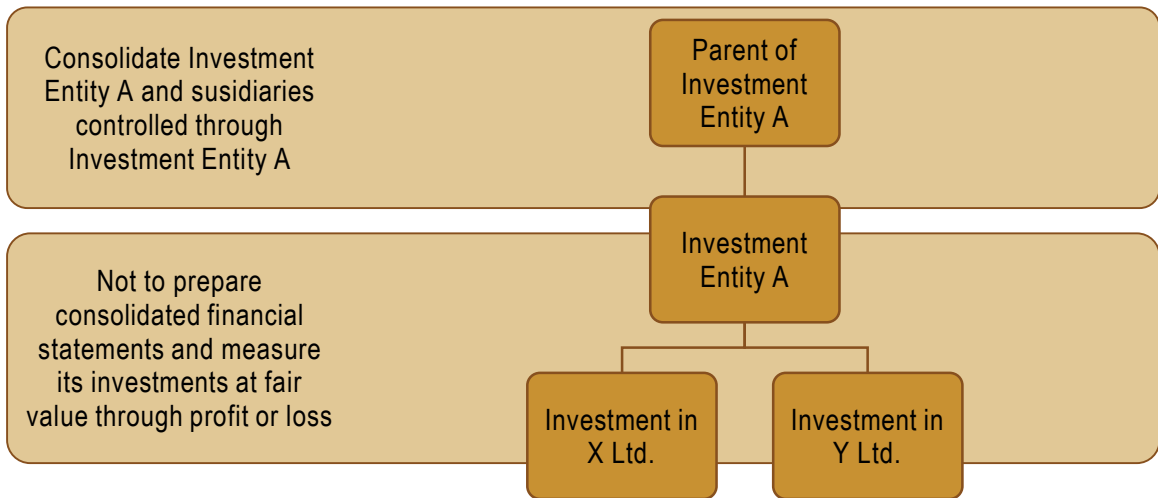


Illustration 23

HTF Ltd. was formed by T Ltd. to invest in technology start-up companies for capital appreciation. T Ltd. holds 70 percent interest in HTF Ltd. and controls HTF Ltd. The other 30 percent ownership interest in HTF Ltd. is owned by 10 unrelated investors. T Ltd. holds options to acquire investments held by HTF Ltd., at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of T Ltd. No plans for exiting the investments have been identified by HTF Ltd. HTF Ltd. is managed by an investment adviser that acts as agent for the investors in HTF Ltd.

Determine whether HTF Ltd. is an investment entity or not.

Solution:

Even though HTF Ltd.'s business purpose is investing for capital appreciation and it provides investment management services to its investors, HTF Ltd. is not an investment entity because of the following arrangements and circumstances:

- (a) T Ltd., the parent of HTF Ltd. holds options to acquire investments in investees held by HTF Ltd. if the assets developed by the investees would benefit the operations of T Ltd. This provides a benefit in addition to capital appreciation or investment income; and
- (b) the investment plans of HTF Ltd. do not include exit strategies for its investments, which are equity investments. The options held by T Ltd. are not controlled by HTF Ltd. and do not constitute an exit strategy.

UNIT 4:

CONSOLIDATION PROCEDURE FOR SUBSIDIARIES



4.1 OVERVIEW

The consolidated financial statement includes following:

- Consolidated balance sheet
- Consolidated statement of profit and loss
- Consolidated statement of changes in equity
- Consolidated cash flow statement
- Consolidated notes to the financial statements

When a company is required to prepare consolidated financial statements, the company shall mutatis mutandis follow the requirements of Division II of Schedule III to the Companies Act, 2013 as applicable to a company in the preparation of balance sheet, statement of changes in equity and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Ind AS. In addition, the company shall disclose additional information as required by Ind AS 27 and Ind AS 112 (Refer Unit 8).



4.2 CONSOLIDATION PROCEDURE FOR SUBSIDIARIES

Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee.

Following are the key concepts relating to preparation of consolidated financial statements:

Calculation of goodwill / capital reserve and determination of non-controlling interest on the date of acquisition of control over a subsidiary

Calculation of goodwill / capital reserve when the interest in subsidiary is acquired on different dates (i.e. step acquisition)

How to account for control obtained over a subsidiary without transfer of consideration?

Requirement to have uniform accounting policies

How the income and expense of a subsidiary should be measured for while consolidating them in the parent's consolidated financial statements?

How the potential voting rights held in subsidiary should be accounted?

How to deal with different reporting periods of parent and subsidiary?

Dividend from subsidiary: How to account for it and its impact on non-controlling interest?

Requirement to eliminate intra-group transaction and elimination of unrealised profit / loss

Allocating share in profit / loss to non-controlling interest and accounting of change in the proportion held by controlling and non-controlling interests

Preparation of consolidated financial statements using all the above principles

How to account for chain-holding under consolidation?

Each of the above concepts are explained in detail below. When a parent loses control over a subsidiary, it will stop consolidating that subsidiary. The principles of accounting in case of loss of control over a subsidiary are discussed in section 4.3 below.

4.2.1 Calculation of goodwill / capital reserve and determination of non-controlling interest on the date of acquisition of control over a subsidiary

The guidance related to calculation of goodwill / capital reserve on acquisition of a subsidiary is provided in **Ind AS 103 'Business Combinations'**. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

Calculation of goodwill

An entity that acquires interest in a subsidiary shall recognise goodwill on the acquisition date. Goodwill is measured as the **excess of (a) over (b)** below:

- a) The aggregate of
 - a. the consideration transferred measured in accordance with Ind AS 103, which generally requires acquisition-date fair value; and
 - b. the amount of any non-controlling interest in the acquiree measured in accordance with Ind AS 103;
 - c. in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree
- b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with Ind AS 103. (Ind AS 103 requires the net assets acquired to be measured at fair value except in case of a common control business combination transaction. Such transaction is explained in more detail in chapter 13).

Calculation of capital reserve

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the amount in b) mentioned above exceeds the aggregate of the amounts specified in a) above. If that excess remains after applying certain requirements of paragraph 36 of Ind AS 103, then the acquirer shall recognise the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve. The gain shall be attributed to the acquirer. In all other cases, the excess of b) over a) above shall be recognised directly in equity as a capital reserve.

Measurement of non-controlling interest

Non-controlling interest is the equity **not attributable, directly or indirectly, to a parent**.

Non-controlling interest in the acquiree are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation.

For each business combination, the acquirer shall **measure at the acquisition date** components of non-controlling interest that give the holder ownership interest in the acquiree at either:

- a) Fair value or
- b) The present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets

Summary of calculation of goodwill / capital reserve

To summarise, following steps are involved in calculation of goodwill / capital reserve:

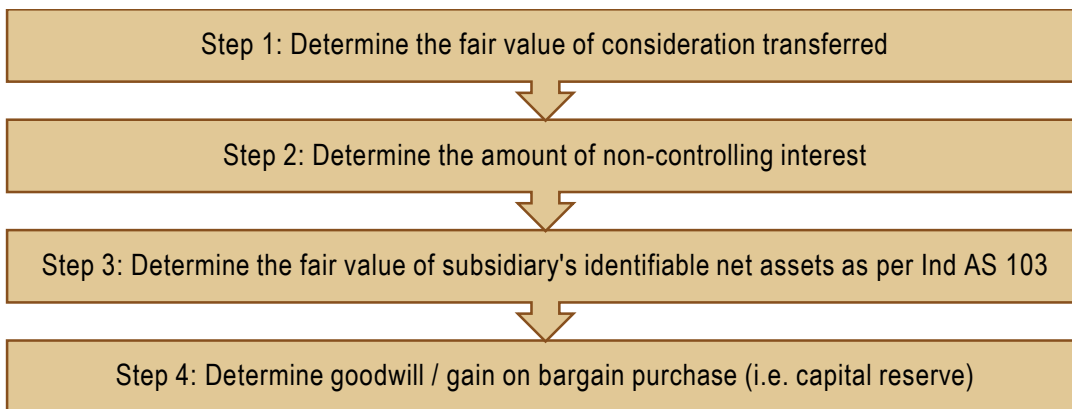


Illustration 1: Determination of goodwill

A Limited acquires 80% of B Limited by paying cash consideration of ₹ 120 crore. The fair value of non-controlling interest on the date of acquisition is ₹ 30 crore. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 130 crore. Determine the value of goodwill and pass the journal entry.

Solution:

The amount of non-controlling interest can be measured as per i) Fair value method or ii) Proportionate share method (i.e. proportionate share in the net identifiable assets of the acquiree). The value of goodwill will be different under both the methods. The goodwill is calculated as per both the methods below:

<u>Fair value method</u>	₹ crore
Fair value of consideration transferred	120
Fair value of non-controlling interest	<u>30</u>
	150
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(130)</u>
Goodwill	<u>20</u>
<u>Proportionate share method</u>	₹ crore
Fair value of consideration transferred	120
Proportional share of non-controlling interest in the net identifiable assets of acquiree (130 x 20%)	<u>26</u>
	<u>146</u>
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(130)</u>
Goodwill	<u>16</u>

Journal Entries

<u>Fair value method</u>		₹ crore	
		Dr.	Cr.
Net identifiable assets	Dr.	130	
Goodwill	Dr.	20	
To Cash			120
To Non-controlling interest			30
<u>Proportionate share method</u>		₹ crore	
		Dr.	Cr.
Net identifiable assets	Dr.	130	
Goodwill	Dr.	16	
To Cash			120
To Non-controlling interest			26

Illustration 2: Determination of goodwill

Ram Ltd. acquires 60% of Raja Ltd. by paying cash consideration of ₹ 750 lakh (including control premium). The fair value of non-controlling interest on the date of acquisition is ₹ 480 lakh. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 1,000 lakh. Determine the value of goodwill and pass the journal entry.

Solution:

The amount of non-controlling interest can be measured wither as per i) Fair value method or ii) Proportionate share method (i.e. proportionate share in the net identifiable assets of the acquiree). The value of goodwill will be different under both the methods. The goodwill is calculated as per both the methods below:

<u>Fair value method</u>	₹ lakh
Fair value of consideration transferred	750
Fair value of non-controlling interest	<u>480</u>
	1,230
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(1,000)</u>
Goodwill	<u>230</u>

<u>Proportionate share method</u>	₹ lakh
Fair value of consideration transferred	750
Proportional share of non-controlling interest in the net identifiable assets of acquiree (1,000 x 40%)	<u>400</u>
	1,150
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(1,000)</u>
Goodwill	<u>150</u>

Journal Entries

<u>Fair value method</u>	₹ lakh	
	Dr.	Cr.
Net identifiable assets Dr.	1,000	
Goodwill Dr.	230	
To Cash		750
To Non-controlling interest		480
<u>Proportionate share method</u>	₹ lakh	
	Dr.	Cr.
Net identifiable assets Dr.	1,000	
Goodwill Dr.	150	
To Cash		750
To Non-controlling interest		400

Illustration 3: Determination of gain on bargain purchase

X Ltd. acquires 80% of Y Ltd. by paying cash consideration of ₹ 400 lakh. The fair value of non-controlling interest on the date of acquisition is ₹ 100 lakh. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 520 lakh. Determine the value of gain on bargain purchase and pass the journal entry.

Solution:

The amount of non-controlling interest can be measured as per i) Fair value method or ii) Proportionate share method (i.e. proportionate share in the net identifiable assets of the acquiree). The value of gain on bargain purchase will be different under both the methods. The gain is calculated as per both the methods below:

Fair value method		₹ lakh
Fair value of consideration transferred		400
Fair value of non-controlling interest		<u>100</u>
		500
Value of subsidiary's identifiable net assets as per Ind AS 103		<u>(520)</u>
Gain on bargain purchase		<u>(20)</u>
Proportionate share method		₹ lakh
Fair value of consideration transferred		400
Proportional share of non-controlling interest in the net identifiable assets of acquiree (520 x 20%)		<u>104</u>
		504
Value of subsidiary's identifiable net assets as per Ind AS 103		<u>(520)</u>
Gain on bargain purchase		<u>(16)</u>

Journal Entries

Fair value method		₹ lakh	
		Dr.	Cr.
Net identifiable assets	Dr.	520	
To Cash			400
To Gain on bargain purchase*			20
To Non-controlling interest			100

Proportionate share method		₹ lakh	
		Dr.	Cr.
Net identifiable assets	Dr.	520	
To Cash			400
To Gain on bargain purchase*			16
To Non-controlling interest			104

* Gain on bargain purchase is either recognised in OCI or is recognised directly in equity as a capital reserve.

Illustration 4: Determination of goodwill when there is no non-controlling interest

M Ltd. acquires 100% of N Ltd. by paying cash consideration of ₹ 100 lakh. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 80 lakh. Determine the value of goodwill.

Solution:

The value of goodwill is calculated as follows:

Determination of goodwill	₹ lakh
Fair value of consideration transferred	100
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(80)</u>
Goodwill	<u>20</u>

4.2.2 Calculation of goodwill / capital reserve when the interest in subsidiary is acquired on different dates (i.e. step acquisition)

An entity may be holding some equity interest in a subsidiary immediately before it obtained control over the subsidiary.

Example 1

On 1 April 20X1, A Ltd. Was holding 25% stake in B Ltd. On that date, A Ltd. Acquired further 40% stake in B Ltd. And thereby obtained control over B Ltd.

Such transaction is referred to as business combination achieved in stages or also referred to as step acquisition.

In a business combination achieved in stages, the acquirer shall **remeasure its previously held equity interest** in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

A change from holding a non-controlling investment in an entity to obtaining control of that entity is a significant change in the nature of and economic circumstances surrounding that investment. That change warrants a change in the classification and measurement of that investment. Once it obtains control, the acquirer is no longer the owner of a non-controlling investment asset in the acquiree. The acquirer therefore ceases its accounting for an investment asset and begins reporting in its financial statements the underlying assets, liabilities and results of operations of the acquiree. In effect, the acquirer exchanges its status as an owner of an investment asset in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity (acquiree) and the right to direct how the acquiree and its management use those assets in its operations. In a business combination achieved in stages, the acquirer derecognises its investment asset in an entity in its consolidated financial statements when it achieves control.

Thus, it is appropriate to recognise any resulting gain or loss in profit or loss at the acquisition date.

In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income (refer Chapter 12 which contains guidance on accounting for investments in equity instruments which are measured at fair value through other comprehensive income). If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest. In other words, the gains or losses from changes in the fair value accumulated in other comprehensive income would never be reclassified to profit or loss but may be transferred into the retained earnings on 'deemed disposal' of the investment, which is consistent with the accounting in case of 'actual disposal' of such an investment.

Illustration 5: Step acquisition

RS Ltd. holds 30% stake in PQ Ltd. This investment in PQ Ltd. is accounted as an investment in associate in accordance with Ind AS 28 and the carrying value of such investment is ₹ 100 lakh. RS Ltd. purchases the remaining 70% stake for a cash consideration of ₹ 700 lakh. The fair value of previously held 30% stake is measured to be ₹ 300 lakh on the date of acquisition of 70% stake. The value of PQ Ltd.'s identifiable net assets as per Ind AS 103 on that date is ₹ 800 lakh. How should RS Ltd. account for the business combination?

Solution:

The amount of goodwill is calculated as follows:

Determination of goodwill	₹ lakh
Fair value of consideration transferred	700
Fair value of previously held equity interest	<u>300</u>
	1,000
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(800)</u>
Goodwill	<u>200</u>

RS Ltd. should record the difference between the fair value of previously held equity interest in the subsidiary and the carrying value of that interest in the profit or loss i.e. ₹ 200 lakh (300 – 100) should be recognised in profit or loss.

Journal entries

Fair value method	₹ lakh	
	Dr.	Cr.
Net identifiable assets	Dr. 800	

Goodwill	Dr.	200	
To Cash			700
To Investment in associate			100
To Gain on fair valuation of previously held equity interest			200

4.2.3 Control obtained over a subsidiary without the transfer of consideration

An acquirer sometimes obtains control of an acquiree without transferring consideration. Such circumstances include:

- The **acquiree repurchases** a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.
- Minority veto rights lapse** that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.
- The acquirer and acquiree agree to combine their businesses **by contract** alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

In a business combination achieved without the transfer of consideration, “acquisition-date fair value of the consideration transferred” in the formula for measurement of goodwill or gain on bargain purchase is substituted by “acquisition-date fair value of its interest in the acquiree”. In other words, the acquirer shall remeasure its existing equity interest in the acquiree at its acquisition date fair value (and recognise the gain or loss on such remeasurement in profit or loss or other comprehensive income, as the case may be) and use that to compute goodwill or gain on bargain purchase.

In a business combination achieved by contract alone, the acquirer shall attribute to the owners of the acquiree (i.e. those holding equity interests) the amount of the acquiree’s net assets recognised in accordance with Ind AS 103. In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer’s post-combination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the non-controlling interest.

Example 2

A Ltd. obtained control over B Ltd. by contract alone. There is no stake in B Ltd. held by A Ltd. So, while preparing the consolidated financial statements, A Ltd. will attribute 100% of the net assets of B Ltd. to the non-controlling interest.

4.2.4 Uniform accounting policies

A parent shall prepare consolidated financial statements using uniform accounting policies for **like transactions and other events in similar circumstances**.

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

Example 3

A Ltd. (a company incorporated and registered in India) has a subsidiary B Inc. (a company incorporated and registered in United States). A Ltd. follows Ind AS for the preparation of its financial statements. However, B Inc. follows generally accepted accounting principles in United States (US GAAP). Hence, while using B Inc.'s financial statements for the purpose of preparing consolidated financial statements of A Ltd., appropriate adjustments should be made to B Inc.'s financial statements to convert its US GAAP financial statements to Ind AS financial statements.

Illustration 6: Uniform accounting policies

PQR Ltd. is the subsidiary company of MNC Ltd. In the individual financial statements prepared in accordance with Ind AS, PQR Ltd. has adopted Straight-line method (SLM) of depreciation and MNC Ltd. has adopted written-down value method (WDV) for depreciating its property, plant and equipment. As per Ind AS 110, Consolidated Financial Statements, a parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

How will these property, plant and equipment be depreciated in the consolidated financial statements of MNC Ltd. prepared as per Ind AS?

Solution:

As per paragraph 60 and 61 of Ind AS 16, 'Property, Plant and Equipment', a change in the method of depreciation shall be accounted for as a change in an accounting estimate as per Ind AS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

Therefore, the selection of the method of depreciation is an accounting estimate and not an accounting policy.

The entity should select the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method should be applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits in separate financial statements as well as consolidated financial statements.

Therefore, there can be different methods of estimating depreciation for property, plant and equipment, if their expected pattern of consumption is different. The method once selected in the individual financial statements of the subsidiary should not be changed while preparing the consolidated financial statements.

Accordingly, in the given case, the property, plant and equipment of PQR Ltd. (subsidiary company) may be depreciated using straight line method and property, plant and equipment of parent company (MNC Ltd.) may be depreciated using written down value method, if such method closely reflects the expected pattern of consumption of future economic benefits embodied in the respective assets.

Illustration 7: Uniform accounting policies

H Limited has a subsidiary, S Limited and an associate, A Limited. The three companies are engaged in different lines of business.

These companies are using the following cost formulas for their valuation in accordance with Ind AS 2 'Inventories'.

Name of the Company	Cost formula used
<i>H Limited</i>	<i>FIFO</i>
<i>S Limited, A Limited</i>	<i>Weighted average cost</i>

Whether H Limited is required to value inventories of S Limited and A Limited also using FIFO formula in preparing its consolidated financial statements?

Solution:

Paragraph 19 of Ind AS 110 states that a parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

Paragraph B87 of Ind AS 110 states that if a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

It may be noted that the above mentioned paragraphs require an entity to apply uniform accounting policies "for like transactions and events in similar circumstances". If any member of the group follows a different accounting policy for like transactions and events in similar circumstances, appropriate adjustments are to be made in preparing consolidated financial statements.

Paragraph 5 of Ind AS 8 defines accounting policies as “the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.”

Ind AS 2 requires inventories to be measured at the lower of cost and net realisable value.

Paragraph 25 of Ind AS 2 states that the cost of inventories shall be assigned by using FIFO or weighted average cost formula. 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.

Elaborating on the requirements of paragraph 25, paragraph 26 of Ind AS 2 illustrates that 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.

Paragraph 36(a) of Ind AS 2 requires disclosure of “the accounting policies adopted in measuring inventories, including the cost formula used”. Thus, as per Ind AS 2, the cost formula applied in valuing inventories is also an accounting policy.

As mentioned earlier, as per Ind AS 2, different cost formulas may be justified for inventories of a different nature or use. Thus, if inventories of S Limited and A Limited differ in nature or use from inventories of H Limited, then use of cost formula (weighted average cost) different from that applied in respect of inventories of H Limited (FIFO) in consolidated financial statements may be justified. In other words, in such a case, no adjustment needs to be made to align the cost formula applied by S Limited and A Limited to cost formula applied by H Limited.

4.2.5 Measurement of income and expense of subsidiary

An entity includes the income and expenses of a subsidiary in the consolidated financial statements **from the date it gains control** until the date when the entity ceases to control the subsidiary.

Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date.

Example 4

On the date of acquisition of control by A Ltd over B Ltd., the fair value of B Ltd.’s property, plant and equipment were ₹ 100 lakh and such assets are recorded in the consolidated financial statements of A Ltd. at that value. However, the carrying value of such assets in the books of B Ltd. on the date of acquisition were ₹ 80 lakh. Hence, for the purpose consolidated financial statements, the depreciation expense should be computed based on ₹ 100 lakh and not ₹ 80 lakh.

4.2.6 Accounting of potential voting rights held in subsidiary

When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and **does not reflect the possible exercise or conversion of potential voting rights** and other derivatives. Such instruments with potential voting rights are **accounted as per Ind AS 109**.

However, there can be some cases where an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns. Accordingly, Ind AS 109 is not applied to instruments containing potential voting rights in such circumstances.

- This can be the situation where, **for example**, an investor currently holds 60% of the voting power of an investee (and hence controls the investee) has a purchase option to acquire additional 20% voting power in the investee and the terms of the contract provides that the investor will also get the returns on the underlying shares even for the period prior to the date of actual exercise of the option.

4.2.7 Reporting period of parent and subsidiary

The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the **same reporting date**.

When the end of the reporting period of the parent is different from that of a subsidiary (e.g. parent's financial year ends on 31 March 20X1 but the subsidiary's financial year ends on 31 December 20X0), the subsidiary prepares, **for consolidation purposes**, additional financial information as of the same date as the financial statements of the parent to enable the parent to consolidate the financial information of the subsidiary, unless it is impracticable to do so.

If it is impracticable to do so, the parent shall consolidate the financial information of the subsidiary using the **most recent financial statements** of the subsidiary adjusted for the **effects of significant transactions or events** that occur between the date of those financial statements and the date of the consolidated financial statements. In any case, the difference between the date of the subsidiary's financial statements and that of the consolidated financial statements **shall be no more than three months**.

The length of the reporting periods and any difference between the dates of the financial statements shall be the same from period to period. This means that if the financial statements of a subsidiary used for consolidation in previous periods were ending on different dates than that

of the parent whereas the financial statements used for current period end on the same date as that of the parent then the comparatives for previous period should be restated to have comparison of equivalent periods.

Illustration 8: Different reporting dates

How should assets and liabilities be classified into current or non-current in consolidated financial statements when parent and subsidiary have different reporting dates?

Solution:

Paragraphs B92 and B93 of Ind AS 110 require subsidiaries with reporting period end different from parent, to provide additional information or details of significant transactions or events if it is impracticable to provide additional information to enable the parent entity to consolidate such financial information at group's reporting period end.

The appropriate classification of the assets and liabilities as current or non-current in the consolidated financial statements has to be determined by reference to the reporting period end of the group. Accordingly, when a subsidiary's financial statements are for a different reporting period end, it is necessary to review the subsidiary's balance sheet to ensure that items are correctly classified as current or non-current as at the end of the group's reporting period.

For example, a subsidiary with the financial year end of 31st December, 20X1 has a payable outstanding that is due for payment on 1st January, 20X3, and has accordingly classified it as non-current in its balance sheet. The financial year end of the parent's consolidated financial statements is 31st March 20X2. Due to the time lag, the subsidiary's payable falls due within 12 months from the end of the parent's reporting period.

Accordingly, in this case, the payable should be classified as a current liability in the consolidated financial statements of the parent because the amount is repayable within nine months of the end of the parent's reporting period.

Illustration 9: Different reporting dates

A Limited, an Indian Company has a foreign subsidiary, B Inc. Subsidiary B Inc. has taken a long-term loan from a foreign bank, which is repayable after the year 20X9. However, during the year ended 31st March, 20X2, it breached one of the conditions of the loan, as a consequence of which the loan became repayable on demand on the reporting date. Subsequent to year end but before the approval of the financial statements, B Inc. rectified the breach and the bank agreed not to demand repayment and to let the loan run for its remaining period to maturity as per the original loan terms. While preparing its standalone financial statements as per IFRS, B Inc. has classified this loan as a current liability in accordance with IAS 1 'Presentation of Financial Statements'.

Whether A limited is required to classify such loan as current while preparing its consolidated financial statement under Ind AS?

Solution:

As per paragraph 74 of Ind AS 1, where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

The above position under Ind AS 1 differs from the corresponding position under IAS 1. As per paragraph 74 of IAS 1, when an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the recognized on of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.

Accordingly, the loan liability recognized as current liability by B Inc. in its standalone financial statements prepared as per IFRS, should be aligned as per Ind AS in the consolidated financial statements of A Limited and should be classified as non-current in the consolidated financial statements of A Limited in accordance with Ind AS 1.

4.2.8 Accounting of dividend from subsidiary and its impact on non-controlling interest

As per para 5.7.1A of Ind AS 109, dividends are recognized in profit or loss by an investor entity only when:

- The entity's **right to receive** payment of the dividend is established,
- It is **probable** that the economic benefits associated with the dividend will flow to the entity, and
- the amount of the dividend can be **measured reliably**.

As per para 12 of Ind AS 27, an entity shall recognize a dividend from a subsidiary in its separate financial statements when its right to receive the dividend is **established**.

As per the Companies Act, 2013, the entity's right to receive the dividend is established when it is declared by the shareholders in the annual general meeting of the company.

An investor should recognise a dividend from a subsidiary, a joint venture or an associate as income in its separate financial statements. As per Ind AS 36, declaration of dividend by a subsidiary, associate or joint venture coupled with a few more evidence is an indication of impairment of investment.

Illustration 10: Dividend proposed by subsidiary

XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st April, 20X1 for ₹ 1,40,000. The issued capital of ABC Ltd., on 1st April, 20X1 was ₹ 1,00,000 and the balance in the Statement of Profit and Loss was ₹ 60,000.

For the year ending on 31st March, 20X2 ABC Ltd. has earned a profit of ₹ 20,000 and later on it declared and paid a dividend of ₹ 30,000.

Assume, the fair value of non-controlling interest is same as the fair value on a per-share basis of the purchased interest[#]. All net assets are identifiable net assets, there are no non-identifiable assets. The fair value of identifiable net assets is ₹ 1,50,000.

Show by an entry how the dividend should be recorded in the books of XYZ Ltd. Whenever it is received after approval in the ensuing annual general meeting.

What is the amount of non-controlling interest as on 1st April, 20X1 (using Fair value Method) and 31st March, 20X2? Also pass a journal entry on the acquisition date.

([#]This assumption is only for illustration purpose. However, in practical scenarios the fair value of NCI will be different than the fair value of the controlling interest.)

Solution:

XYZ Ltd.'s share of dividend ₹ 30,000 x 80% = ₹ 24,000.

₹		
	Dr.	Cr.
Bank	Dr.	24,000
To Profit & Loss A/c		24,000

Calculation of Non- controlling interest and Journal Entry

NCI on 1st April 20X1 = 20% of the fair value on a pre-share basis of the purchased interest.

$$= 20\% \times ₹ 1,75,000 \text{ (W.N.1)} = ₹ 35,000$$

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

₹		
	Dr.	Cr.
Identifiable net assets	Dr.	1,50,000
Goodwill (Balancing Figure)	Dr.	25,000
To Cash		1,40,000
To NCI		35,000

Working Note 1

Fair value on a per-share basis of the purchased interest / Fair Value of Identifiable net assets

$$= \text{consideration transferred} \times 100/80$$

$$= 1,40,000 \times 100/80 = ₹ 1,75,000$$

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

$$= 35,000 + (20,000 \times 20\%) = ₹ 39,000$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received in the annual general meeting.

Illustration 11: Dividend proposed by subsidiary

From the facts given in the above illustration, calculate the amount of non-controlling interest as on 1st April, 20X1 (Using NCI's proportionate share method) and 31st March, 20X2.

Also pass a journal entry on the acquisition date.

Solution:

NCI on 1st April 20X1 = 20% of the fair value on identifiable assets.

$$= 20\% \times ₹ 1,50,000 = ₹ 30,000$$

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	
		Dr.	Cr.
Identifiable net assets	Dr.	1,50,000	
Goodwill (Balancing Figure)	Dr.	20,000	
To Cash			1,40,000
To NCI			30,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

$$= 30,000 + (20,000 \times 20\%) = ₹ 34,000$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received in the annual general meeting.

Illustration 12: Dividend proposed by subsidiary

The facts are same as in the above illustration except that the fair value of net identifiable asset is ₹ 1,60,000. Calculate NCI and Pass Journal Entry on the acquisition date

Note: Use fair value method for 31st March 20X1.

Solution:**Calculation of Non- controlling interest and Journal Entry**

NCI on 1st April 20X1 = 20% of the fair value on a pre-share basis of the purchased interest.

$$= 20\% \times ₹ 1,75,000 \text{ (W.N.1)} = ₹ 35,000$$

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	
		Dr.	Cr.
Identifiable net assets	Dr.	1,60,000	
Goodwill (Balancing Figure)	Dr.	15,000	
To Cash			1,40,000
To NCI			35,000

Working Note

Fair value on a per-share basis of the purchased interest / Fair Value of Identifiable net assets

$$= \text{consideration transferred} \times 100/80$$

$$= 1,40,000 \times 100/80 = ₹ 1,75,000$$

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

$$= 35,000 + (20,000 \times 20\%) = ₹ 39,000$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

Illustration 13: Dividend proposed by subsidiary

The facts are same as in the above illustration except that the fair value of net identifiable asset is ₹ 1,60,000. Calculate NCI and Pass Journal Entry on the acquisition date. Use NCI's proportionate share method for 31st March 20X1.

Solution:

NCI on 1st April 20X1 = 20% of the fair value on identifiable assets.

$$= 20\% \times ₹ 1,60,000 = ₹ 32,000$$

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	
		Dr.	Cr.
Identifiable net assets	Dr.	1,60,000	
Goodwill (Balancing Figure)	Dr.	12,000	
To Cash			1,40,000
To NCI			32,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

$$= 32,000 + (20,000 \times 20\%) = ₹ 36,000$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

4.2.9 Elimination of intra-group transactions

In order to present financial statements for the group in a consolidated format, the effect of transactions between group entities should be eliminated. Intra – group balances and intra – group transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intra – group transactions should also be eliminated unless cost cannot be recovered.

Liabilities due to one group entity by another will be set off against the corresponding asset in the other group entity's financial statements; sales made by one group entity to another should be excluded from turnover and from purchase (or related head) or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying entity has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets are reduced to cost to the group.

For transactions between group entities, unrealized profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and Property, Plant and Equipment, Intangible Assets and Investment Property, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

4.2.9.1 Unrealised profit on inventories

Where a group entity sells goods to another, the selling entity, as a separate legal entity, records profits made on those sales. If these goods are still held in inventory by the buying entity at the year end, however, the profit recorded by the selling entity, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealized profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

4.2.9.2 Unrealised profit on transfer of non-current assets

Similar to the treatment described above for unrealized profits in inventories, unrealized inter-company profits arising from intra-group transfers of Property, Plant and Equipment, Intangible Assets and Investment Property are also eliminated from the consolidated financial statements.

4.2.9.3 Unrealised losses

Unrealised losses resulting from intra-group transactions that are deducted in arriving at the carrying amount of assets are also eliminated **unless cost cannot be recovered**.

Illustration 14: Elimination of intra-group profit on sale of assets by a subsidiary to its parent

A parent owns 60% of a subsidiary. The subsidiary sells some inventory to the parent for ₹ 35,000 and makes a profit of ₹ 15,000 on the sale. The inventory is in the parent's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution:

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000 (₹ 35,000 - ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

		₹ ' 000	
		Dr.	Cr.
Consolidated revenue	Dr.	35	
To Cost of sales			20
To Inventory			15

The reduction of group profit of ₹ 15,000 is allocated between the parent company and non-controlling interest in the ratio of their interests 60% and 40%.

Illustration 15: Elimination of intra-group profit on sale of assets by a parent to its subsidiary

In the above illustration, assume that it is the parent that makes the sale. The parent owns 60% of a subsidiary. The parent sells some inventory to the subsidiary for ₹ 35,000 and makes a profit of ₹ 15,000. On the sale the inventory is in the subsidiary's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution:

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000 (₹ 35,000 - ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

The double entry on consolidation is as follows:

		₹ ' 000	
		Dr.	Cr.
Consolidated revenue	Dr.	35	
To Cost of sales			20
To Inventory			15

In this case, since it is the parent that has made the sale, the reduction in profit of ₹ 15,000 is allocated entirely to the parent company.

Illustration 16: Inventories of subsidiary out of purchases from the parent

A Ltd, a parent company sold goods costing ₹ 200 lakh to its 80% subsidiary B Ltd. at ₹ 240 lakh. 50% of these goods are lying at its stock. B Ltd. has measured this inventory at cost i.e. at ₹ 120 lakh. Show the necessary adjustment in the consolidated financial statements (CFS). Assume 30% tax rate.

Solution:

A Ltd. shall reduce the inventories of ₹ 120 lakh of B Ltd., by ₹ 20 lakh in CFS. This will increase expenses and reduce consolidated profit by ₹ 20 lakh. It shall also create deferred tax asset of ₹ 6 lakh since accounting base of inventories (₹ 100 lakh) is lower than its tax base (₹ 120 lakh).

Illustration 17: Inventories of parent out of purchases from the subsidiary

Ram Ltd., a parent company purchased goods costing ₹ 100 lakh from its 80% subsidiary Shyam Ltd. at ₹ 120 lakh. 50% of these goods are lying at the godown. Ram Ltd. has measured this inventory at cost i.e. at ₹ 60 lakh. Show the necessary adjustment in the consolidated financial statements (CFS). Assume 30% tax rate.

Solution:

Ram Ltd. shall reduce the inventories of ₹ 60 lakh of Shyam Ltd., by ₹ 10 lakh in CFS. This will increase expenses and reduce consolidated profit by ₹ 10 lakh. It shall also create deferred tax asset of ₹ 3 lakh since accounting base of inventories (₹ 50 lakh) is lower than its tax base (₹ 60 lakh).

Illustration 18: Property, plant and equipment (PPE) sold by parent to subsidiary

A Ltd. (which is involved in the business of selling capital equipment) a parent company sold a capital equipment costing ₹ 100 lakh to its 80% subsidiary B Ltd. at ₹ 120 lakh. The capital equipment is recorded as PPE by B Ltd. The useful life of the PPE on the date of transfer was 10 years. Show the necessary adjustment in the consolidated financial statements (CFS).

Solution:

A Ltd. shall reduce the value of PPE of ₹ 120 lakh of B Ltd., by ₹ 20 lakh in CFS. This will increase expenses and reduce consolidated profit by ₹ 20 lakh. Further, A Ltd. should also reduce the depreciation charge of B Ltd. to the extent of value of PPE reduced as above. Hence, A Ltd. should reduce the depreciation by ₹ 2 lakh ($₹ 20 \text{ lakh} \div 10 \text{ years}$). Further, the sales and cost of goods sold recorded by parent A Ltd. shall also be eliminated.

The double entry on consolidation is as follows:

		₹' lakh	
		Dr.	Cr.
Consolidated revenue	Dr.	120	
To Cost of sales			100
To PPE			18
To Depreciation			2

4.2.10 Allocating share in profit / loss to non-controlling interest and change in the proportion held by controlling and non-controlling interest

A parent shall present non-controlling interests in the consolidated balance sheet within equity, separately from the equity of the owners of the parent.

4.2.10.1 Allocating share in profit / loss to non-controlling interests

An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

Illustration 19: Attribution of profit / loss to non-controlling interest

A Ltd. acquired 70% equity shares of B Ltd. on 1.4.20X1 at cost of ₹ 10,00,000 when B Ltd. had an equity share capital of ₹ 10,00,000 and other equity of ₹ 80,000. In the four consecutive years, B Ltd. fared badly and suffered losses of ₹ 2,50,000, ₹ 4,00,000, ₹ 5,00,000 and ₹ 1,20,000 respectively. Thereafter in 20X5-20X6, B Ltd. experienced turnaround and registered an annual profit of ₹ 50,000. In the next two years i.e. 20X6-20X7 and 20X7-20X8, B Ltd. recorded annual profits of ₹ 1,00,000, and ₹ 1,50,000 respectively. Show the non-controlling interests and goodwill at the end of each year for the purpose of consolidation. Assume that the assets are at fair value. Ignore impairment of goodwill.

Solution:

₹

Year	Profit / (Loss)	Non-controlling interest (30%)	Additional consolidated P&L (Dr.) / Cr.	Goodwill
At the time of acquisition in 20X1		3,24,000 (W.N.)		2,44,000(W.N.)
20X1-20X2	(2,50,000)	<u>(75,000)</u> 2,49,000	(1,75,000)	2,44,000
20X2-20X3	(4,00,000)	<u>(1,20,000)</u> 1,29,000	(2,80,000)	2,44,000
20X3-20X4	(5,00,000)	<u>(1,50,000)</u> (21,000)	(3,50,000)	2,44,000
20X4-20X5	(1,20,000)	<u>(36,000)</u> (57,000)	(84,000)	2,44,000

20X5-20X6	50,000	<u>15,000</u> (42,000)	35,000	2,44,000
20X6-20X7	1,00,000	<u>30,000</u> (12,000)	70,000	2,44,000
20X7-20X8	1,50,000	<u>45,000</u> 33,000	1,05,000	2,44,000

Working note:

Calculation of non-controlling interest:	₹
Share capital	10,00,000
Other equity	<u>80,000</u>
Total	<u>10,80,000</u>
NCI (30% x 10,80,000)	3,24,000

NCI is measured at NCI's proportionate share of the acquiree's identifiable net assets. (Considering the carrying amount of share capital & other equity to be fair value)

Calculation of Goodwill:	₹
Consideration	10,00,000
Non-controlling interest	3,24,000
Less: Net Assets	<u>(10,80,000)</u>
Goodwill	<u>2,44,000</u>

Illustration 20: Non-controlling interest and goodwill

From the following data, determine in each case:

- 1) Non-controlling interest at the date of acquisition (using proportionate share method) and at the date of consolidation
- 2) Goodwill or Gain on bargain purchase.
- 3) Amount of holding company's share of profit in the Consolidated Balance Sheet assuming holding company's own retained earnings to be ₹ 2,00,000 in each case

Case	Subsidiary Company	% of shares owned	Cost	Date of Acquisition 1.04.20X1		Consolidation date 31.03.20X2	
				Share Capital [A]	Retained earnings [B]	Share Capital [C]	Retained earnings [D]
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000
Case 2	B	85%	1,04,000	1,00,000	30,000	1,00,000	20,000
Case 3	C	80%	56,000	50,000	20,000	50,000	20,000
Case 4	D	100%	1,00,000	50,000	40,000	50,000	56,000

The company has adopted an accounting policy to measure Non-controlling interest at NCI's proportionate share of the acquiree's identifiable net assets. It may be assumed that the fair value of acquiree's net identifiable assets is equal to their book values.

Solution:

- (1) Non-controlling Interest = the equity in a subsidiary not attributable, directly or indirectly, to a parent. Equity is the residual interest in the assets of an entity after deducting all its liabilities i.e. in this given case Share Capital + Balance in Statement of Profit & Loss (Assuming it to be the net aggregate value of identifiable assets in accordance with Ind AS)

	% shares owned by NCI [E]	Non-controlling interest as at the date of acquisition [E] X [A + B]	Non-controlling interest as at the date of consolidation [E] X [C + D]
Case 1 [100-90]	10%	15,000	17,000
Case 2 [100-85]	15%	19,500	18,000
Case 3 [100-80]	20%	14,000	14,000
Case 4 [100-100]	Nil	Nil	Nil

(3) Calculation of Goodwill or Gain on bargain purchase

	Consideration [G]	Non- controlling interest [H]	Net Identifiable assets [A] + [B] = [I]	Goodwill [G] + [H] – [I]	Gain on bargain Purchase [I] – [G] – [H]
Case 1	1,40,000	15,000	1,50,000	5,000	-
Case 2	1,04,000	19,500	1,30,000	-	6,500
Case 3	56,000	14,000	70,000	Nil	Nil
Case 4	1,00,000	0	90,000	10,000	-

(4) On 31.03.20X2 in each case the following amount shall be added or deducted from the balance of holding Co.'s Retained earnings.

	% Share Holding [K]	Retained earnings as on 31.03.20X1 [L]	Retained earnings as on consolidation Date [M]	Retained earnings post- acquisition [N] = [M] – [L]	Amount to be added/(deducted) from holding's Retained earnings [O] = [K] X [N]
1	90%	50,000	70,000	20,000	18,000
2	85%	30,000	20,000	(10,000)	(8,500)
3	80%	20,000	20,000	Nil	Nil
4	100%	40,000	56,000	16,000	16,000

If a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by non-controlling interests, the entity shall compute its share of profit or loss after adjusting for the dividends on such shares, whether or not such dividends have been declared.

Example 5

R Ltd. holds 80% stake on Y Ltd. Y Ltd. has also issued 10% cumulative preference shares worth ₹ 10,00,000 to the non-controlling interest. During the year, Y Ltd. earned profit of ₹ 5,00,000. Y Ltd. has not declared any dividend on cumulative preference share for current year. Ignore requirements of irredeemable preference shares.

In such case, the profit attributable to R Ltd. for current year would be as follows:

	₹
Total profit of Y Ltd.	5,00,000
Dividend on preference shares (10,00,000 x 10%)	<u>(1,00,000)</u>
Net profit	<u>4,00,000</u>
Profit attributable to R Ltd. (4,00,000 x 80%)	3,20,000

4.2.10.2 Change in the proportion held by controlling and non-controlling interests

A parent's ownership interest may change without a loss of control, for example, in following situations:

- Parent buys shares from non-controlling interest (say, increase in stake from 60% to 70%)
- Parent sells shares to non-controlling interest (say, decrease in stake from 70% to 60%)
- Subsidiary issues new shares to non-controlling interest in a capital raising exercise resulting in dilution in stake of parent

Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are **equity transactions** (i.e. transactions with owners in their capacity as owners).

Example 6

M Ltd. holds 70% stake in N Ltd. Now if M Ltd. purchases additional 10% stake in N Ltd. or sells 10% of its existing stake (i.e. without losing control) then it is an equity transaction.

When the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise **directly in equity** any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Further, it must be noted that due to such changes in controlling and non-controlling interests, no changes are made to subsidiary's assets (including goodwill) and liabilities. It is again emphasized that no gain or loss is recognized in such transactions.

Illustration 21: Sale of 20% interest in a wholly- owned subsidiary

Entity P sells a 20% interest in a wholly owned subsidiary to outside investors for ₹ 100 lakh in cash. The carrying value of the subsidiary's net assets is ₹ 300 lakh, including goodwill of ₹ 65 lakh from the subsidiary's initial acquisition.

Pass journal entries to record the transaction.

Solution:

The accounting entry in the consolidated financial statements recorded on the disposition date for the 20% interest sold as follows:

		₹ lakh	
		Dr.	Cr.
Cash	Dr.	100	
To Non-controlling interest (20% x 300 lakh)			60
To Other Equity (Gain on sale of interest in subsidiary)			40

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between amount by which NCI (60 lakh) is adjusted and fair value of consideration received (100 lakh) to be attributed to parent in other equity i.e. 40 lakh.

Illustration 22: Acquisition of additional stake in a subsidiary

Entity A acquired 60% of entity B two years ago for ₹ 6,000. At that time, entity B's fair value was ₹ 10,000. It had net assets with a fair value of ₹ 6,000 (which is assumed same as book value). Goodwill of ₹ 2,400 was recorded (being ₹ 6,000 – (60% x ₹ 6,000)). On 1 October 20X0, entity A acquires a further 20% interest in entity B, taking its holding to 80%. At that time the fair value of entity B is ₹ 20,000 and entity A pays ₹ 4,000 for the 20% interest. At the time of the purchase the fair value of entity B's net assets is ₹ 12,000 and the carrying amount of the non-controlling interest is ₹ 4,000.

Pass journal entries to record the transaction.

Solution:

The accounting entry recorded for the purpose of the non-controlling interest is as follows:

		₹	
		Dr.	Cr.
Non-controlling interest (4,000 ÷ 40 x 20)	Dr.	2,000	
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	2,000	
To Cash			4,000

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between amount by which NCI (₹ 2,000) is adjusted and fair value of consideration received (₹ 4,000) to be attributed to parent in other equity i.e. ₹ 2,000.

Note: This illustration mentions two types of fair values:

- Fair value of Entity B, and
- Fair value of net assets of Entity B

It should be borne in mind that the two fair values are different concepts. The former is used only for the purpose of determining the consideration to be paid for purchase of equity interests. It can be seen that for the initial stake purchase, Entity A paid 60% of the “fair value of Entity B” i.e. 60% of ₹ 10,000 = ₹ 6,000. Further, for the second purchase transaction, Entity A paid 20% of the “fair value of Entity B” i.e. 20% of ₹ 20,000 = ₹ 4,000.

The latter i.e. fair value of net assets of Entity B is used for the purpose of accounting. It can be seen that the goodwill arising on acquisition of Entity B is determined as difference between consideration paid i.e. ₹ 6,000 and Entity A’s share in fair value of net assets of Entity B on date of acquisition i.e. 60% of ₹ 6,000 = ₹ 6,000 minus ₹ 3,600 = ₹ 2,400. The fair value of net assets after the date of acquisition (i.e. ₹ 12,000 in this illustration) is not relevant for accounting purposes.

Illustration 23: Acquisition of additional stake in a subsidiary

A Ltd. acquired 10% additional shares of its 70% subsidiary. The following relevant information is available in respect of the change in non-controlling interest on the basis of Balance Sheet finalized as at 1.4.20X0:

	₹ in thousand
Separate financial statements	As at 31.3.20X0
Investment in subsidiary (70% interest) – at cost	14,000
Purchase price for additional 10% interest	2,600
Consolidated financial statements	
Non-controlling interests (30%)	6,600
Consolidated profit & loss account balance	2,000
Goodwill	600

The reporting date of the subsidiary and the parent is 31 March 20X0. Prepare note showing adjustment for change of non-controlling interest. Should goodwill be adjusted for the change?

Solution:

The following accounting entry is passed:

₹ '000		
	Dr.	Cr.
Non-controlling interest (6,600 ÷ 30 x 10) Dr.	2,200	
Other Equity (Loss on acquisition of interest in subsidiary) Dr.	400	
To Cash		2,600

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between amount by which NCI (₹ 22,00,000) is adjusted and fair value of consideration received (₹ 26,00,000) to be attributed to parent in other equity i.e. ₹ 4,00,000.

Consolidated goodwill is not adjusted.

Illustration 24: Acquisition of additional stake in a subsidiary

A Ltd. acquired 70% shares of B Ltd. on 1.4.20X0 when the fair value of net assets of B Ltd. was ₹ 200 lakh. During 20X0-20X1, B Ltd. made profit of ₹ 100 lakh. Individual and consolidated balance sheets as at 31.3.20X1 are as follows:

₹ lakh

	A	B	Group
Assets			
Goodwill			10
PPE	627	200	827
Financial assets:			
Investments	150		
Cash	200	30	230
Other current assets	23	70	93
	1,000	300	1160
Equity and liability			
Share capital	200	100	200
Other equity	800	200	870
Non-controlling interest			90
	1,000	300	1160

A Ltd. acquired another 10% stake in B Ltd. on 1.4.20X1 at ₹ 32 lakh. The proportionate carrying amount of the non-controlling interest is ₹ 30 lakh. Show the individual and consolidated balance sheet of the group immediately after the change in non-controlling interest.

Solution:

₹ lakh

	A	B	Workings	Group
Assets				
Goodwill				10
PPE	627	200		827
Financial assets:				
Investments (150+32)	182			
Cash* (200-32)	168	30	(200+30)-32)	198
Other current assets	<u>23</u>	<u>70</u>		<u>93</u>
	<u>1,000</u>	<u>300</u>		<u>1,128</u>
Equity and liability				
Share capital	200	100		200
Other equity	800	200	870-2	868
Non-controlling interest	<u> </u>	<u> </u>	90-30	<u>60</u>
	<u>1,000</u>	<u>300</u>		<u>1,128</u>

*Cash has been adjusted through Individual Balance Sheet.

Journal Entry

	₹ lakh
	Dr. Cr.
Non-controlling interest (90 ÷ 30 x 10)	Dr. 30
Other Equity (Loss on acquisition of interest in subsidiary)	Dr. 2
To Cash	32

Illustration 25: Reduction in interest in subsidiary

Amla Ltd. purchased a 100% subsidiary for ₹ 10,00,000 at the end of 20X1 when the fair value of the subsidiary Lal Ltd.'s net asset was ₹ 8,00,000.

The parent sold 40% of its investment in the subsidiary in March 20X4 to outside investors for ₹ 9,00,000. The parent still maintains a 60% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is ₹ 18,00,000 (including net assets of ₹ 16,00,000 & goodwill of ₹ 2,00,000).

Calculate gain / loss on sale of interest in subsidiary as at 31st March 20X4.

Solution:

As per Ind AS 110, a change in ownership that does not result in a loss of control is equity transaction. The identifiable net assets (including goodwill) remain unchanged and any difference between the amount by which the non-controlling interest is recorded (including the non-controlling interest portion of goodwill) and a fair value of the consideration received is recognized directly in equity and attributed to the controlling interest. For disposals that do not result in the loss of control, the change in the non-controlling interest is recorded at its proportionate interest of the carrying value of the subsidiary.

Gain on the sale of the investment of ₹ 5,00,000 in parent's separate financial statements calculated as follows:

	₹' 000
Sale proceeds	900
Less: Cost of investment in subsidiary (10,00,000 x 40%)	<u>(400)</u>
Gain on sale in the parent's separate financial statements	<u>500</u>

As discussed above, the group's consolidated income statement for 31st March 20X4 would show no gain on the sale of the interest in the subsidiary. Instead, the difference between the fair value of the consideration received and the amount by which the non-controlling interest is recorded is recognized directly in equity.

	₹' 000
Sale proceeds	900
Less: Recognition of non-controlling interest (18,00,000 x 40%)	<u>(720)</u>
Credit to other equity	<u>180</u>

The entry recognized in the consolidated accounts under Ind AS 110 is:

		₹' 000	
Cash	Dr.	900	Cr.
To Non-controlling interest			720
To Other Equity (Gain on sale of interest in subsidiary)			180

The difference between the gain in the parent's income statement and the increase reported in the group's consolidated equity is ₹ 3,20,000. This difference represents the share of post-acquisition profits retained in the subsidiary ₹ 3,20,000 [(that is, 18,00,000 – 10,00,000) x 40%] that have been reported in the group's income statement up to the date of sale.

Illustration 26: Reduction in interest in subsidiary

Entity A sells 30% interest in its wholly-owned subsidiary to outside investors in an arm's length transaction for ₹ 500 crore in cash and retains a 70% controlling interest in the subsidiary. At the time of the sale, the carrying value of the subsidiary's net assets in the consolidated financial statements of Entity A is ₹ 1,300 crore, additionally, there is a goodwill of ₹ 200 crore that arose on the subsidiary's acquisition. Entity A initially accounted for NCI representing present ownership interests in the subsidiary at fair value and it recognises subsequent changes in NCI in the subsidiary at NCI's proportionate share in aggregate of net identifiable assets and associated goodwill. How should Entity A account for the transaction?

Solution:

As per paragraph 23 of Ind AS 110, changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners). Thus, changes in ownership interest that do not result in loss of control do not impact goodwill associated with the subsidiary or the statement of profit and loss.

Paragraph B96 of Ind AS 110 states that when the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Thus, at the time of sale of 30% of its equity interest, consolidated financial statements include an amount of ₹ 1,500 crore in respect of the subsidiary. Accordingly, in the present case, the accounting entry in the consolidated financial statements on the date of sale of the 30% interest would be as follows:

		₹ in crore	
		Dr.	Cr.
Cash	Dr.	500	
To Non-controlling interest (1,500 x 30%)			450
To Other Equity (Gain on sale of interest in subsidiary)			50

Illustration 27: Treatment of goodwill and non-controlling interest where a parent holds an indirect interest in a subsidiary

A parent company (entity A) has an 80% owned subsidiary (entity B). Entity B makes an acquisition for cash of a third company (entity C), which it then wholly owns. Goodwill of ₹ 1,00,000 arises on the acquisition of entity C.

How should that goodwill be reflected in consolidated financial statement of entity A? Should it be reflected as

- a) 100% of the goodwill with 20% then being allocated to the non- controlling interest, or*
- b) 80% of the goodwill that arises?*

Solution:

Assuming that entity B prepares consolidated financial statements, 100% of the goodwill would be recognized on the acquisition of entity C in those financial statements. Entity A should reflect 100% of goodwill and allocate 20% to the non- controlling interest in its consolidated financial statements. This is because the non-controlling interest is a party to the transaction and the goodwill forms part of the net assets of the sub group (in this case, the sub group being the group headed by entity B).

4.2.11 Preparation of consolidated financial statements after applying above principles

In this section we will discuss how the full set of consolidated financial statements is prepared after applying the consolidation principles discussed above.

4.2.11.1 Preparation of consolidated balance sheet

- Assets and outside liabilities of the subsidiary company are combined with those of the parent company. Appropriate intra group elimination adjustments as explained in section 4.2.9 above are recognised.
- The equity share capital of the subsidiary and investment of parent company are eliminated and goodwill / capital reserve and non-controlling interest are recognised.
- The parent's share in post-acquisition profits of the subsidiary company (added to appropriate concerned account of the parent company) are accounted in consolidated balance sheet.

4.2.11.2 Preparation of consolidated profit & loss

- The items of income and expenses are added on line by line basis.

- Intra-group transactions are eliminated in full (e.g. sales made by parent to a subsidiary which is recorded as purchase by subsidiary are eliminated from the consolidated profit & loss by reducing both sales of parent and purchase of subsidiary) – refer section 4.2.9 above.

4.2.11.3 Preparation of consolidated cash flows

- Items of cash flow from various activities are to be added on line by line basis and from the consolidated items, inter-company transactions should be eliminated.

4.2.12 Chain-holding under consolidation

4.2.12.1 Meaning of chain control

A parent company can establish control over subsidiary directly or indirectly. Chain-holding refers to situations wherein a parent is controlling a subsidiary indirectly, i.e., having a controlling interest over a company indirectly. This may happen in number of ways, for example, parent company (P Ltd.) holding controlling interest in a subsidiary (S1 Ltd.), which in turn is holding a controlling interest in another company (S2 Ltd.). In this case, P Ltd. is having an indirect control over S2 Ltd. through its direct subsidiary S1 Ltd.

4.2.12.2 Consolidation procedures in case of chain-holding

Holding in subsidiary may be of various structures like:

Situation 1: Sub-subsidiaries

Parent P → 80% → Subsidiary 1 → 60% → Sub-subsidiary (S2)

In the above case, P holds a controlling interest in S1 which in turn holds a controlling interest in S2.

Analysis:

1. P owns 80% of 60% = 48% of S2
2. The non-controlling interest (NCI) in S1 owns 20% of 60% = 12% of S2
3. The non-controlling interest (NCI) in S2 itself owns the remaining 40% of the S2 equity.

S2 is nevertheless a sub-subsidiary of P, because it is a subsidiary of S1 which in turn is a subsidiary of P. The chain of control thus makes S2 sub-subsidiary of P which owns only 48% of its equity.

Date of effective control:

The date the sub-subsidiary (S2) comes under the control of the holding company is either:

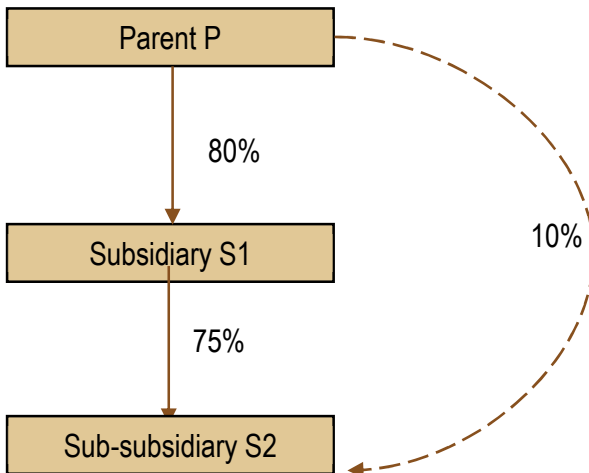
1. The date P acquired S1 if S1 already holds shares in S2, or
2. If S1 acquires shares in S2 later, i.e. after the acquisition by P in S1, then such date of acquisition by S1.

Points to remember:

The dates of acquisition and the order in which the group is built up should be considered while identifying as to which balances to select as the pre-acquisition reserves of the sub-subsidiary.

Care must be taken when consolidating sub-subsidiaries, because (usually) either:

1. The parent company acquired the subsidiary before the subsidiary bought the sub-subsidiary
2. The parent holding company acquired the subsidiary after the subsidiary bought the sub-subsidiary
3. Depending on whether (1) or (2) is the case, the retained earnings of the subsidiary at acquisition will be different.

Situation II: Direct holdings in sub-subsidiaries:

In this case, S2 is a sub-subsidiary of P with additional shares held directly by P.

In the above case, there is:

1. Direct non-controlling share (NCI) in S1 of	20%
2. Direct non-controlling share (NCI) in S2 of (25-10)	15%
3. Indirect non-controlling share (NCI) in S2 of 20% x 75%	<u>15%</u> <u>30%</u>

Analysis:

The effective interest in SS is:

Group (80% x 75%)	60% interest
Direct holding	<u>10%</u>
	70%

Thus NCI 30%
 100%

Note: Once we have ascertained the structure and non-controlling interest, we can proceed as we do for case A.

Illustration 29: Chain holding

Prepare the consolidated Balance Sheet as at 31st March, 20X2 of a group of companies comprising P Limited, S Limited and SS Limited. Their balance sheets on that date are given below:

₹ in lakhs

	P Ltd.	S Ltd.	SS Ltd.
Assets			
<u>Non-Current Assets</u>			
Property, Plant and Equipment	320	360	300
Investment:			
32 lakh shares in S Ltd.	340		
24 lakh shares in SS Ltd.		280	
<u>Current Assets</u>			
Inventories	220	70	50
Financial Assets			
Trade Receivables	260	100	220
Bills Receivables	72	-	30
Cash in hand and at Bank	<u>228</u>	<u>40</u>	<u>40</u>
	<u>1440</u>	<u>850</u>	<u>640</u>
Equity and Liabilities			
<u>Shareholder's Equity</u>			
Share Capital (₹ 10 per share)	600	400	320
Other Equity			
Reserves	180	100	80
Retained earnings	160	50	60
<u>Current Liabilities</u>			
Financial Liabilities			
Trade Payables	470	230	180
Bills Payable			

P Ltd.		70	
SS Ltd.	<u>30</u>	=	=
	<u>1440</u>	<u>850</u>	<u>640</u>

The following additional information is available:

- P Ltd. holds 80% shares in S Ltd. and S Ltd. holds 75% shares in SS Ltd. Their holdings were acquired on 30th September, 20X1.
- The business activities of all the companies are not seasonal in nature and therefore, it can be assumed that profits are earned evenly throughout the year.
- On 1st April, 20X1 the following balances stood in the books of S Ltd. and SS Ltd.

₹ in Lakhs

	S Limited	SS Limited
Reserves	80	60
Retained earnings	20	30

- ₹ 10 lakhs included in the inventory figure of S Ltd, is inventory which has been purchased from SS Ltd at cost plus 25%.
- The parent company has adopted an accounting policy to measure non-controlling interest at fair value (quoted market price) applying Ind AS 103. Assume market prices of S Ltd and SS Ltd are the same as respective face values.

Solution:

Consolidated Balance Sheet of the Group as at 31st March, 20X2

Particulars	Note No.	₹ in lakh
ASSETS		
Non-current assets		
Property, plant and equipment	1	980
Current assets		
(a) Inventory	2	338
(b) Financial assets		
Trade receivable	3	580
Bills receivable	4	2
Cash and cash equivalent	5	<u>308</u>

Total assets		<u>2,208</u>
EQUITY & LIABILITIES		
Equity attributable to owners of parent		
Share Capital		600
Other Equity		
Reserve (W.N.5)		194
Retained Earnings (W.N.5)		179.8
Capital Reserve (W.N.3)		188
Non-controlling interests (W.N.4)		<u>166.2</u>
Total equity		<u>1,328</u>
LIABILITIES		
Non-current liabilities		Nil
Current liabilities		
(a) Financial Liabilities		
(i) Trade payables	6	<u>880</u>
Total liabilities		<u>880</u>
Total equity and liabilities		<u>2,208</u>

Notes to Accounts

(₹ in lakh)

1. Property Plant & Equipment		
P Ltd.	320	
S Ltd.	360	
SS Ltd.	<u>300</u>	980
2. Inventories		
P Ltd.	220	
S Ltd. (70-2)	68	
SS Ltd.	<u>50</u>	338
3. Trade Receivable		
P Ltd.	260	
S Ltd.	100	
SS Ltd.	<u>220</u>	580

4.	Bills Receivable		
	P Ltd. (72-70)	2	
	SS Ltd. (30-30)	<u>-</u>	2
5.	Cash & Cash equivalents		
	P Ltd.	228	
	S Ltd.	40	
	SS Ltd.	<u>40</u>	308
6.	Trade Payables		
	P Ltd.	470	
	S Ltd.	230	
	SS Ltd.	<u>180</u>	880

Working Notes:**1. Analysis of Reserves and Surplus**

(₹ in lakh)

		S Ltd.	SS Ltd.
Reserves as on 31.3.20X1		80	60
Increase during the year 20X1-20X2	20		20
Increase for the half year till 30.9.20X1		<u>10</u>	<u>10</u>
Balance as on 30.9.20X1 (A)		90	70
Total balance as on 31.3.20X2		<u>100</u>	<u>80</u>
Post-acquisition balance		<u>10</u>	<u>10</u>
Retained Earnings as on 31.3.20X1		20	30
Increase during the year 20X1-20X2	30		30
Increase for the half year till 30.9.20X1		<u>15</u>	<u>15</u>
Balance as on 30.9.20X1 (B)		35	45
Total balance as on 31.3.20X2		<u>50</u>	<u>60</u>
Post-acquisition balance		15	15
Less: Unrealised Gain on inventories (10 ÷ 125 x 25)		<u>-</u>	<u>(2)</u>
Post-acquisition balance for CFS		<u>15</u>	<u>13</u>
Total balance on the acquisition date ie. 30.9.20X1 (A+B)		125	115

2. Calculation of Effective Interest of P Ltd. in SS Ltd.

Acquisition by P Ltd. In S Ltd.	= 80%
Acquisition by S Ltd. In SS Ltd.	= 75%
Acquisition by Group in SS Ltd. (80% x 75%)	= 60%
Non-controlling Interest	= 40%

3. Calculation of Goodwill / Capital Reserve on the acquisition

	S Ltd.	SS Ltd.
Investment or consideration	340	(280 x 80%) 224
Add: NCI at Fair value		
(400 x 20%)	80	
(320 x 40%)	<u>-</u>	<u>128</u>
	420	352
Less: Identifiable net assets (Share Capital + Increase in the Reserves and Surplus till acquisition date)	(400+125) (525)	(320+115) (435)
Capital Reserve	<u>105</u>	<u>83</u>
Total Capital Reserve (105 + 83)	188	

4. Calculation of Non-controlling Interest

	S Ltd.	SS Ltd.
At Fair Value (See Note 3)	80	128
Add: Post Acquisition Reserves (See Note 1)	(10 x 20%) 2	(10 x 40%) 4
Add: Post Acquisition Retained Earnings (See Note 1)	(15 x 20%) 3	(13 x 40%) 5.2
Less: NCI share of investment in SS Ltd.	(280 x 20%) <u>(56)*</u>	<u>-</u>
	<u>29</u>	<u>137.2</u>
Total (29 + 137.2)	166.2	

***Note:** The non-controlling interest in S Ltd. will take its proportion in SS Ltd. So, they have to bear their proportion in the investment by S Ltd. (in SS Ltd.) also.

5. Calculation of Consolidated Other Equity

	Reserves	Retained Earnings
P Ltd.	180	160
Add: Share in S Ltd.	(10 x 80%) 8	(15 x 80%) 12
Add: Share in SS Ltd.	(10 x 60%) <u>6</u>	(13 x 60%) <u>7.8</u>
	<u>194</u>	<u>179.8</u>

Note: It is assumed date the sale of goods by SS Ltd. is done after acquisition of shares by S Ltd. Alternatively, it may be assumed that the sale has either been done before acquisition of shares by S Ltd. in SS Ltd. or sale has been throughout the year. Accordingly, the treatment for unrealized gain may vary.



4.3 LOSS OF CONTROL

A parent can lose control over a subsidiary in a number of ways. These include:

- Loss of control due to outright sale – where the entire stake is sold off,
- Loss of control due to partial sale – where the parent retains interest as an associate, jointly controlled entity or a financial asset,
- Deemed loss of control where no consideration is received but the parent's interest is diluted in some other manner such as:
 - voting rights issued to a new investor,
 - control on relevant activities,
 - consolidation of voting rights of other shareholders;
 - an investor acquiring substantial stake from the stock exchange.

In this section we will discuss following two things:

- Accounting treatment of loss of control of a subsidiary
- Loss of control of a subsidiary in two or more arrangements (transactions)

4.3.1 Accounting treatment on loss of control of a subsidiary

If a parent loses control of a subsidiary, it shall follow the accounting treatment mentioned below:

If a parent loses control of a subsidiary, it shall

<u>Derecognise:</u>	<u>Recognise:</u>	<u>Reclassify:</u>	<u>Recognises gain / loss:</u>
- the assets (including any goodwill) and liabilities of the subsidiary - the carrying amount of any non-controlling interests in the former subsidiary	- the fair value of the consideration received - if loss of control involves a distribution of shares of the subsidiary to owners, then that distribution; and - any investment retained in the former subsidiary at its fair value at the date when control is lost (refer note 1 below)	to profit or loss, or transfer directly to retained earnings if required by other Ind ASs, the amounts recognised in other comprehensive income in relation to the subsidiary (refer note 2 below)	recognise any resulting difference as a gain or loss in profit or loss attributable to the parent

Note 1: The fair value at which the retained interest is recognized shall be regarded as the fair value on initial recognition of a financial asset in accordance with Ind AS 109 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.

Example 7

A Ltd. was holding 60% stake in B Ltd. Now A Ltd. has sold 50% stake to a third party and balance 10% stake is retained. The fair value of that 10% stake on the date of loss of control is ₹ 1,00,000. So, A Ltd. will record the 10% stake at ₹ 1,00,000 on the date of loss of control. This fair value will be treated as fair value on initial recognition as per Ind AS 109. In case, after the loss of control, A Ltd. still has significant influence over B Ltd. (e.g. through board representation) then this fair value of ₹ 1,00,000 will be treated as cost on initial recognition of investment in associate B Ltd.

Note 2: If a parent loses control of a subsidiary, the parent shall account for all amounts previously recognized in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.

Example 8

X Ltd. has previously recognized in other comprehensive income in relation to a subsidiary Y Ltd. i) cumulative exchange differences relating to a foreign operation and ii) revaluation surplus. Now X Ltd. has sold its entire holding in Y Ltd. and hence has lost control over it. Hence, on loss of control, X Ltd. should reclassify the cumulative exchange differences relating to the foreign operation (that would have been reclassified to profit or loss if the parent had directly disposed of that foreign operation) to profit or loss as reclassification adjustment. The revaluation surplus (that would have been transferred directly to retained earnings if the parent had directly disposed of the asset) shall be transferred directly to retained earnings.

Illustration 30: Subsidiary issues shares to a third party and parent loses control

In March 20X1 a group had a 60% interest in subsidiary with share capital of 50,000 ordinary shares. The carrying amount of goodwill is ₹ 20,000 at March 20X1 calculated using the partial goodwill method. On 31 March 20X1, an option held by the minority shareholders exercised the option to subscribe for a further 25,000 ordinary shares in the subsidiary at ₹ 12 per share, raising ₹ 3,00,000. The net assets of the subsidiary in the consolidated balance sheet prior to the option's exercise were ₹ 4,50,000, excluding goodwill.

Calculate gain or loss on loss of interest in subsidiary due to option exercised by minority shareholder.

Solution:

Shareholdings

	Before		After	
	No	%	No	%
Group	30,000	60	30,000	40
Other party	<u>20,000</u>	<u>40</u>	<u>45,000</u>	<u>60</u>
	<u>50,000</u>	<u>100</u>	<u>75,000</u>	<u>100</u>
Net assets	₹' 000	%	₹' 000	%
Group's share	270	60	300	40
Other party's share	<u>180</u>	<u>40</u>	<u>450</u>	<u>60</u>
	<u>450</u>	<u>100</u>	<u>750</u>	<u>100</u>

Calculation of group gain on deemed disposal	₹' 000
Fair value of 40% interest retained (₹ 12 x 30,000)**	360
Less: Net assets derecognized	(450)
Non-controlling interest derecognized	180
Goodwill	<u>(20)</u>
Gain on deemed disposal	<u>70</u>

**** Note:** For simplicity, it has been assumed the fair value per share is equal to the subscription price.

As control of the subsidiary is lost, the retained interest is recognized at its fair value at the date control is lost. The resulting remeasurement gain is recognized in profit and loss.

Illustration 31: Calculation of gain on outright sale of subsidiary

A parent purchased 80% interest in a subsidiary for ₹ 1,60,000 on 1 April 20X1 when the fair value of the subsidiary's net assets was ₹ 1,75,000. Goodwill of ₹ 20,000 arose on consolidation under the partial goodwill method. An impairment of goodwill of ₹ 8,000 was charged in the consolidated financial statements for year ended 31 March 20X3. No other impairment charges have been recorded. The parent sold its investment in the subsidiary on 31 March 20X4 for ₹ 2,00,000. The book value of the subsidiary's net assets in the consolidated financial statements on the date of the sale was ₹ 2,25,000 (not including goodwill of ₹ 12,000). When the subsidiary met the criteria to be classified as held for sale under Ind AS 105, no write off was required because the expected fair value less cost to sell (of 100% of the subsidiary) was greater than the carrying value.

The parent carried the investment in the subsidiary in its separate financial statements at cost, as permitted by Ind AS 27.

Calculate gain or loss on disposal of subsidiary in parent's separate and consolidated financial statements as at 31st March 20X4.

Solution:

The parent's separate statement of profit and loss for 20X3-20X4 would show a gain on the sale of investment of ₹ 40,000 calculated as follow:

	₹' 000
Sales proceeds	200
Less: Cost of investment in subsidiary	(160)
Gain on sale in parent's account	<u>40</u>

However, the group's statement of profit & loss for 20X3-20X4 would show a gain on the sale of subsidiary of ₹ 8,000 calculated as follows:

		₹' 000
Sales proceeds		200
Less: Share of net assets at date of disposal (₹ 2,25,000 X 80%)	(180)	
Goodwill on consolidation at date of sale (W.N.)	<u>(12)</u>	<u>(192)</u>
Gain on sale in group's account		<u>8</u>

Working note

The goodwill on consolidation (assuming partial goodwill method) is calculated as follows:

		₹' 000
Fair value of consideration at the date of acquisition		160
Non-controlling interest measured at proportionate share of the acquiree's identifiable net assets (1,75,000 X 20%)	35	
Less: Fair value of net assets of subsidiary at date of acquisition	<u>(175)</u>	<u>(140)</u>
Goodwill arising on consolidation		20
Impairment at 31 March 20X3		<u>(8)</u>
Goodwill at 31 March 20X4		<u>12</u>

Illustration 32: Partial disposal when subsidiary becomes an associate

AT Ltd. purchased a 100% subsidiary for ₹ 50,00,000 on 31st March 20X1 when the fair value of the net assets of BT Ltd. was ₹ 40,00,000. Therefore, goodwill is ₹ 10,00,000. AT Ltd. sold 60% of its investment in BT Ltd. on 31st March 20X3 for ₹ 67,50,000, leaving the AT Ltd. with 40% and significant influence. At the date of disposal, the carrying value of net assets of BT Ltd. excluding goodwill is ₹ 80,00,000. Assume the fair value of the investment in associate BT Ltd. retained is proportionate to the fair value of the 60% sold, that is ₹ 45,00 000.

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as at 31st March 20X3. Provide Journal Entries.

Solution:

AT Ltd.'s standalone statement for profit or loss of 20X2-20X3 would show a gain on the sale of investment of a ₹ 37,50,000 calculated as follows:

	₹' lakh
Sales proceeds	67.5
Less: Cost of investment in subsidiary (₹ 50,00,000 * 60%)	<u>(30.0)</u>
Gain on sale in parent's account	<u>37.5</u>

In the consolidated financial statements, the group will calculate the gain or loss on disposal differently. The carrying amount of all of the assets including goodwill is derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

The gain on the disposal will, therefore, be calculated as follows:

	₹' lakh
Sales proceeds	67.5
Fair value of 40% interest retained	<u>45.0</u>
	112.5
Less: Net assets disposed, including goodwill (80,00,000+ 10,00,000)	<u>(90.0)</u>
Gain on sale in the group's financial statements	<u>22.5</u>

The gain on loss of control would be recorded in consolidated statement of profit and loss. The gain or loss includes the gain of ₹ 13,50,000 [₹ 67,50,000 – (₹ 90,00,000 x 60%)] on the portion sold. However, it also includes a gain on remeasurement of the 40% retained interest of ₹ 9,00,000 (₹ 36,00,000* to ₹ 45,00,000). The entity will need to disclose the portion of the gain that is attributable to remeasuring any remaining interest to fair value, that is, ₹ 9,00,000.

* 90,00,000 x 40% = 36,00,000

Illustration 33: Partial disposal when 10% investment in former subsidiary is retained

The facts of this illustration are same per the above Illustration, except the group AT Ltd. Disposes of a 90% interest for ₹ 85,50,000 leaving the AT Ltd. with a 10% investment. The fair value of the remaining interest is ₹ 9,50,000 (assumed for simplicity to be pro rata to the fair value of the 90% sold)

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as at 31st March 20X3.

Solution:

The parent's AT Ltd. income statement in its separate financial statements for 20X2-20X3 would show a gain on the sale of the investment of ₹ 40,50,000 calculated as follows:

	₹' lakh
Sales proceeds	85.5
Less: Cost of investment in subsidiary (₹ 50,00,000 * 90%)	<u>(45.0)</u>
Gain on sale in parent's account	<u>40.5</u>

In the consolidated financial statements, all of the assets, including goodwill are derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

	₹' lakh
Sales proceeds	85.5
Fair value of 10% interest retained	<u>9.5</u>
	95.0
Less: Net assets disposed, including goodwill (80,00,000 + 10,00,000)	<u>(90.0)</u>
Gain on sale in the group's financial statements	<u>5.0</u>

The gain on loss of control would be recorded in profit or loss. The gain or loss includes the gain of ₹ 4,50,000 related to the 90% portion sold [₹ 85,50,000 – (₹ 90,00,000 x 90%)] as well as ₹ 50,000 related to the remeasurement of fair value of 10% retained interest (₹ 9,00,000 to ₹ 9,50,000).

4.3.2 Loss of control of a subsidiary in two or more arrangements (transactions)

A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be **accounted for as a single transaction**.

The above requirement is relevant because Ind AS 110 requires an entity to record gain / loss on disposal of investment in subsidiary in profit or loss only when the control is lost. This can give opportunity to an entity to arrange the disposal in such a way that it can reduce the amount to be recognized in profit or loss.

Example 9

MN Ltd. was holding 80% stake in UV Ltd. Now, MN Ltd. wants to dispose its entire holding in UV Ltd. It can do it in following ways:

- Option 1: Sale entire 80% stake in single transaction. In this case, the entire gain / loss on sale of 80% stake would be recognised in profit or loss.
- Option 2: Sale 25% stake in one transaction and sale the remaining 55% stake in another transaction. In this case, the gain / loss on sale of 25% stake would be recognised directly in equity since it will be sale of stake without loss of control. When the remaining 55% stake is sold then the gain / loss pertaining to that stake will be recognised in profit or loss.

In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:

They are entered into at the same time or in contemplation of each other.

They form a single transaction designed to achieve an overall commercial effect

The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.

One arrangement considered on its own is not economically justified, unless it is considered together with other arrangements. (e.g. when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market)

Illustration 34: Loss control of a subsidiary in two transactions

MN Ltd. was holding 80% stake in UV Ltd. Now, MN Ltd. has disposed of the entire stake in UV Ltd. in two different transactions as follows:

- Transaction 1: Sale of 25% stake for a cash consideration of ₹ 2,50,000
- Transaction 2: Sale of 55% stake for a cash consideration of ₹ 5,50,000

Both the transactions have happened within a period of one month. In accordance with the guidance given in Ind AS 110, both the transactions have to be accounted as a single transaction.

The net assets of UV Ltd. and non-controlling interest on the date of both the transactions was ₹ 9,00,000 and ₹ 1,80,000 respectively (assuming there were no earnings between the period of two transactions).

How MN Ltd. should account the transaction?

Solution:

MN Ltd. will account for the transaction as follows:

	₹	
Recognise:		
Fair value of consideration (2,50,000 + 5,50,000)		8,00,000
Derecognise:		
Net assets of UV Ltd.	(9,00,000)	
Non-controlling interest	<u>1,80,000</u>	<u>(7,20,000)</u>
Gain to be recorded in profit or loss		<u>80,000</u>

If MN Ltd. loses control over UV Ltd. on the date of transaction 1, then the above gain is recorded on the date of transaction 1 and MN Ltd. will stop consolidating UV Ltd. from that date. The consideration of ₹ 5,50,000 receivable in transaction 2 will be shown as consideration receivable.

If MN Ltd. loses control over UV Ltd. on the date of transaction 2, then the above gain is recorded on the date of transaction 2 and MN Ltd. will stop consolidating UV Ltd. from that date. The consideration of ₹ 2,50,000 received in transaction 1 will be shown as advance consideration received.



4.4 ACCOUNTING FOR A CHANGE IN INVESTMENT ENTITY STATUS

A parent that either ceases to be an investment entity or becomes an investment entity shall account for the change in its status **prospectively** from the date at which the change in status occurred.

4.4.1 Accounting when an entity ceases to be an investment entity

When an entity ceases to be an investment entity, it shall apply Ind AS 103 to any subsidiary that was previously measured at fair value through profit or loss. The date of the change of status shall be the deemed acquisition date. The fair value of the subsidiary at the deemed acquisition date shall represent the transferred deemed consideration when measuring any goodwill or gain from a bargain purchase that arises from the deemed acquisition. All subsidiaries shall be consolidated in accordance with the consolidation principles discussed above in this unit.

Illustration 35: An entity ceases to be an investment entity

A Limited ceased to be an investment entity from 1st April 20X1 on which date it was holding 80% of B Limited. The carrying value of such investment in B Limited (which was measured at fair value through profit or loss) was ₹ 4,00,000. The fair value of non-controlling interest on the date of change in status was ₹ 1,00,000. The value of subsidiary's identifiable net assets as per Ind AS 103 was ₹ 4,50,000 on the date of change in status. Determine the value of goodwill and pass the journal entry on the date of change in status of investment entity. (Assume that non-controlling interest is measured at fair value method)

Solution:

Goodwill calculation:		₹
Deemed consideration (i.e. fair value of subsidiary on the date of change in status)		4,00,000
Fair value of non-controlling interest		<u>1,00,000</u>
		5,00,000

Value of subsidiary's identifiable net assets as per Ind AS 103		(4,50,000)
Goodwill		50,000
Journal Entry		₹
	Dr.	Cr.
Net identifiable assets	Dr. 4,50,000	
Goodwill	Dr. 50,000	
To Investment in B Limited (on date of change in status)		4,00,000
To Non-controlling interest		1,00,000

4.4.2 Accounting when an entity becomes an investment entity

When an entity becomes an investment entity, it shall cease to consolidate its subsidiaries at the date of the change in status (except for any subsidiary that itself is not an investment entity but provide services related to the investment entity's investment activities. Such subsidiaries shall be continued to be consolidated). The investment entity shall apply the requirements of loss of control explained earlier in this unit to those subsidiaries that it ceases to consolidate as if the investment entity had lost control of those subsidiaries at that date.

Illustration 36: An entity becomes an investment entity

CD Ltd. purchased a 100% subsidiary for ₹ 20,00,000 on 31st March 20X1 when the fair value of the net assets of KL Ltd. was ₹ 16,00,000. Therefore, goodwill was ₹ 4,00,000. CD Ltd. becomes an investment entity on 31st March 20X3 when the carrying value of its investment in KL Ltd. (measured at fair value through profit or loss) was ₹ 25,00,000. At the date of change in status, the carrying value of net assets of KL Ltd. excluding goodwill was ₹ 19,00,000.

Calculate gain or loss with respect to investment in KL Ltd. on the date of change in investment entity status of CD Ltd.

Solution:

The gain on the disposal will be calculated as follows:

	₹
Fair value of retained interest (100%)	25,00,000
Less: Net assets disposed, including goodwill (19,00,000 + 4,00,000)	(23,00,000)
Gain on the date of change in investment entity status of CD Ltd.	<u>2,00,000</u>



4.5 SIGNIFICANT DIFFERENCES BETWEEN IND AS 110 AND AS 21

S. No.	Topic	Ind AS 110	AS 21
1.	Preparation of Consolidated Financial Statements	Ind AS 110 makes the preparation of consolidated financial statements mandatory for a parent (subject to limited exceptions).	AS 21 does not mandate the preparation of consolidated financial statements by a parent. However, if a parent presents consolidated financial statements, it is required to apply AS 21 in preparing and presenting such financial statements.
2.	Control	The definition of control in Ind AS 110 is principle based - an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.	As per AS 21, control is the ownership of more than one-half of the voting power of an enterprise or control of the composition of the board of directors or other similar governing body of another enterprise so as to obtain economic benefits from its activities. Thus, AS 21 lays down quantitative parameters for determining whether an entity controls another entity.
3.		As per the definition of 'control' under Ind AS 110, control of an entity can be with one entity only.	There can occasionally be situations where application of the definition of 'control' as per AS 21 results in there being two parents of an entity. In such a case, both the parents are required to consolidate the entity in their respective consolidated financial statements.

4.	Exclusion of a subsidiary from consolidation	Ind AS 110 does not permit exclusion of a subsidiary from consolidation on either of these grounds.	As per AS 21, a subsidiary is excluded from consolidation when control is intended to be temporary or when it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.
5.	Difference between the date of the subsidiary's financial statements and that of the consolidated financial statements	Under Ind AS 110 difference between the date of the subsidiary's financial statements and that of the consolidated financial statements cannot exceed three months.	As per AS 21, difference between the date of the subsidiary's financial statements and that of the consolidated financial statements cannot exceed six months.
6.	Changes in a parent's ownership interest in a subsidiary not resulting in losing control	Ind AS 110 specifically lays down accounting requirements applicable to changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary.	In AS 21, no such guidance has been given.
7.	Uniform accounting policies	Ind AS 110, require the use of uniform accounting policies. No such exemption is given in Ind AS 110.	AS 21 allows the use of non-uniform accounting policies if it is not practicable to use uniform accounting policies disclosure is, however, required of, that fact together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

8.	Potential equity shares and its voting rights	As per Ind AS 110, potential voting rights that are substantive are also considered when assessing whether an entity has control over another entity.	For considering share ownership, potential equity shares of the investee held by investor are not taken into account as per AS 21.
9.	Recognition of deferred taxes	Ind AS 110, read with Ind AS 12, requires recognition of deferred taxes in respect of temporary differences that arise from such elimination in consolidated financial statements.	According to AS 21, the tax expense (comprising current tax and deferred tax) to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries. This means that under AS 21, deferred taxes are not recognised in consolidated financial statements in respect of timing differences that arise from the elimination of profits and losses resulting from intragroup transactions in consolidated financial statements.

UNIT 5:

IND AS 111: JOINT ARRANGEMENTS



5.1 OBJECTIVE OF IND AS 111

Joint arrangement is an arrangement of which two or more parties have joint control. Joint arrangements are established for a variety of purposes (e.g. as a way for parties to share costs and risks, or as a way to provide the parties with access to new technology or new markets) and can be established using different structures and legal forms.

The objective of Ind AS 111 is to establish principles for financial reporting by entities that have an interest in a joint arrangement.

This Ind AS defines various terms related to joint arrangements. It requires an entity that is a party to a joint arrangement to determine the type of joint arrangement in which it is involved i.e. whether it is a joint operation or a joint venture by assessing its rights and obligations. Based on the type of the arrangement, the accounting treatment for that arrangement will be decided.



5.2 SCOPE OF IND AS 111

Ind AS 111 shall be applied by all entities that are a party to a joint arrangement.



5.3 ASSESSMENT OF JOINT ARRANGEMENT

As mentioned above, a joint arrangement is an arrangement of which two or more parties have joint control.

A joint arrangement has the following characteristics:

The parties are bound by a contractual arrangement

AND

The contractual arrangement gives two or more of those parties joint control of the arrangement

5.3.1 Contractual arrangement

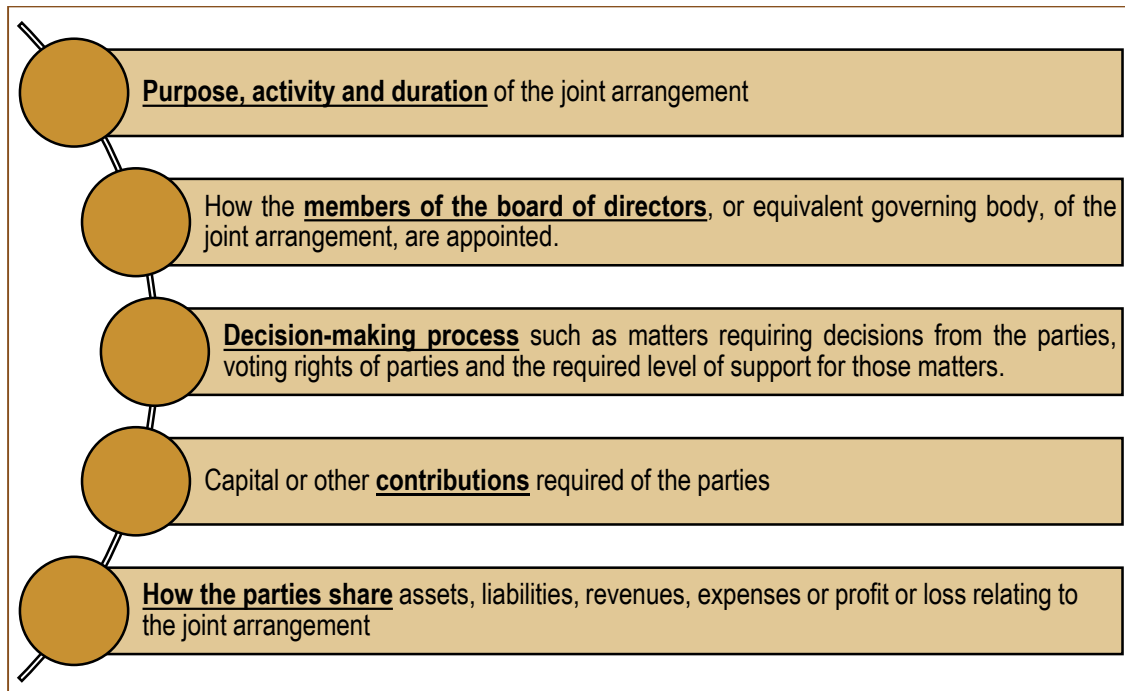
One of the essential elements of a joint arrangement is that there has to be a contractual arrangement between the parties to the arrangement. A contractual arrangement is usually in writing, however, it can be evidenced in several other ways as well.

A joint arrangement can be structured through a separate vehicle. In most of such case, the contractual arrangement is incorporated in the articles, charter or by-laws of the separate vehicle.

Example 1

A Ltd. and B Ltd. incorporated a new entity AB Ltd. The articles of association of AB Ltd. defines the terms of contractual arrangements between A Ltd. and B Ltd.

The contractual arrangement describes the terms of arrangement between the two or more parties that are involved in the activity that is subject of the arrangement. The contractual arrangement generally deals with such matters as:



5.3.2 Joint control

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when **decisions about the relevant activities** require the **unanimous consent** of the parties sharing control.

Hence, in a joint arrangement, all the parties to an arrangement must act collectively in order to take decisions about the relevant activities of the arrangement and there is no single party who

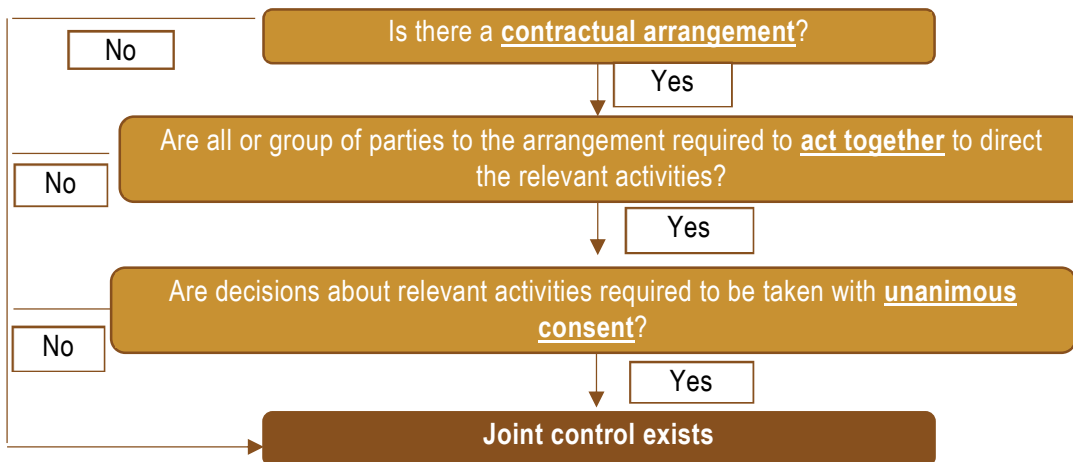
can control the arrangement individually. In a joint arrangement, any party sharing the control can prevent the other party / parties from controlling the arrangement.

In order to assess the joint control, an entity that is a party to an arrangement should **first assess** that whether the contractual arrangement gives all the parties or a group of the parties **control over the arrangement**. Control assessment will be done based on the guidance given in Ind AS 110 (which is discussed in Unit 3). Accordingly, all the principles of control assessment, some of which are summarised below, would be relevant while doing the assessment of joint control by the parties:

- Power over the relevant activities of the investee
 - Power with and without voting rights
 - Potential voting rights
 - Rights to appoint Key Managerial Personnel
 - De-facto control
 - Purpose and design of the investee
 - Contractual arrangements
 - Special relationship with investor and investee
- Exposure to returns
- Ability to use the power to affect the returns of the investee

Hence, if all the parties or a group of parties to a contractual arrangement (**considered collectively**) have power, exposure to returns and ability to use that power to affect the returns of the arrangement then the parties have control over the arrangement collectively.

The flowchart below can be used as a visual aid to remember the aforementioned concepts in brief:



Please remember: In a joint arrangement, no single party controls the arrangement on its own. That is because, by definition, a party with joint control can prevent other parties from controlling the arrangement.

Following are some of the illustrations for doing assessment of joint control.

(One should keep in mind that the illustrations on control assessment discussed in Unit 3 would also be equally relevant for doing assessment of joint control).

Illustration 1: Joint control

ABC Ltd. and DEF Ltd. have entered into a contractual arrangement to manufacture a product and sell that in retail market. As per the terms of the arrangement, decisions about the relevant activities require consent of both the parties. The parties share the returns of the arrangement equally amongst them. Whether the arrangement can be treated as joint arrangement?

Solution:

The arrangement is a joint arrangement since both the parties are bound by the contractual arrangement and the decisions about relevant activities require unanimous consent of both the parties.

Sometimes the decision-making process that is agreed upon by the parties in their contractual arrangement **implicitly leads to joint control**. This is explained in below illustrations:

Illustration 2: Implicit joint control

PQR Ltd. and XYZ Ltd. established an arrangement in which each has 50% of the voting rights and the contractual arrangement between them specifies that at least 51% of the voting rights are required to make decisions about the relevant activities. Whether the arrangement can be treated as joint arrangement?

Solution:

In this case, the parties have implicitly agreed that they have joint control of the arrangement because decisions about the relevant activities cannot be made without both parties agreeing.

Illustration 3: Implicit joint control

A Ltd., B Ltd. and C Ltd. established an arrangement whereby A Ltd. has 50% of the voting rights in the arrangement, B Ltd. has 30% and C has 20%. The contractual arrangement between A Ltd., B Ltd. and C Ltd. specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement. Whether the arrangement can be treated as joint arrangement?

Solution:

In this case, even though A can block any decision, it does not control the arrangement because it needs the agreement of B. The terms of their contractual arrangement requiring at least 75% of the voting rights to make decisions about the relevant activities imply that A Ltd. and B Ltd. have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A Ltd. and B Ltd. agreeing.

Apart from the above-mentioned situations of implicit joint control, there can be other circumstances where the contractual arrangement requires a minimum proportion of the voting rights to make decisions about the relevant activities. When that minimum required proportion of the voting rights can be achieved by more than one combination of the parties agreeing together, that arrangement is not a joint arrangement unless the **contractual arrangement specifies** which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement. This is explained in below illustrations:

Illustration 4: Explicit joint control

An arrangement has three parties: X Ltd. has 50% of the voting rights in the arrangement and Y Ltd. and Z Ltd. each have 25%. The contractual arrangement between them specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement. Whether the arrangement can be treated as joint arrangement?

Solution:

In this case, even though X Ltd. can block any decision, it does not control the arrangement because it needs the agreement of either Y Ltd. or Z Ltd. In this question, X Ltd., Y Ltd. and Z Ltd. collectively control the arrangement. However, there is more than one combination of parties that can agree to reach 75% of the voting rights (i.e. either X Ltd. and Y Ltd. or X Ltd. and Z Ltd.). In such a situation, to be a joint arrangement the contractual arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to decisions about the relevant activities of the arrangement.

Illustration 5: Explicit joint control

An arrangement has A Ltd. and B Ltd. each having 35% of the voting rights in the arrangement with the remaining 30% being widely dispersed. Decisions about the relevant activities require approval by a majority of the voting rights. Whether the arrangement can be treated as joint arrangement?

Solution:

A Ltd. and B Ltd. have joint control of the arrangement only if the contractual arrangement specifies that decisions about the relevant activities of the arrangement require both A Ltd. and

B Ltd. agreeing. However, in the given case, decisions about the relevant activities require approval by a majority of the voting rights. Hence, there is no joint arrangement.

The above illustrations also highlight that it is **not necessary** that all the parties in an arrangement should have joint control to form a joint arrangement. Some party or parties may be participating in the joint arrangement but may not be having joint control of that joint arrangement. That is the reason the word “or” has been used between the words “all” and “group of parties” in the flowchart given earlier.

Following are some further illustrations on assessment of whether a joint arrangement exists or not:

Illustration 6: Joint control through board representation

Electronics Ltd. is established by two investors R Ltd. and S Ltd. The investors are holding 60% and 40% of the voting power of the investee respectively.

As per the articles of association of Electronics Ltd., both the investors have right to appoint 2 directors each on the board of Electronics Ltd. The directors appointed by each investor will act in accordance with the directions of the investor who has appointed such director. Further, articles of association provides that the decision about relevant activities of the entity will be taken by board of directors through simple majority.

Determine whether Electronics Ltd. is controlled by a single investor or is jointly controlled by both the investors.

Solution:

The decisions about relevant activities are required to be taken by majority of board of directors. Hence, out of the 4 directors, at least 3 directors need to agree to pass any decision. Accordingly, the directors appointed by any one investor cannot take the decisions independently without the consent of at least one director appointed by other investor. Hence, Electronics Ltd. is jointly controlled by both the investors. R Ltd. holding majority of the voting rights is not relevant in this case since the voting rights do not given power over the relevant activities of the investee.

Illustration 7: Chairman with casting vote

MN Software Ltd. is established by two investors M Ltd. and N Ltd. Both the investors are holding 50% of the voting power each of the investee.

As per the articles of association of MN Software Ltd., both the investors have right to appoint 2 directors each on the board of the company. The directors appointed by each investor will act in accordance with the directions of the investor who has appointed such director. The decision about relevant activities of the entity will be taken by board of directors through simple majority.

Articles of association also provides that M Ltd. has right to appoint the chairman of the board who will have right of a casting vote in case of a deadlock situation.

Determine whether MN Software Ltd. is jointly controlled by both the investors.

Solution:

The decisions about relevant activities are required to be taken by majority of board of directors. Hence, out of the 4 directors, at least 3 directors need to agree to pass any decision. Accordingly, the directors appointed by any one investor cannot take the decisions independently without the consent of at least one director appointed by other investor. However, the chairman of the board has right for a casting vote in case of a deadlock in the board. Hence, M Ltd. has the ability to take decisions related to relevant activities through 2 votes by directors and 1 casting vote by chairman of the board. Therefore, M Ltd. individually has power over MN Software Ltd. and there is no joint control.

Illustration 8: Equal voting rights but no joint control

ABC Ltd. is established by two investors AB Ltd. and BC Ltd. Each investor is holding 50% of the voting power of the investee.

As per the articles of association of ABC Ltd., AB Ltd. and BC Ltd. have right to appoint 3 directors and 2 directors respectively on the board of ABC Ltd. The directors appointed by each investor will act in accordance with the directions of the investor who has appointed such director. Further, articles of association provides that the decision about relevant activities of the entity will be taken by board of directors through simple majority.

Determine whether ABC Ltd. is jointly controlled by both the investors.

Solution:

The decisions about relevant activities are required to be taken by majority of board of directors. Hence, out of the 5 directors, at least 3 directors need to agree to pass any decision. Accordingly, the directors appointed by AB Ltd. can take the decisions independently without the consent of any of the directors appointed by BC Ltd. Hence, ABC Ltd. is not jointly controlled by both the investors. Equal voting rights held by both the investors is not relevant in this case since the voting rights do not give power over the relevant activities of the investee.

Illustration 9: Joint control over specific asset

X Ltd. and Y Ltd. entered into a contractual arrangement to buy a piece of land to construct residential units on the said land and sell to customers.

As per the arrangement, the land will be further divided into three equal parts. Out of the three parts, both the parties will be responsible to construct residential units on one part each by taking

decision about relevant activities independently and they will be entitled to the returns generated from their own part of land. The third part of the land will be jointly managed by both the parties requiring unanimous consent of both the parties for all the decision making.

Determine whether the arrangement is a joint arrangement or not.

Solution:

The two parts of the land which are required to be managed by both the parties independently on their own would not fall within the definition of a joint arrangement. However, the third part of the land which is required to be managed by both the parties with unanimous decision making would meet the definition of a joint arrangement.

Illustration 10: Multiple relevant activities directed by different investors

Entity R and entity S established a new entity RS Ltd. to construct a national highway and operate the same for a period of 30 years as per the contract given by government authorities.

As per the articles of association of RS Ltd, the construction of the highway will be done by entity R and all the decisions related to construction will be taken by entity R independently. After the construction is over, entity S will operate the highway for the period of 30 years and all the decisions related to operating of highway will be taken by entity S independently. However, decisions related to funding and capital structure of RS Ltd. will be taken by both the parties with unanimous consent.

Determine whether RS Ltd. is a joint arrangement between entity R and entity S?

Solution:

In this case, the investors should evaluate which of the decisions about relevant activities can most significantly affect the returns of RS Ltd. In the given case, construction of the national highway and operation of the same are both significant activities with control over the same being held unilaterally by R Ltd. and S Ltd. However, the decisions related to funding and capital structure of RS Ltd. are taken with unanimous consent.

The above structure is tabulated below:

Activity	Decision-making	Remarks
Construction of the highway	R Ltd., independently	All activities are significant for RS Ltd., but since funding and capital structure are essential without which construction and operation cannot commence, the same is highly significant.
Operation of the highway	S Ltd., independently	
Funding and Capital Structure	Joint decision-making by R Ltd. and S Ltd., both	

In view of the above, since the decision relating to Funding and Capital Structure are taken jointly by R Ltd. and S Ltd. both, we can conclude that RS Ltd. is a joint arrangement.

Illustration 11: Informal agreement for sharing of control

An entity has four investors A, B, C and D holding 10%, 20%, 30% and 40% voting power respectively. The articles of association require decisions about relevant activities to be taken by majority voting rights. However, investor A, B and C have informally agreed to vote together. This informal agreement has been effective in recent meetings of the investors to take decisions about relevant activities. Whether A, B and C have joint control over the entity?

Solution:

In this case, three investors have informally agreed to make unanimous decisions. These three investors together also have majority voting rights in the entity. Hence, investor A, B and C have joint control over the entity. The agreement between investor A, B and C need not be formally documented as long as there is evidence of its existence in recent meetings of the investors.

It should be noted that if the requirement for unanimous consent relates only to decisions that give a party **protective rights** and not to decisions about the relevant activities of an arrangement, that party is not a party with joint control of the arrangement. This is explained in below illustration:

Illustration 12: Party with protective rights

D Ltd., E Ltd. and F Ltd. have established a new entity DEF Ltd. As per the arrangement, unanimous consent of all three parties is required only with respect to decisions related to change of name of the entity, amendment to constitutional documents of the entity to enter into a new business, change in the registered office of the entity, etc. Decisions about other relevant activities require consent of only D Ltd. and E Ltd. Whether F Ltd. is a party with joint control of the arrangement?

Solution:

Consent of F Ltd. is required only with respect to the fundamental changes in DEF Ltd. Hence these are protective rights. The decisions about relevant activities are taken by D Ltd. and E Ltd. Hence, F Ltd. is not a party with joint control of the arrangement.

A contractual arrangement might include clauses on the **resolution of disputes**, such as arbitration. These provisions may allow for decisions to be made **without unanimous consent** among the parties that have joint control. The existence of such provisions does not prevent the arrangement from being jointly controlled and, consequently, from being a joint arrangement. This is explained in below illustration:

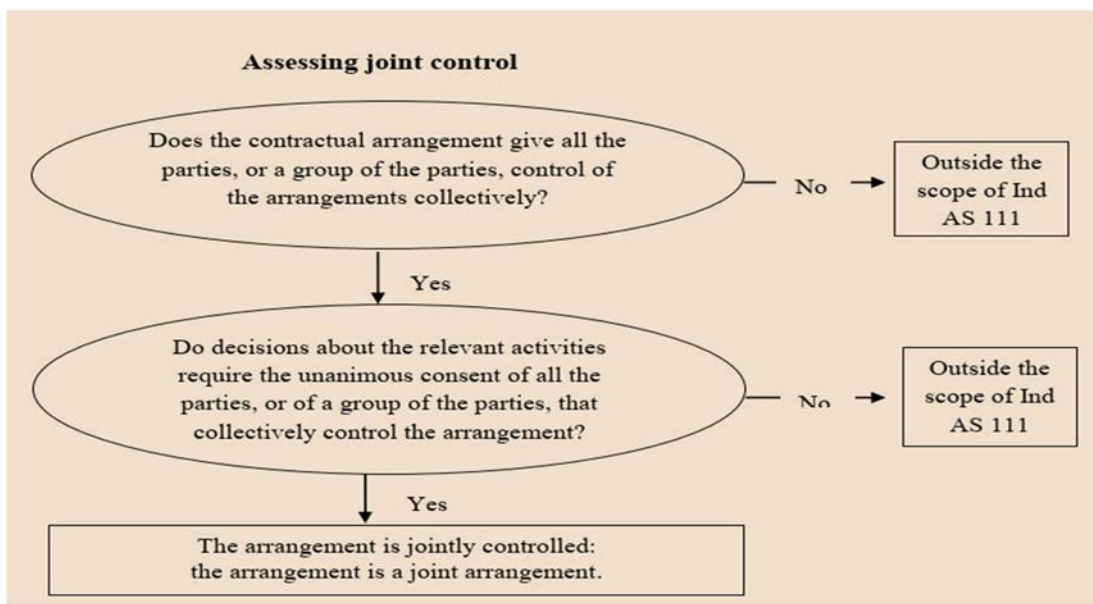
Illustration 13: Resolution of disputes without unanimous consent

Entity A and Entity B established a contractual arrangement whereby the decision related to relevant activities are required to be taken by unanimous consent of both the parties. However, in case of any dispute with any vendor or customer of the arrangement, entity A has right to take necessary decisions for the resolution of disputes including decisions of going for the arbitration or filing a suit in court of law. Whether the arrangement is a joint arrangement?

Solution:

The arrangement is a joint arrangement since the contractual arrangement requires decisions about relevant activities to be taken by unanimous consent of both the parties. The right available with entity A to take decisions for resolution of disputes will not prevent the arrangement from being a joint arrangement.

The following flow chart summarises the requirements of assessing joint control:



When an arrangement is outside the scope of Ind AS 111, an entity accounts for its interest in the arrangement in accordance with relevant Ind AS, such as Ind AS 110, Ind AS 28 or Ind AS 109.

If facts and circumstances change, an entity shall reassess whether it still has joint control of the arrangement.



5.4 TYPES OF JOINT ARRANGEMENT

Once it is determined that an arrangement is a joint arrangement, the entity needs to determine whether the joint arrangement is a joint operation or a joint venture depending upon the rights and obligations of the parties to the arrangement. This determination is relevant because of the way the joint arrangement is accounted for i.e. whether it is a consolidation of assets, liabilities, income and expenses or use of equity method specified under Ind AS 28.

Joint operation and joint venture are defined below:

A **joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have **rights to the assets, and obligations for the liabilities**, relating to the arrangement. Those parties are called joint operators.

A **joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have **rights to the net assets** of the arrangement. Those parties are called joint venturers.

As mentioned above, for classification of a joint arrangement between joint operation and joint venture, the parties shall assess their rights and obligations arising from the arrangement. When making that assessment, an entity shall consider the **structure of the joint arrangement**. Further, if the joint arrangement is **structured through a separate** vehicle then the entity shall consider the following.

The legal form of the separate vehicle

The terms of the contractual arrangement

When relevant, other facts and circumstances

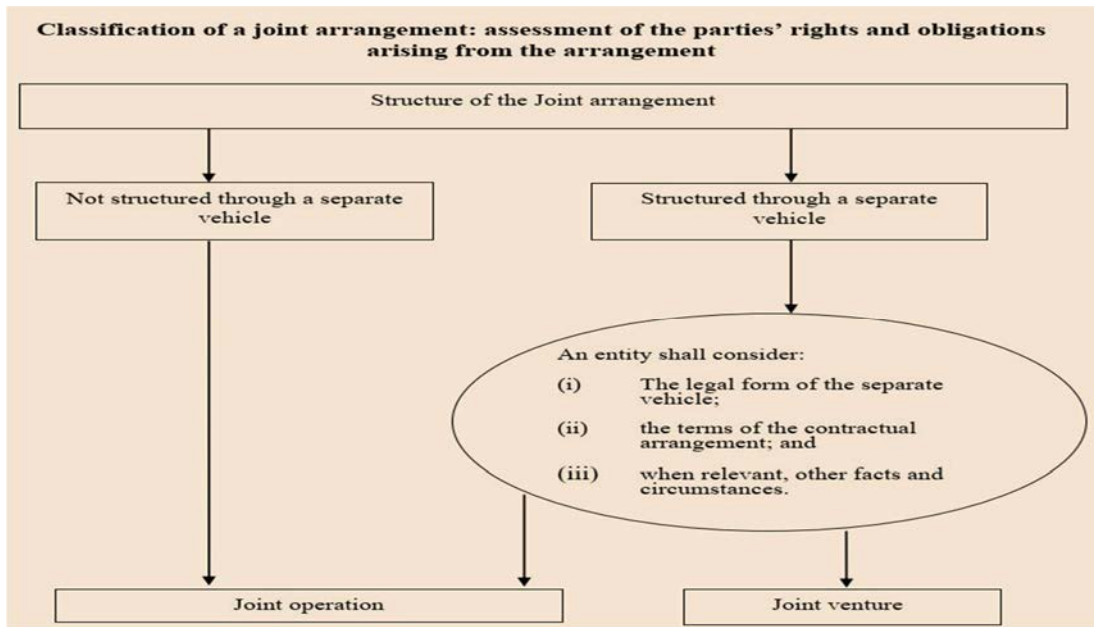
Each of the above factors are discussed below in detail. If facts and circumstances change, an entity shall reassess whether its earlier conclusion on the type of joint arrangement has changed.

5.4.1 Assessment of whether a joint arrangement is a joint operation or a joint venture

When assessing whether a joint arrangement is a joint operation or a joint venture, an entity should first determine whether the joint arrangement is structured through a separate vehicle or not. Some joint arrangements are not structured through a separate vehicle and some joint arrangements are structured through a separate vehicle.

A separate vehicle is defined in Ind AS 111 as a **separately identifiable financial structure**, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality. **Examples** of a separate vehicle include partnership, company, trust, association of persons, government authority, etc.

Below chart summarise the classification of a joint arrangement based on the structure of the arrangement.



5.4.1.1 Joint arrangements not structured through a separate vehicle

A joint arrangement that is not structured through a separate vehicle is a **joint operation**.

In such case, the contractual arrangement often describes the nature of the activities that are the subject of the arrangement and how the parties intend to undertake those activities together. The contractual arrangement also establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement. The contractual arrangement could also specify how the revenues and expenses that are common to the parties are to be shared among them.

This is explained in below illustration:

Illustration 14: Joint operation

P Ltd. and Q Ltd. are two construction entities and they have entered into a contractual arrangement to jointly construct a metro rail project.

The construction of metro rail project involves various activities such as construction of infrastructure (like metro station, control room, pillars at the centre of the road, etc.) for the metro, laying of the tracks, acquiring of the coaches of the metro, etc. The total length of the metro line to be constructed is 50 kms. As per the arrangement, both the parties are responsible to construct 25 kms each. Each party is required to incur its own cost, use its own assets, incur the liability and has right to the revenue from their own part of the work.

Determine whether the arrangement is a joint operation or not?

Solution:

The arrangement is a joint operation since the arrangement is not structured through a separate vehicle and each party has rights to the assets, and obligations for the liabilities relating to their own part of work in the joint arrangement.

In some cases, the parties to a joint arrangement might agree, for example, to share and operate an asset together. However, such arrangements are still a joint operation since they are not structured through a separate vehicle.

In such a case, the contractual arrangement establishes the parties' rights to the asset that is operated jointly, and how output or revenue from the asset and operating costs are shared among the parties. This is explained in below illustration:

Illustration 15: Joint operation by sharing an asset

RS Ltd. and MN Ltd. entered into a contractual arrangement to run a business of providing cars of hire. The cars will be owned by both the parties jointly. The expenses to run the car (like driver salary, petrol, maintenance, insurance, etc.) and revenues from the business will be shared between both the parties as agreed in the contractual arrangement. Determine whether the arrangement is a joint operation or not?

Solution:

The arrangement is a joint operation since the arrangement is not structured through a separate vehicle.

5.4.1.2 Joint arrangements structured through a separate vehicle

A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle can be either **a joint venture or a joint operation**.

As mentioned earlier, when the joint arrangement is structured through a separate vehicle, an entity should consider i) legal form of the separate vehicle, ii) the terms of the contractual arrangement and, when relevant, iii) any other facts and circumstances to assess whether the arrangement is a joint venture or a joint operation. Each of these factors are further explained below.

5.4.1.2.1 The legal form of the separate vehicle

The legal form of the separate vehicle is relevant when assessing the type of joint arrangement.

For example, there may be a situation where the legal form of a separate vehicle causes the separate vehicle to be **considered in its own right** (i.e. the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and

liabilities of the parties). In such case, the legal form of the separate vehicle indicates that the arrangement is a joint venture.

If the legal form of the separate vehicle indicates that the arrangement is a joint venture then the entity should further evaluate the terms of contractual arrangements and any other relevant facts and circumstance to see whether those factors indicate that the arrangement is a joint operation or not. However, if the legal form indicates that the arrangement is a joint operation (i.e. in a situation where the legal form does not confer separation between the parties and the separate vehicle) then there is no need to evaluate any other factor and the arrangement is concluded to be a joint operation.

Illustration 16: Legal form indicates the arrangement to be a joint venture

Entity X and Entity Y are engaged in the business of Engineering, Procurement and Construction (EPC) for its customers. Both the parties have jointly won a contract from a customer for executing an EPC contract and for that the parties have established a new entity XY Ltd. The contract will be executed through XY Ltd.

All the assets required for the execution of the contract will be acquired and liabilities relating to the execution will be incurred by XY Ltd. in its own name. Entity X and entity Y will have share in the net profits of XY Ltd. in the ratio of their shareholding i.e. 50% each. Assuming that the arrangement meets the definition of a joint arrangement, determine whether the joint arrangement is a joint operation or a joint venture?

Solution:

The legal form of the separate vehicle is a company. The legal form of the separate vehicle causes the separate vehicle to be considered in its own right. Hence, it indicates that the arrangement is a joint venture. In this case, the parties should further evaluate the terms of contractual arrangements and other relevant facts and circumstance to conclude whether the arrangement is a joint venture or a joint operation.

Illustration 17: Legal form indicates the arrangement to be a joint operation

Two entities have established a Limited Liability Partnership (LLP) with each party having 50% share in the net profits of the firm. If the arrangement meets the definition of a joint arrangement, determine whether the joint arrangement is a joint operation or a joint venture? Would your answer change if a partnership firm was established instead of an LLP.

Solution:

A limited liability partnership is recognized as a body corporate with an existence distinct from that of its partners. Accordingly, the partners to the LLP would have a right to the net assets of the LLP as against a right to the assets and obligations to the liabilities of the same. Accordingly, such an arrangement would be a joint venture.

In case the entity formed is a partnership firm, the Indian Partnership Act, 1932 does not distinguish the partners from the partnership firm, and therefore all the partners would be liable to the liabilities of the firm, as well as have interest in the assets of the firm (and not the net assets). accordingly, there would be no separation between the partners and the partnership firm. Hence, in such a case, the joint arrangement would be regarded as a joint operation.

5.4.1.2.2 Assessing the terms of the contractual arrangement

Generally, the rights and obligations conferred through contractual arrangement are consistent with the rights and obligations conferred by the legal form of the separate vehicle. However, in some case the contractual arrangement alters the rights and obligations conferred by the legal form of the separate vehicle.

If the contractual arrangement indicates that the arrangement is a joint operation then there is no need to evaluate any other facts and circumstances and the arrangement is concluded to be a joint operation.

Illustration 18: Assessing the terms of the contractual arrangement

Continuing with the illustration 16 above, assume that Entity X and Entity Y have entered into a separate agreement whereby they have agreed that each party has an interest in the assets of the XY Ltd. and each party is liable for the liabilities of XY Ltd. in a specified proportion. Determine whether the joint arrangement is a joint operation or a joint venture?

Solution:

In this case, the terms of the separate agreement may cause the arrangement to be a joint operation.

The following table provides some examples (not an exhaustive list) of some common terms present in contractual arrangements of parties to a joint operation and a joint venture:

Assessing the terms of the contractual arrangement		
	Joint operation	Joint venture
The terms of the contractual arrangement	The terms provide the parties with rights to the assets, and obligations for the liabilities, relating to the arrangement.	The terms provide the parties with rights to the net assets of the arrangement.
Rights to assets	The parties share all interests (e.g. rights, title or ownership) in the	The assets brought into the arrangement or subsequently acquired by the joint

	assets relating to the arrangement in a specified proportion.	arrangement are the arrangement's assets. The parties have no interests (i.e. no rights, title or ownership) in the assets of the arrangement.
Obligations for liabilities	The parties to the joint arrangement share all liabilities, obligations, costs and expenses in a specified proportion. The parties to the joint arrangement are liable for claims raised by third parties.	The joint arrangement is liable for the debts and obligations of the arrangement. The parties are liable to the arrangement only to the extent of their respective investments in the arrangement or to their respective obligations to contribute any unpaid or additional capital to the arrangement. Creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.
Revenues, expenses, profit or loss	Revenues and expenses are allocated on the basis of the relative performance of each party to the joint arrangement. However, the parties might have agreed to share the profit or loss relating to the arrangement on the basis of a specified proportion such as the parties' ownership interest in the arrangement. This would not prevent the arrangement from being a joint operation if the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.	Each party has share in the profit or loss relating to the activities of the arrangement.

Guarantees	The parties to joint arrangements might provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees does not, by itself, determine that the joint arrangement is a joint operation. The feature that determines whether the classification of joint arrangement is whether the parties have obligations for the liabilities relating to the arrangement (whether they are guaranteed by the parties or not is irrelevant).

5.4.1.2.3 Assessing other facts and circumstances

When the legal form of the separate vehicle and the terms of the contractual arrangement indicate that the arrangement is a joint venture, the parties should evaluate other relevant facts and circumstance to assess whether the arrangement is a joint operation or not. If the other relevant facts and circumstances also do not have evidence of the arrangement being a joint operation then the arrangement is concluded to be a joint venture.

The other relevant facts and circumstances that should be evaluated which might indicate that the arrangement is a joint operation are as follows. If both the following conditions are satisfied then the arrangement is a joint operation.

- The arrangement's activities primarily aim to **provide the parties with an output** (i.e. the parties have rights to substantially all the economic benefits of the assets held in the separate vehicle); and
- The parties are substantially the **only source of cash flows** contributing to the continuity of the operations of the arrangement. Hence, the arrangement depends on the parties on a continuous basis for settling the liabilities relating to the activity conducted through the arrangement.

Illustration 19: Assessing other facts and circumstances

Two parties structure a joint arrangement in an incorporated entity i.e. Entity A in which each party has a 50% ownership interest. The purpose of the arrangement is to manufacture materials required by the parties for their own, individual manufacturing processes. The arrangement ensures that the parties operate the facility that produces the materials to the quantity and quality specifications of the parties. The legal form of Entity A (an incorporated entity) through which the activities are conducted initially indicates that the assets and liabilities held in Entity A are the assets and liabilities of Entity A. The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of Entity A. There are following other relevant facts and circumstances applicable in this case:

- *The parties agreed to purchase all the output produced by Entity A in a ratio of 50:50. Entity A cannot sell any of the output to third parties, unless this is approved by the two parties to the arrangement. Because the purpose of the arrangement is to provide the parties with*

output they require, such sales to third parties are expected to be uncommon and not material.

- *The price of the output sold to the parties is set by both parties at a level that is designed to cover the costs of production and administrative expenses incurred by Entity A. On the basis of this operating model, the arrangement is intended to operate at a break-even level.*

Based on the above fact pattern, determine whether the arrangement is a joint operation or a joint venture?

Solution:

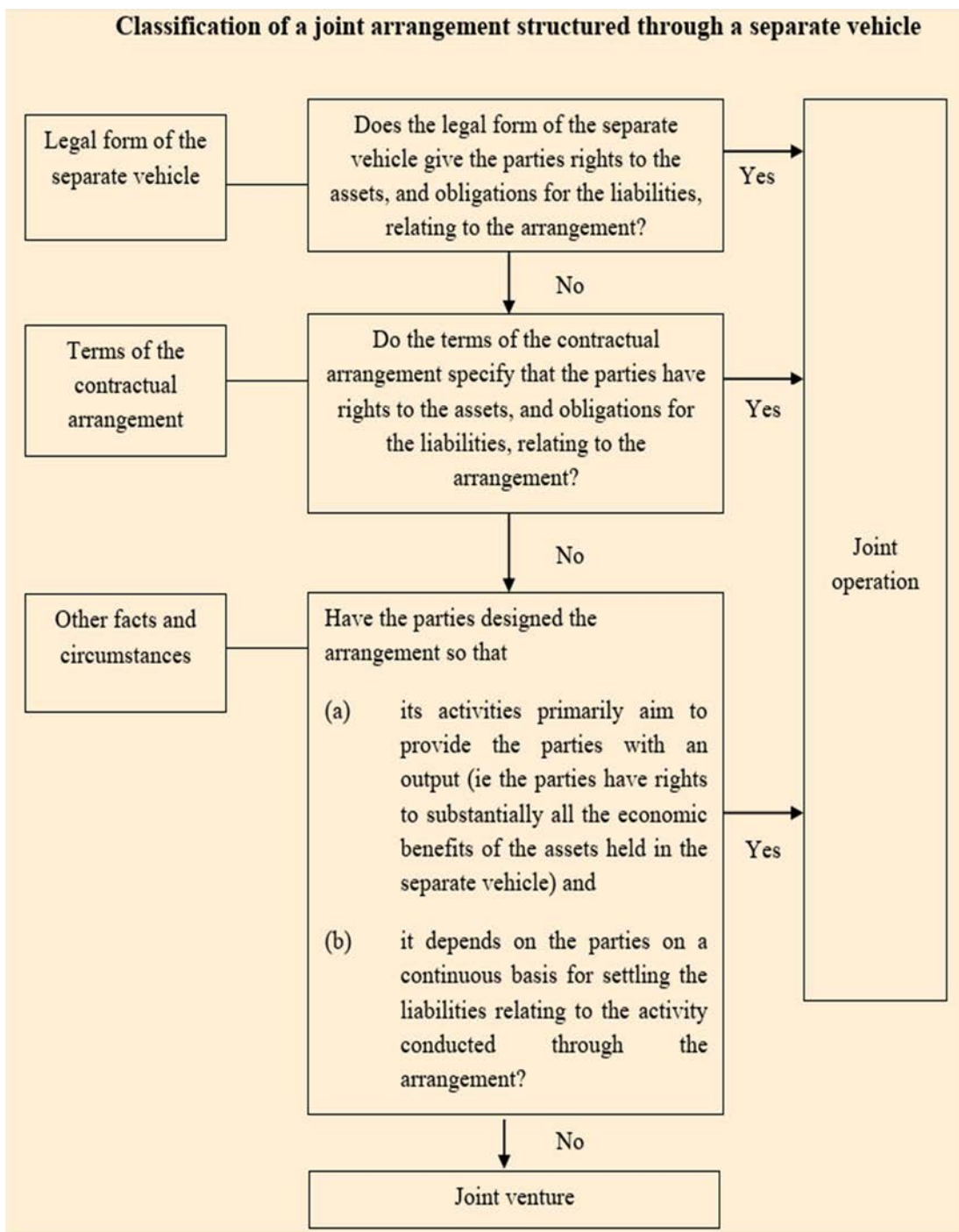
The legal form of Entity A and the terms of the contractual arrangement indicate that the arrangement is a joint venture. However, the other relevant facts and circumstances mentioned above indicates that:

- the obligation of the parties to purchase all the output produced by Entity A reflects the exclusive dependence of Entity A upon the parties for the generation of cash flows and, thus, the parties have an obligation to fund the settlement of the liabilities of Entity A.
- the fact that the parties have rights to all the output produced by Entity A means that the parties are consuming, and therefore have rights to, all the economic benefits of the assets of Entity A.

These facts and circumstances indicate that the arrangement is a joint operation. The conclusion about the classification of the joint arrangement in these circumstances would not change if, instead of the parties using their share of the output themselves in a subsequent manufacturing process, the parties sold their share of the output to third parties.

If the parties changed the terms of the contractual arrangement so that the arrangement was able to sell output to third parties, this would result in Entity A assuming demand, inventory and credit risks. In that scenario, such a change in the facts and circumstances would require reassessment of the classification of the joint arrangement. Such facts and circumstances would indicate that the arrangement is a joint venture.

The following flow chart summarises the above principles an entity should follow to classify an arrangement when the joint arrangement is **structured through a separate vehicle**:



5.4.2 Multiple joint arrangements under single framework agreement

Sometimes the parties may be bound by a framework agreement that sets up the general

contractual terms for undertaking one or more activities. Under a single framework agreement, the parties might establish different joint arrangements for different activities to be performed under the framework agreement. Even though all such joint arrangements are related to the same framework agreement, their type might be different i.e. one joint arrangement can be a joint operation and another joint arrangement can be a joint venture. This is explained in below illustration:

Illustration 20: Multiple joint arrangements under single framework agreement

AB Ltd. and CD Ltd. have entered into a framework agreement to manufacture and distribute a new product i.e. Product X. The two activities to be performed as per the framework agreement are i) Manufacture of Product X and ii) Distribution of Product X. The manufacturing of the product will not be done through a separate vehicle. The parties will purchase the necessary machinery in their joint name. For the distribution of the product, the parties have established a new entity ABCD Ltd. All the goods manufactured will be sold to ABCD Ltd. as per price mutually agreed by the parties. Then ABCD Ltd. will do the marketing and distribution of the product. Both the parties will have joint control over ABCD Ltd.

The legal form of ABCD Ltd. causes it to be considered in its own right (ie the assets and liabilities held in ACD Ltd. are the assets and liabilities of ABC Ltd. and not the assets and liabilities of the parties). Further, the contractual arrangement and other relevant facts and circumstances also do not indicate otherwise.

Determine whether various arrangements under the framework agreement are joint operation or joint venture?

Solution:

The manufacturing of Product X is not done through a separate vehicle and the assets used to manufacture the product are jointly owned by both the parties. Hence, the manufacturing activity is a joint operation.

The distribution of Product X is done through a separate vehicle i.e. ABCD Ltd. Further, AB Ltd. and CD Ltd. do not have rights to the assets, and obligations for the liabilities, relating to ABCD Ltd. Hence ABCD Ltd. is a joint venture.



5.5 ACCOUNTING OF JOINT OPERATIONS

In this section, we will discuss following concepts related to accounting of joint operations:

- Accounting of interest in joint operations in separate and consolidated financial statement of joint operator

- Accounting for sales or contributions of assets to a joint operation in separate and consolidated financial statement of joint operator
- Accounting for purchases of assets from a joint operation in separate and consolidated financial statement of joint operator
- Accounting by an entity that is a party to the joint operation but does not have joint control

5.5.1 Accounting of interest in joint operations in separate and consolidated financial statement of joint operator

A joint operator shall recognise in its **separate and consolidated financial statements** in relation to its interest in a joint operation:

- a) its assets, including its share of any assets held jointly;
- b) its liabilities, including its share of any liabilities incurred jointly;
- c) its revenue from the sale of its share of the output arising from the joint operation;
- d) its share of the revenue from the sale of the output by the joint operation; and
- e) its expenses, including its share of any expenses incurred jointly.

A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the Ind ASs applicable to the particular assets, liabilities, revenues and expenses.

Illustration 21: Accounting of interest in joint operation

P and Q form a joint arrangement PQ using a separate vehicle. P and Q each own 50% of the capital of PQ. However, the contractual terms of the joint arrangement states that P has the rights to all of Machinery and the obligation to pay Bank Loan in PQ. P and Q have rights to all other assets in PQ and obligations for all other liabilities in PQ in proportion to their share of capital (i.e. 50% each).

PQ's balance sheet is as follows:

Balance Sheet

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

How should P record in its financial statements its rights and obligations in PQ?

Solution:

Under Ind AS 111, P should record the following in its financial statements, to account for its rights in the assets of PQ and its obligations for the liabilities of PQ.

Machinery	2,50,000
Cash	25,000
Capital	75,000
Bank Loan	75,000
Other Loan	37,500

Illustration 22: Accounting of interest in joint operation

AB Ltd. and BC Ltd. have established a joint arrangement through a separate vehicle PQR. The legal form of the separate vehicle does not confer separation between the parties and the separate vehicle itself. Thus, both the parties have rights to the assets and obligations for the liabilities of PQR. As neither the contractual terms nor the other facts and circumstances indicate otherwise, it is concluded that the arrangement is a joint operation and not a joint venture.

Both the parties own 50% each of the equity interest in PQR. However, the contractual terms of the joint arrangement state that AB Ltd. has the rights to all of Building No. 1 owned by PQR and the obligation to pay all of the debt owned by PQR to a lender XYZ. AB Ltd. and BC Ltd. have rights to all other assets of PQR and obligations for all other liabilities of PQR in proportion of their equity interests (i.e. 50% each)

PQR's balance sheet is as follows:

Balance Sheet

Liabilities	₹	Assets	₹
Debt owed to XYZ	240	Cash	40
Employee benefit plan obligation	100	Building 1	240
Equity	140	Building 2	200
	480		480

How should AB Ltd. record in its financial statements its rights and obligations in PQR?

Solution:

Under Ind AS 111, AB Ltd. should record the following in its financial statements, to account for its rights in the assets of PQR and its obligations for the liabilities of PQR.

	₹
Assets	
Cash	20
Building 1 *	240
Building 2	100
Liabilities	
Debt (third party) ^	240
Employee benefit plan obligation	50
Equity	70

* Since AB Ltd. has the rights to all of Building No. 1, it records the amount in its entirety.

^ AB Ltd. has obligation for the debt owed by PQR to XYZ in its entirety

5.5.2 Accounting for sales or contributions of assets to a joint operation in separate and consolidated financial statement of joint operator

When a joint operator sells or contributes any asset to the joint operation, it is in effect transacting with the other parties to the joint operation and hence the joint operator shall **recognise gains and losses** resulting from such transactions **only to the extent of the other parties' interest** in the joint operation.

Illustration 23: Accounting for sales or contributions of assets to a joint operation

A Ltd. is one of the parties to a joint operation holding 60% interest in a joint operation and the balance 40% interest is held by another joint operator. A Ltd. has contributed an asset held by it to the joint operation for the activities to be conducted in joint operation. The carrying value of the asset sold was ₹ 100 and the asset was actually sold for ₹ 80 i.e. at a loss of ₹ 20.

How should A Ltd. account for the sale of asset to joint operation in its books?

Solution:

A Ltd. should record the loss on the transaction only to the extent of other party's interest in the joint operation.

The total loss on the transaction is ₹ 20. Hence, A Ltd. shall record loss on sale of asset to the extent of ₹ 8 (₹ 20 x 40%) which is the loss pertaining to the interest of other party to the joint operation. The loss of ₹ 12 (₹ 20 - ₹ 8) shall not be recognised as that is unrealised loss.

Further, while accounting its interest in the joint operation, A Ltd. shall record its share in that asset at value of ₹ 60 [A Ltd. share of asset ₹ 48 (₹ 80 x 60%) plus unrealised loss of ₹ 12].

The journal entry for the transaction would be as follows:

Bank	Dr.	₹ 32	
Loss on sale	Dr.	₹ 8	
To Asset			₹ 40

When above transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed to the joint operation, or of an impairment loss of those assets, those losses shall be recognised fully by the joint operator.

5.5.3 Accounting for purchases of assets from a joint operation in separate and consolidated financial statement of joint operator

When a joint operator purchases any asset from the joint operation, it shall not recognise its share of the gains and losses until it resells those assets to a third party.

Illustration 24: Accounting for purchases of assets from a joint operation

A Ltd. is one of the parties to a joint operation holding 60% interest in the joint operation and the balance 40% interest is held by another joint operator. A Ltd. has purchased an asset from the joint operation. The carrying value of the asset in the books of joint operation was ₹ 100 and the asset was actually purchased for ₹ 80 i.e. at a loss of ₹ 20. How should A Ltd. account for the purchase of asset from joint operation in its books?

Solution:

A Ltd. should not record its share of the loss until the asset is resold to a third party.

The joint operation has sold the asset at ₹ 80 by incurring a loss of ₹ 20. Hence, A Ltd. shall record the asset at ₹ 92 [Purchase price ₹ 80 + A Ltd.'s share in loss ₹ 12 (₹ 20 x 60%)].

Further, while accounting its interest in the joint operation, A Ltd. shall not record any share in the loss incurred in sale transaction by the joint operation.

The journal entry for the transaction would be as follows:

Asset	Dr.	₹ 32	
To Bank			₹ 32

When above transactions provide evidence of a reduction in the net realisable value of the assets to be purchased or of an impairment loss of those assets, a joint operator shall recognise its share of those losses.

5.5.4 Accounting by an entity that is a party to the joint operation but does not have joint control

A party that participates in, but does not have joint control of, a joint operation shall also account for its interest in the arrangement in its separate and consolidated financial statements as follows:

A party that **participates in, but does not have joint control** of, a joint operation – Whether the party has rights to the assets, and obligations for the liabilities, relating to that joint operation?

Yes

Account as per requirements mentioned above for a joint operator

No

Account as per the Ind AS applicable to that interest



5.6 ACCOUNTING OF JOINT VENTURES

5.6.1 Accounting in the consolidated financial statements

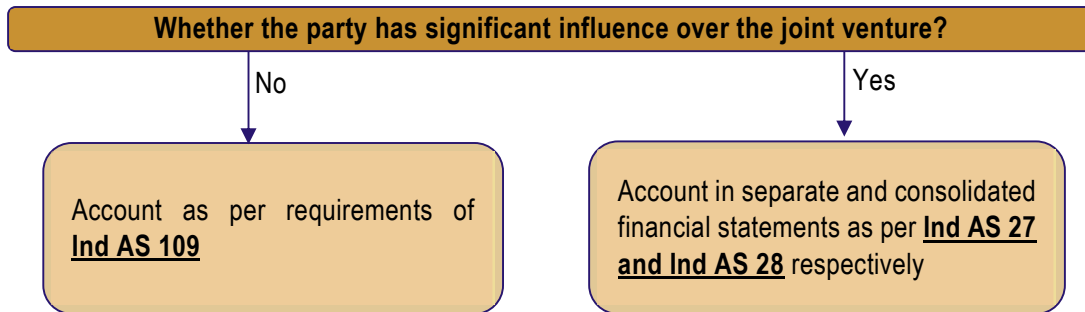
A joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the **equity method** in accordance with **Ind AS 28**, unless the entity is exempted from applying the equity method as specified in that standard. These requirements are discussed in detail in unit 6.

5.6.2 Accounting in the separate financial statements

In its separate financial statements, a joint venturer shall account for its interest in a joint venture in accordance **Ind AS 27**. These requirements are discussed in detail in unit 7.

5.6.3 Accounting by an entity that is a party to the joint venture but does not have joint control

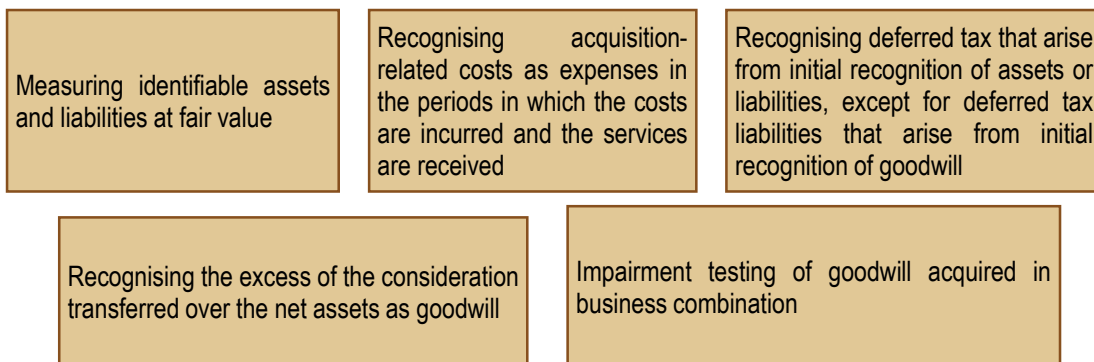
A party that participates in, but does not have joint control of, a joint venture shall also account for its interest in the arrangement in its **separate and consolidated financial statements** as follows:



5.7 ACCOUNTING FOR ACQUISITIONS OF INTERESTS IN JOINT OPERATIONS IN SEPARATE AND CONSOLIDATED FINANCIAL STATEMENT OF JOINT OPERATOR

When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes **a business, as defined in Ind AS 103**, it shall apply, to the extent of its share in the joint operation, all the requirements of business combinations accounting as per Ind AS 103, and other Ind ASs, that do not conflict with the guidance in Ind AS 111. Necessary disclosure shall also be made as required by those Ind ASs in relation to business combinations.

The principles on business combinations accounting that do not conflict with the guidance in Ind AS 111 include but are not limited to following:



The above requirements also apply to the **formation of a joint operation** if, and only **if, an existing business**, as defined in Ind AS 103, is contributed to the joint operation on its formation by one of the parties that participate in the joint operation. However, these requirements **do not apply** to the formation of a joint operation if all of the parties that participate in the joint operation **only contribute assets or groups of assets that do not constitute businesses** to the joint operation.

A joint operator might **increase its interest in a joint operation** in which the activity of the joint operation constitutes a business, as defined in Ind AS 103, by acquiring an additional interest in the joint operation. In such cases, **previously held interests in the joint operation are not remeasured** if the joint operator retains joint control.

A party that participates in, but does not have joint control of, a joint operation might obtain joint control of the joint operation in which the activity of the joint operation constitutes a business as defined in Ind AS 103. In such cases, previously held interests in the joint operation are not remeasured.

If the transaction of acquisition of interest in the joint operation is a **common control transaction** as defined in Ind AS 103 then an entity should not apply the requirements mentioned above. In such case, the entity shall apply the accounting specified in **Appendix C of Ind AS 103**.



5.8 SIGNIFICANT DIFFERENCES BETWEEN IND AS 111 AND AS 27

S. No.	Topic	Ind AS 111	AS 27
1.	Joint arrangement	Ind AS 111 defines the term 'joint arrangement' as "an arrangement of which two or more parties have joint control." Essentially, Ind AS 111 substitutes the term 'joint arrangement' for the term 'joint venture' used in AS 27 without any substantive change in the underlying concept. Ind AS 111 uses the term 'joint venture' in a restrictive sense to refer to one type of joint arrangement (the other type being a joint operation).	AS 27 defines the term 'joint venture' as "a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control".
2.	Classification	Under Ind AS 111, a joint arrangement is either a joint operation or a joint venture. Arrangements that are classified as jointly controlled operations or jointly controlled assets under AS 27 would be classified as 'joint	AS 27 classifies joint venture into three categories, namely, jointly controlled operations, jointly controlled assets and jointly controlled entities.

		operations' under Ind AS 111. An arrangement that is classified as a jointly controlled entity under AS 27 would be classified as either a joint operation or a joint venture under Ind AS 111. The classification of joint arrangement depends on whether the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement (a joint operation) or whether those parties have rights to the net assets of the arrangement (a joint venture).	
3.	Accounting for interest in a jointly controlled entity	Ind AS 111 requires interest in a jointly controlled entity to be accounted for in the venturer's consolidated financial statements in accordance with Ind AS 28, i.e., using equity method of accounting (which is also used to account for interests in associates under Ind AS 28).	AS 27 requires a venturer to account for its interest in a jointly controlled entity in its (i.e., venturer's) consolidated financial statements using proportionate consolidation method.
4.	Circumstances in which proportionate consolidation method or equity method is not, or may not be, applied	Ind AS 111 (or Ind AS 28) does not provide a similar exemption from application of equity method to an interest in a joint venture, unless such an interest meets the criteria laid down in Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations to be classified as held for sale (in which case Ind AS 105 rather than equity method is applied to the interest).	Under AS 27 a venturer does not apply proportionate consolidation method to an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future.

UNIT 6:

IND AS 28: INVESTMENTS IN ASSOCIATES AND JOINT VENTURES



6.1 OBJECTIVE OF IND AS 28

Ind AS 28 prescribes following:

- guidance on accounting of investments in associates and
- the requirements for the application of the equity method when accounting for investments in associates and joint ventures.



6.2 SCOPE OF IND AS 28

Ind AS 28 shall be applied by all entities that are

- investors with joint control of an investee (i.e. the investee is a joint venture of the investor), or
- significant influence over an investee (i.e. the investee is an associate of the investor).



6.3 SIGNIFICANT INFLUENCE

An associate is an entity over which the investor has significant influence. Hence, to assess whether an investee is an associate or not, an entity needs to understand the term 'significant influence'.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

In this section, we will discuss following concepts related to assessment of significant influence:

- Presumption of significant influence
- Judgement required in assessment of significant influence
- Consideration of potential voting rights when assessing significant influence
- Loss of significant influence

Each of the above concepts are discussed in detail below.

6.3.1 Presumption of significant influence

Presumption of significant influence:

- If an entity holds (directly or indirectly through a subsidiary) **20% or more of the voting rights** of an investee then it is **presumed that the entity has significant influence**, unless it can be clearly demonstrated that it is not the case.
- Conversely, if the entity holds, (directly or indirectly through a subsidiary), less **than 20% of the voting power** of the investee, it is **presumed that the entity does not have significant influence**, unless such influence can be clearly demonstrated.

It should be noted that a substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

Illustration 1: Significant influence

E Ltd. holds 25% of the voting power of an investee. The balance 75% of the voting power is held by three other investors each holding 25%.

The decisions about the financing and operating policies of the investee are taken by investors holding majority of the voting power. Since, the other three investors together hold majority voting power, they generally take the decisions without taking the consent of E Ltd. Even if E Ltd. proposes any changes to the financing and operating policies of the investee, the other three investors do not vote in favour of those changes. So, in effect the suggestions of E Ltd. are not considered while taking decisions related to financing and operating policies.

Determine whether E Ltd. has significant influence over the investee?

Solution:

Since E Ltd. is holding more than 20% of the voting power of the investee, it indicates that E Ltd. might have significant over the investee. However, the other investors in the investee prevent E Ltd. from participating in the financing and operating policy decisions of the investee. Hence, in this case, E Ltd. is not in a position to have significant influence over the investee.

6.3.2 Judgement required in assessment of significant influence

The assessment of whether the investor has significant influence over the investee requires application of judgement. In making such judgement, the investor shall consider following factors which generally demonstrate the existence of significant influence:

- a) representation on the board of directors or equivalent governing body of the investee

Illustration 2: Representation on board

Kuku Ltd. holds 12% of the voting shares in Boho Ltd. Boho Ltd.'s board comprise of eight members and two of these members are appointed by Kuku Ltd. Each board member has one vote at meeting. is Boho Ltd an associate of Kuku Ltd?

Solution:

Boho Ltd is an associate of Kuku Ltd as significant influence is demonstrated by the presence of directors on the board and the relative voting rights at meetings.

It is presumed that entity has significant influence where it holds 20% or more of the voting power of the investee, but it is not necessary to have 20% representation on the board to demonstrate significant influence, as this will depend on all the facts and circumstances. One board member may represent significant influence even if that board member has less than 20% of the voting power. But for significant influence to exist it would be necessary to show based on specific facts and circumstances that this is the case, as significant influence would not be presumed.

- b) participation in policy-making processes, including participation in decisions about dividends or other distributions

Illustration 3: Participation in policy-making processes

M Ltd. holds 10% of the voting power an investee. The balance 90% voting power is held by nine other investors each holding 10%.

The decisions about the relevant activities (except decision about taking borrowings) of the investee are taken by the members holding majority of the voting power. The decisions about taking borrowings are required to be taken by unanimous consent of all the investors. Further, decisions about taking borrowing are not the decisions that most significantly affect the returns of the investee.

Determine whether M Ltd. has significant influence over the investee?

Solution:

In this case, though M Ltd. is holding less than 20% of the voting power of the investee, M Ltd.'s consent is required to take decisions about taking borrowings which is one of the relevant activities. Further, since the decisions about taking borrowing are not the decisions that most significantly affect the returns of the investee, it cannot be said that all the investors have joint control over the investee.

Hence, it can be said that M Ltd. has significant influence over the investee.

- c) material transactions between the entity and its investee

Illustration 4: Material transactions between the entity and its investee

RS Ltd. is an entity engaged in the business of pharmaceuticals. It has invested in the share capital of an investee XY Ltd. and is holding 15% of XY Ltd.'s total voting power.

XY Ltd. is engaged in the business of producing packing materials for pharmaceutical entities. One of the incentives for RS Ltd. to invest in XY Ltd. was the fact that XY Ltd. is engaged in the business of producing packing materials which is also useful for RS Ltd. Since last many years, XY Ltd.'s almost 90% of the output is procured by RS Ltd.

Determine whether RS Ltd. has significant influence over XY Ltd.?

Solution:

Since 90% of the output of XY Ltd. is procured by RS Ltd., XY Ltd. would be dependent on RS Ltd. for the continuation of its business. Hence, even though RS Ltd. is holding only 15% of the voting power of XY Ltd. it has significant influence over XY Ltd.

- d) interchange of managerial personnel

Illustration 5: Interchange of managerial personnel

Entity X and entity Y operate in the same industry, but in different geographical regions. Entity X acquires a 10% shareholding in entity Y as a part of a strategic agreement. A new production process is key to serve a fundamental change in the strategic direction of entity Y. The terms of agreement provide for entity Y to start a new production process under the supervision of two managers from entity X. The managers seconded from entity X, one of whom is on entity X's board, will oversee the selection and recruitment of new staff, the purchase of new equipment, the training of the workforce and the negotiation of new purchase contracts for raw materials. The two managers will report directly to entity Y's board and as well as to entity X. Analyse.

Solution:

The secondment of the board member and a senior manager from entity X to entity Y gives entity X a range of power over a new production process and may evidence that entity X has significant influence over entity Y. This assessment takes into the account what are the key financial and operating policies of entity Y and the influence this gives entity X over those policies.

- e) provision of essential technical information

Illustration 6: Provision of essential technical information

R Ltd. is a tyre manufacturing entity. The entity has entered into a technology transfer agreement with another entity Y Ltd. which is also involved in the business of tyre manufacturing. R Ltd. is an established entity in this business whereas Y Ltd. is a relatively new entity.

As per the agreement, R Ltd. has granted to Y Ltd. a license to use its technical information and know-how which are related to the processes for the manufacture of tyres. Y Ltd. is dependent on the technical information and know-how supplied by R Ltd. because of its lack of expertise and experience in this business. Further, R Ltd. has also invested in 10% of the equity share capital of Y Ltd.

Determine whether R Ltd. has significant influence over Y Ltd.?

Solution:

Y Ltd. obtains essential technical information for the running of its business from R Ltd. Hence R Ltd. has significant influence over Y Ltd. despite of holding only 10% of the equity share capital of Y Ltd.

6.3.3 Consideration of potential voting rights when assessing significant influence

An entity may own potential voting rights such as share warrants, share call options, convertible instruments, or other similar instruments that can give the entity additional voting power or reduce another party's voting power over the investee.

Potential voting rights that are **currently exercisable are considered** when assessing whether an entity has significant influence. Potential voting rights that are currently not exercisable are not considered for the assessment. This can be the case when the rights cannot be exercised until a future date or until the occurrence of a future event.

In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances except (a) the intentions of management and (b) the financial ability to exercise those potential rights.

Illustration 7: Potential voting rights

An entity which is currently holding 10% of the voting power of an entity has an option of purchase additional 15% voting power of the investee from other investors. However, the entity currently does not have financial ability to purchase additional 15% voting power of the investee. Determine whether the entity has significant influence over the investee?

Solution:

Considering the potential voting rights, the entity can have more than 20% of the voting power of the investee and hence it is presumed that the entity has significant influence over the investee. The fact that the entity does not have financial ability to purchase such additional voting power is not considered in such assessment (It should be noted that under Ind AS 110, potential voting rights which an entity cannot exercise because of its financial ability are not considered as substantive and hence not factored in the assessment. However, under Ind AS 28, there is no such requirement given. Hence the potential voting rights, even if they are not substantive as per Ind AS 110, are included in the assessment of significant influence.)

6.3.4 Loss of significant influence

An entity loses significant influence over an investee **when it loses the power to participate in the financial and operating policy decisions** of that investee.

The loss of significant influence can occur with or without a change in ownership levels. For example, loss of significant influence can occur when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual arrangement.



6.4 EQUITY METHOD

The **equity method** is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income. In this section, we will discuss following principles related to equity method of accounting:

- Application of the equity method
- Exemptions from applying the equity method
- Equity method procedure

The above principles are explained below.

6.4.1 Application of the equity method

An investor is required to account its investments in associates and joint ventures as per equity method.

It should be noted that equity method is **not applied** for accounting of investments in associates

and joint ventures in the separate financial statements of the investor. In separate financial statements, an investor shall apply the guidance given in Ind AS 27 which is discussed in detail in unit 7.

Under the equity method of accounting, an investor shall pass following entries at various stages of investment:

- 1) Initial entry to record investment done in associate or joint venture at cost
- 2) Recording of investor's share in the profit / loss of the associate or joint venture after the date of acquisition
- 3) Recording of investor's share in the other comprehensive income of the associate or joint venture after the date of acquisition
- 4) Distributions received from an investee

Above entries are explained by way of an illustration below:

Illustration 8: Accounting entries related investment in associate / joint venture

On the first day of a financial year, A Ltd. invested in the equity share capital of B Ltd. at a cost of ₹ 1,00,000 to acquire 25% share in the voting power of B Ltd. A Ltd. has concluded that B Ltd. is an associate of A Ltd. At the end of the year, B Ltd. earned profit of ₹ 10,000 and other comprehensive income of ₹ 2,000. In that year, B Ltd. also declared dividend to the extent of ₹ 4,000. Pass necessary entries in the books of A Ltd. to account for the investment in associate.

Solution:

Following entries would be passed in the books of A Ltd.:

1) Initial entry to record investment done in associate

Investment in B Ltd. A/c	Dr.	1,00,000	
To Bank A/c			1,00,000

2) Recording of share in the profit of the associate

Investment in B Ltd. A/c	Dr.	2,500	
To Share in profit of investee (P&L)			2,500

[A Ltd. share in profit would be ₹ 2,500 (₹ 10,000 x 25%)]

3) Recording of share in the other comprehensive income (OCI) of the associate

Investment in B Ltd. A/c	Dr.	500	
To Share in OCI of investee (OCI)			500

[A Ltd. share in OCI would be ₹ 500 (₹ 2,000 x 25%)]

4) Recording of dividend distributed by associate

Dividend Receivable A/c	Dr.	1,000	
To Investment in B Ltd. A/c			1,000

[A Ltd. share in dividend would be ₹ 1,000 (₹ 4,000 x 25%)]

It should be noted that Ind AS 28 not only requires to record the income distributed by the associate or joint venture but it also requires an investor to record its share in the profit / loss of the associate or joint venture (which may not be yet distributed). This provides more informative reporting of the investor's net assets and profit or loss.

Potential voting rights

Generally, an entity accounts for its interest in an associate or joint venture on the basis of existing ownership interests and the possible effect of exercise or conversion of any **potential voting rights are not considered for applying equity method**. Instruments with such potential voting rights are accounted for as per Ind AS 109.

For example, if potential voting rights are contained in Compulsorily Convertible Preference Shares (CCPS) of the investee and such CCPS do not give present access to returns associated with ownership interests (refer below), then such CCPS shall be accounted for as per Ind AS 109 (refer chapter 12) i.e. either at fair value through profit or loss or at fair value through other comprehensive income.

However, there can be some cases where the potential voting rights in substance currently give access to the returns associated with an ownership interest in an associate or a joint venture. In such cases, the investor shall account for instruments with such potential voting rights as per equity method and not as per Ind AS 109. This can be the situation where, **for example**, an investor has a purchase option to acquire additional voting power in an investee and the terms of the contract provides that the investor will also get the share in the profit / loss of the investee even for the period prior to the date of actual exercise of the option.

6.4.2 Exemptions from applying the equity method

An entity need not apply the equity method to its investment in an associate or a joint venture in following cases:

Exemption 1

As per paragraph 17 of Ind AS 28, an entity need not apply equity method if the entity is a parent that is **exempt from preparing consolidated financial statements** by the scope exception in paragraph 4(a) of Ind AS 110 **or if all the following** apply:

Owners of the entity	
The entity is a wholly owned or partly owned subsidiary of another entity and all the owners of the entity are informed and they do not object to the entity not applying the equity method.	The entity's ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind ASs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110.
Public trading of instruments of the entity	
The debt or equity instruments of the entity are not traded in a public market (whether domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).	The entity has not filed nor is it in the process of filing its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

The above conditions are similar to the conditions given in paragraph 4(a) of Ind AS 110. To see illustration of above conditions, refer to the scope exemption illustrations give in unit 3 on Ind AS 110.

Exemption 2

When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a **venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds**, the entity may elect to measure investments in those associates and joint ventures at **fair value through profit or loss** in accordance with Ind AS 109. Such election shall be made separately for each associate or joint venture at time of its initial recognition.

Example 1

A mutual fund has invested in the equity share capital of certain companies in excess of 20% of the total equity share of those entities. Hence, those investees are presumed to be an associate of the mutual fund. In this case, the mutual fund can decide not to apply equity method to account for those investments and instead measure them at fair value through profit or loss as per Ind AS 109.

Exemption 3

When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with Ind AS 109.

This is regardless of whether the venture capital organisation has significant influence over that portion of the investment.

If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organisation.

This exemption is explained in below illustration:

Illustration 9: Exemption from applying equity method

MNO Ltd. holds 15% of the voting power of DEF Ltd. PQR Mutual Fund (which is a subsidiary of MNO Ltd.) also holds 10% voting power of DEF Ltd. Hence, MNO Ltd. holds total 25% voting power of DEF Ltd. (15% held by own and 10% held by subsidiary) and accordingly has significant influence over DEF Ltd. How should MNO Ltd. account for investment in DEF Ltd. in its consolidated financial statements?

Solution:

The 15% interest which is held directly by MNO Ltd. should be measured as per equity method of accounting. However, with respect to the 10% interest which is held through a mutual fund, MNO Ltd. can avail the exemption from applying the equity method to that 10% interest and instead measure that investment at fair value through profit or loss. To summarise, the total interest of 25% in DEF Ltd. should be measured as follows:

- 15% interest held directly by MNO Ltd.: Measure as per equity method of accounting
- 10% interest held indirectly through a mutual fund: Measure as per equity method of accounting or at fair value thorough profit or loss as per Ind AS 109

6.4.3 Equity method procedure

Many of the concepts used in applying the equity method of accounting are similar to the concepts used for consolidation procedure for subsidiaries. Following is the summary of various concepts used in applying the equity method of accounting:

Calculation of goodwill / capital reserve on acquisition of investment in associate or joint venture and calculation of share in profit / loss of associate or joint venture

Determination group's share in an associate or a joint venture

Accounting of upstream and downstream transactions between the entity and its associate or joint venture

Accounting of contribution of non-monetary asset by an entity to its associate or joint venture

How to deal with different reporting periods of the entity and its associate or joint venture?

Requirement to have uniform accounting policies

What are the long-term interests in associate or joint venture apart from equity investment?

How to account for share in losses of loss making associate or joint venture in excess of value interest in the associate or joint venture?

Each of the above concepts are explained below.

6.4.3.1 Calculation of goodwill / capital reserve and calculation of share in profit / loss of associate or joint venture

An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture.

On acquisition of the investment, an entity shall identify the goodwill or capital reserve.

Goodwill

Any excess of the cost of the investment over the entity's share of the net fair value of the investee's identifiable assets and liabilities is treated as goodwill. Goodwill is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.

Capital reserve

Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is treated as capital reserve. It is recorded directly in equity.

While recording the entity's share in the profit / loss of the investee, the entity needs to make certain adjustment to that share of profit / loss. For example, adjustment shall be made for:

- depreciation of the depreciable assets based on their fair values at the acquisition date.
- impairment losses such as for goodwill or property, plant and equipment.

Illustration 10: Acquisition of interest in an associate

Blue Ltd. acquired 25% of the equity share capital of Green Ltd. on the first day of the financial year for ₹ 1,25,000. As of that date, the carrying value of the net assets of Green Ltd. was ₹ 3,00,000 and the fair value was ₹ 4,00,000. The excess of fair value over the carrying value was attributable to one of the buildings owned by Green Ltd. having a remaining useful life of 20 years. Green Ltd. earned profit of ₹ 40,000 and other comprehensive income of ₹ 10,000 during the year. Calculate the goodwill / capital reserve on the date of acquisition, Blue Ltd.'s share in the profit and other comprehensive income for the year and closing balance of investment at the end of the year.

Solution:

- (1) Goodwill / capital reserve on the date of acquisition

The cost of the investment is higher than the net fair value of the investee's identifiable assets and liabilities. Hence there is goodwill. Amount of goodwill is calculated as follows

	₹
Cost of acquisition of investment	1,25,000
Blue Ltd.'s share in fair value of net assets of Green Ltd. on the date of acquisition (4,00,000 x 25%)	<u>(1,00,000)</u>
Goodwill	<u>25,000</u>

Above goodwill will be recorded as part of carrying amount of the investment.

- (2) Share in profit and other comprehensive income of Green Ltd.

	₹
Share in profit of Green Ltd. (40,000 x 25%)	10,000
Adjustment for depreciation based on fair value (1,00,000 ÷ 20) x 25%	<u>(1,250)</u>
Share in profit after adjustment	<u>8,750</u>
Share in other comprehensive income (10,000 x 25%)	2,500

(3) Closing balance of investment at the end of the year

	₹
Cost of acquisition of investment (including goodwill of ₹ 25,000)	1,25,000
Share in profit after adjustments	8,750
Share in other comprehensive income	<u>2,500</u>
Closing balance of investment	<u>1,36,250</u>

Illustration 11: Cumulative preference shares issued by associate or joint venture

KL Ltd. has invested in 50% voting power of a joint venture MN Ltd. MN Ltd. has also issued 10% cumulative preference shares, classified as equity, to other investors worth ₹ 10,00,000. During the year, MN Ltd. earned profit of ₹ 4,00,000. Also, MN Ltd. has not declared any dividend on the preference shares for current year. Calculate KL Ltd.'s share in the net profit of MN Ltd. for the year.

Solution:

If an associate or a joint venture has outstanding cumulative preference shares that are held by parties other than the entity and are classified as equity, the entity should compute its share of profit or loss after adjusting for dividend on such shares, whether or not the dividends have been declared.

In current case, KL Ltd.'s share in net profit of MN Ltd. would be as follows.

	₹
Profit of MN Ltd. for the year	4,00,000
Dividend on cumulative preference shares (10,00,000 x 10%)	<u>(1,00,000)</u>
Net profit attributable to the holders of equity share	<u>3,00,000</u>
KL Ltd.'s 50% share in net profit of MN Ltd.	1,50,000

6.4.3.2 Group's share in an associate or a joint venture

For applying the equity method, an entity shall consider the share held by it directly or indirectly (through a subsidiary) in an associate or a joint venture. The holding by the entity's associate or joint venture in another associate or joint venture of the entity is ignored for this purpose.

Example 2

A Ltd., its subsidiary B Ltd. and its joint venture C Ltd. holds 15%, 10% and 10% respectively of the share capital of an associate X Ltd. Hence, to apply equity method, A Ltd. shall consider the interest held by it and by its subsidiary B Ltd. i.e. total interest of 25%. It shall not consider the interest held by C Ltd. which is a joint venture.

When an **associate or a joint venture has subsidiaries, associates or joint ventures**, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's **financial statements which include** the associate's or joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures.

Example 3

X Ltd. has an associate P Ltd. P Ltd. has further invested in a subsidiary Q Ltd. and a joint venture R Ltd. Hence, for the purpose of applying the equity method, X Ltd. shall consider the consolidated financial statements of P Ltd.

Illustration 12: Share in the consolidated financial statements of associate

Entity A holds a 20% equity interest in Entity B (as associate) that in turn has a 100% equity interest in Entity C. Entity B recognised net assets relating to Entity C of ₹ 1,000 in its consolidated financial statements. Entity B sells 20% of its interest in Entity C to a third party (a non-controlling shareholder) for ₹ 300 and recognises this transaction as an equity transaction in accordance with paragraph 23 of Ind AS 110, resulting in a credit in Entity B's equity of ₹ 100.

The financial statements of Entity A and Entity B are summarised as follows before and after the transaction:

Before**A's consolidated financial statements**

Assets	₹	Liabilities	₹
Investment in B	200	Equity	200
Total	200	Total	200

B's consolidated financial statements

Assets	₹	Liabilities	₹
Assets (from C)	1,000	Equity	1,000
Total	1,000	Total	1,000

The financial statements of B after the transaction are summarised below:

After

B's consolidated financial statements

Assets	₹	Liabilities		₹
Assets (from C)	1,000	Equity	1,000	
Cash	300	Equity transaction with non-controlling interest	100	
		Equity attributable to owners		1,100
		Non-controlling interest		200
Total	1,300	Total		1,300

Although Entity A did not participate in the transaction, Entity A's share of net assets in Entity B increased as a result of the sale of B's 20% interest in C. Effectively, A's share in B's net assets is now ₹ 220 (20% of ₹ 1,100) i.e. ₹ 20 in addition to its previous share.

How is an equity transaction that is recognised in the financial statements of Entity B reflected in the consolidated financial statements of Entity A that uses the equity method to account for its investment in Entity B?

Solution:

The change of interest in the net assets / equity of the associate as a result of the investee's equity transaction is reflected in the investor's financial statements as 'share of other changes in equity of investee' (in the statement of changes in equity) instead of gain in Statement of profit and loss, since it reflects the post-acquisition change in the net assets of the investee and also faithfully reflects the investor's share of the associate's transaction as presented in the associate's consolidated financial statements.

Thus, in the given case, Entity A recognises ₹ 20 as change in other equity instead of in statement of profit and loss and maintains the same classification as of its associate, Entity B, i.e., a direct credit to equity as in its consolidated financial statements.

6.4.3.3 Upstream and downstream transactions between the entity and its associate or joint venture

An entity (or a subsidiary of the entity) may enter into upstream or downstream transactions with its associate or joint venture.

- 'Upstream' transactions are, for example, sales of assets from an associate or a joint venture to the investor.

- 'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture.

There may be some gain / loss resulting from such transactions. The entity shall record such gain / loss in its financial statements only to the extent of the unrelated investors' interests in the associate or joint venture.

Illustration 13: Upstream and downstream transaction between an entity and its associate

Scenario A

M Ltd. has invested in 40% share capital of N Ltd. and hence N Ltd. is an associate of M Ltd. During the year, N Ltd. sold inventory to M Ltd. for a value of ₹ 10,00,000. This included profit of 10% on the transaction price i.e. profit of ₹ 1,00,000. Out the above inventory, M Ltd. sold inventory of ₹ 6,00,000 to outside customers. Hence, the inventory of ₹ 4,00,000 purchased from N Ltd. is still lying with M Ltd. Determine the unrealised profit to be eliminated on above transaction.

Scenario B

Assume the same facts as per Scenario A except that the inventory is sold by M Ltd. to N Ltd. instead of N Ltd. selling to M Ltd. Determine the unrealised profit to be eliminated on above transaction.

Solution:

Scenario A

Firstly, as part of its equity method accounting for investment in N Ltd., M Ltd. will pass this journal entry:

Investment in N Ltd.	Dr.	40,000	
To Share in profit of N Ltd.			40,000

Out of the inventory of ₹ 10,00,000, M Ltd. has sold inventory worth ₹ 6,00,000 to outside customers. Hence, the profit of ₹ 60,000 (6,00,000 x 10% profit margin) on such inventory is realised. However, the inventory worth ₹ 4,00,000 is still held by M Ltd. which consists profit of ₹ 40,000 (4,00,000 x 10%). Hence, M Ltd.'s share in such profit i.e. ₹ 16,000 (40,000 x 40%) is considered as unrealised.

Accordingly, after recording of share in total profit of N Ltd., M Ltd. should pass following adjustment entry to reverse the unrealised profit margin:

Share in profit of N Ltd.	Dr.	16,000	
To Inventory / Investment in N Ltd.			16,000

In subsequent period, when this inventory of ₹ 4,00,000 is sold by N Ltd. to an outside customer then the above profit margin of ₹ 16,000 will be treated as realised and hence the above entry will be reversed in that period.

[**Note:** in the separate financial statements of M Ltd., inventory is carried at ₹ 4,00,000 whereas in its consolidated financial statements, inventory is carried at ₹ 3,84,000 (due to elimination entry above in respect of unrealized profit). In the subsequent period, when the inventory is sold, Inventory Account is credited by ₹ 4,00,000 whereas for the purpose of consolidated financial statements, it should have been credited by only ₹ 3,84,000. The difference is adjusted by debiting back ₹ 16,000 to the Inventory Account and a corresponding recognition of share in profit of associate.]

Scenario B

Out of the inventory of ₹ 10,00,000, N Ltd. has sold inventory worth ₹ 6,00,000 to outside customers. Hence, the profit of ₹ 60,000 ($6,00,000 \times 10\%$ profit margin) on such inventory is realised. However, the inventory worth ₹ 4,00,000 is still held by N Ltd. which consists profit of ₹ 40,000 ($4,00,000 \times 10\%$). Out of this profit of ₹ 40,000, profit to the extent of other investor's interest in the investee is treated as realised profit i.e. ₹ 24,000 ($40,000 \times 60\%$) is treated as realised profit. Balance profit of ₹ 16,000 ($40,000 \times 40\%$) is considered as unrealised. Hence, M Ltd. should pass following adjustment entry to reverse the unrealised profit:

Sales	Dr. 160,000	
To Cost of material consumed		144,000
To Investment in N Ltd.		16,000

In subsequent period, when this inventory of ₹ 4,00,000 is sold by N Ltd. to an outside customer then the above profit margin of ₹ 16,000 will be treated as realised and hence the above entry will be reversed in that period.

When downstream transactions provide evidence of a **reduction in the net realisable value** of the assets to be sold or contributed, or of an **impairment loss** of those assets, those losses shall be **recognised in full** by the investor.

When upstream transactions provide evidence of a reduction in the **net realisable value** of the assets to be purchased or of an **impairment loss** of those assets, the investor shall **recognise its share** in those losses.

Illustration 14: Impairment loss on downstream and upstream transaction between an entity and its joint venture

Scenario A

X Ltd. has invested in a joint venture Y Ltd. by holding 50% of its equity share capital. During the year, X Ltd. sold an asset to Y Ltd. at its market value of ₹ 8,00,000. The asset's carrying value in X Ltd.'s books was ₹ 10,00,000. Determine how should X Ltd. account for the sale transaction in its books.

Scenario B

Assume the same facts as per Scenario A except that the asset is sold by Y Ltd. to X Ltd. instead of X Ltd. selling to Y Ltd. Determine how should X Ltd. account for the above transaction in its books.

Solution:**Scenario A**

X Ltd. should record full loss of ₹ 2,00,000 (10,00,000 – 8,00,000) in its books as that would represent the impairment loss because the market value has actually declined. This loss would have been recorded even if X Ltd. had first impaired the asset and then sold to Y Ltd. at zero profit / loss. Following entry should be passed in the books of X Ltd.

Bank A/c	Dr.	8,00,000	
Loss on sale of asset	Dr.	2,00,000	
	To Asset		10,00,000

Scenario B

X Ltd. should record loss to the extent of its share in Y Ltd. Hence, X Ltd.'s share in loss i.e. ₹ 1,00,000 [(10,00,000 – 8,00,000) x 50%] should be recorded by X Ltd. in its books. The loss should be recorded since the market value of the asset has actually declined and this would represent impairment. This loss would have been recorded even if Y Ltd. would have first recorded an impairment loss of ₹ 2,00,000 and then sold to X Ltd. at zero profit / loss. Following entry should be passed in the books of X Ltd.

Asset	Dr.	8,00,000	
Share in loss of Y Ltd.	Dr.	1,00,000	
	To Bank		8,00,000
	To Investment in Y Ltd.		1,00,000

6.4.3.4 Contribution of non-monetary asset by an entity to its associate or joint venture

An entity might contribute a non-monetary asset to an associate or a joint venture in exchange of an equity interest in that associate or joint venture. Such contribution of asset shall be accounted in accordance with the **guidance for downstream transactions** discussed above.

However, if such contribution of non-monetary asset **lacks commercial substance**, then the gain / loss involved in such transaction is treated as unrealised and such **gain / loss is eliminated against the investment value**. In other words, the carrying amount of the investment in associate

or joint venture in such a situation will be equal to the carrying amount of non-monetary asset contributed in exchange. The term 'commercial substance' has the same meaning as defined in Ind AS 16 '*Property, Plant and Equipment*' and discussed in unit 2 of chapter 7.

If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity **recognises in full** in profit or loss the portion of the **gain or loss** on the non-monetary contribution **relating to the monetary or non-monetary assets received**.

6.4.3.5 Different reporting periods of the entity and its associate or joint venture

To apply equity method of accounting, an entity shall use the **most recent** available financial statements of the associate or joint venture.

When the end date of the reporting period of the entity and that of the associate or joint venture is different (e.g. entity's financial year ends on 31 March 20X1 but the associate's financial year ends on 31 December 20X0) then associate or joint venture shall prepare financial statements as of the period end date of the entity **for the purpose of doing equity method accounting** by the entity.

In above situation, if it is impracticable for the associate or joint venture to prepare financial statements as of the period end date of the entity then the entity can use the financial statements of associate or joint venture ending on different date subject to **giving effect of significant transactions or events** occurring between the end date of the associate's or joint venture's financial statements and end date of the entity's financial statements.

In no case, the difference between the end date of the reporting period of associate or joint venture and end date of reporting period of the entity **can exceed 3 months**.

The length of the reporting periods and any difference between the ends of the reporting periods shall be the same from period to period. This means that if the financial statements of an associate or a joint venture used for equity accounting in previous periods were ending on different dates than that of the entity whereas the financial statements used for current period end on the same date as that of the entity then the comparatives for previous period should be restated to have comparison of equivalent periods.

6.4.3.6 Uniform accounting policies

When using the financial statements of an associate or joint venture for doing equity method accounting, the **accounting policies** (for like transaction and events in similar circumstances) as used by associate or joint venture in preparing their financial statements **should be same as the policies used by the entity** in preparing its financial statements.

If the accounting policies are not same then **adjustments should be made to align** the accounting policies of associate or joint venture to those of the entity.

Example 4

A Ltd. (a company incorporated and registered in India) holds 25% voting power of B Inc. (a company incorporated and registered in United States). B Inc. is an associate for A Ltd. A Ltd. Follows Ind AS for the preparation of its financial statements. However, B Inc. follows generally accepted accounting principles in United States (US GAAP). Hence, while using B Inc.'s financial statements for the purpose of doing equity method accounting, A Ltd. Shall do necessary adjustment to covert US GAAP financial statements to Ind AS financial statements and then do equity method accounting.

There are two exceptions to above rule:

Exception 1

In case of an **associate**, the adjustment for uniformity of accounting policies with those of the entity will not be done **if it is impracticable to do so.**

It is to be noted that this exemption is available in case of an associate only and not available for joint venture. This is because for an investor with just significant influence over an investee, it may be difficult to obtain necessary information to do adjustment for aligning accounting policies. However, in case of a joint venture, it would be relatively easy to obtain such information as the investor has joint control over the joint venture.

Exception 2

An entity may have interest in **an associate or a joint venture that is an investment entity.** Such an associate or a joint venture may also have interest in one or more subsidiaries. When this is the case, such associate or joint venture, being an investment entity, would **account for its interest in subsidiaries at fair value.** Hence, in such case, the **entity can elect to retain** the fair value measurement used by the associate or joint venture.

Such election can be made by the entity **separately for each associate or joint venture** at the later of the date on which:

- a) the associate or joint venture is initially recognised
- b) the associate or joint venture becomes an investment entity
- c) the associate or joint venture first becomes a parent

6.4.3.7 Long-term interests in associate or joint venture apart from equity investment

An entity might hold financial instruments in an associate or joint venture other than the investments accounted for using the equity method. These includes long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture.

For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture.

- Such items may include
 - preference shares and
 - long-term receivables or loans,
- but do not include
 - trade receivables,
 - trade payables or
 - any long-term receivables for which adequate collateral exists, such as secured loans.

An entity shall account such long-term interest in accordance with Ind AS 109. It is to be noted that certain requirements of Ind AS 28 also apply to such long-term interests (like allocating share in loss of associate or joint venture to such interests and testing for impairment and recording of impairment loss on the net investment in associate or joint venture – these are explained in subsequent paragraphs). However, an entity should first apply Ind AS 109 to those interests and then apply Ind AS 28 to the balance remaining after applying Ind AS 109.

6.4.3.8 Loss making associate or joint venture

In case of a loss making associate or joint venture, an entity's share of losses of such associate or joint venture may equal or exceed its **interest in the associate or joint venture**. In such case, the entity discontinues recognized its share of further losses.

It should be noted that the interest in the associate or joint venture not only includes the carrying amount of the investment in the associate or joint venture determined using the equity method but also includes any **long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture**. The examples of such long-term interests are discussed in 6.4.2.8 above. It should be noted that an entity should **first apply Ind AS 109** to such long-term interests and then apply the above requirement of allocating to such long-term interest any share in loss of associate or joint venture. Further, while applying Ind AS 109, an entity shall not take account of any adjustments to the carrying value of long-term interests that arise from applying Ind AS 28.

Losses recognized using the equity method in excess of the entity's investment in ordinary shares are applied to the other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (i.e. priority in liquidation).

After the entity's interest is reduced to zero, additional losses are provided for, and a liability is recognized, only to the extent that the entity has incurred **legal or constructive obligations or made payments** on behalf of the associate or joint venture.

If the associate or joint venture **subsequently reports profits**, the entity resumes recognized its share of those profits **only after** its share of the profits equals the share of losses not recognized.

Illustration 15: Loss making associate and long-term interests

An entity has following three type interests in an associate:

- *Equity shares: 25% of the equity shares to which equity method of accounting is applied*
- *Preference shares: Non-cumulative preference shares that form part of net investment in the associate. Such preference shares are measured at fair value as per Ind AS 109.*
- *Long-term loan: The loan carrying interest of 10% p.a. The interest income is received at the end of each year. The long-term loan is accounted as per amortised cost as per Ind AS 109. This loan also forms part of net investment in the associate.*

At the start of year 1, the carrying value of each of the above interests is as follows:

- *Equity shares – ₹ 10,00,000*
- *Preference shares – ₹ 5,00,000*
- *Long-term loan – ₹ 3,00,000*

Following table summarises the changes in the fair value of preference shares as per Ind AS 109, impairment loss on long-term loan as per Ind AS 109 and entity's share in profit / loss of associate for year 1-5.

₹

End of Year	Increase / (Decrease) in fair value of preference shares as per Ind AS 109	Impairment loss / (reversal) on long-term loan as per Ind AS 109	Entity's share in profit / (loss) of associate
1	(50,000)	(50,000)	(16,00,000)
2	(50,000)	-	(2,00,000)
3	1,00,000	50,000	-
4	50,000	-	10,00,000
5	30,000	-	10,00,000

Throughout year 1 to 5, there has been no objective evidence of impairment in the net investment in the associate. The entity does not have any legal or constructive obligation to share the losses of the associate beyond its interest in the associate.

Based on above, determine the closing balance of each of the above interests at the end of each year.

Solution:

Year 1

Below table summarises the closing balance of each of the interest at the end of year 1: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	10,00,000	NA	10,00,000	(10,00,000)	-
Preference shares	5,00,000	(50,000)	4,50,000	(4,50,000)	-
Long-term loan	<u>3,00,000</u>	<u>(50,000)</u>	<u>2,50,000</u>	<u>(1,50,000)</u>	<u>1,00,000</u>
Total	<u>18,00,000</u>	<u>(1,00,000)</u>	<u>17,00,000</u>	<u>(16,00,000)</u>	<u>1,00,000</u>

The entire loss of ₹ 16,00,000 is recognised. Hence, there is no unrecognised loss at the end of year 1.

Year 2

Below table summarises the closing balance of each of the interest at the end of year 2: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	-	NA	-	-	-
Preference shares	-	(50,000)	(50,000)	50,000 *	-
Long-term loan	<u>1,00,000</u>	<u>-</u>	<u>1,00,000</u>	<u>(1,00,000)</u>	<u>-</u>
Total	<u>1,00,000</u>	<u>(50,000)</u>	<u>50,000</u>	<u>(50,000)</u>	<u>-</u>

* Recognition of changes in fair value as per Ind AS 109 has resulted in the carrying amount of Preference shares being negative ₹ 50,000. Consequently, the entity shall reverse a portion of the associate's losses previously allocated to Preference shares.

Out of the total loss of ₹ 2,00,000 for the year, loss of only ₹ 50,000 is recognized. Hence, there is unrecognized loss to the extent of ₹ 1,50,000 at the end of year 2.

Year 3

Below table summarises the closing balance of each of the interest at the end of year 3: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	-	NA	-	-	-
Preference shares	-	1,00,000	1,00,000	(1,00,000)	-
Long-term loan	-	50,000	50,000	(50,000)	-
Total	-	1,50,000	1,50,000	(1,50,000)	-

The share in profit / loss for the year is nil. However, there was previously unrecognised loss of ₹ 1,50,000 which is allocated in current year. After recognising the above loss, there is no unrecognised loss at the end of year 3.

Year 4

Below table summarises the closing balance of each of the interest at the end of year 4: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	-	NA	-	2,00,000	2,00,000
Preference shares	-	50,000	50,000	5,00,000	5,50,000
Long-term loan	-	-	-	3,00,000	3,00,000
Total	-	50,000	50,000	10,00,000	10,50,000

The entity's share in profit of associate for the year is ₹ 10,00,000. The entity shall allocate such profit to each of the instruments in order of their seniority in liquidation. The entity should limit the amount of profit to be allocated to preference shares and long-term loan to the extent of losses previously allocated to them. Hence, the entity has allocated ₹ 5,00,000 to preference shares and ₹ 3,00,000 to long-term debt.

There is no unrecognised loss at the end of year 4.

Year 5

Below table summarises the closing balance of each of the interest at the end of year 5:

₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	2,00,000	NA	2,00,000	10,00,000	12,00,000
Preference shares	5,50,000	30,000	5,80,000	-	5,80,000
Long-term loan	<u>3,00,000</u>	<u>-</u>	<u>3,00,000</u>	<u>-</u>	<u>3,00,000</u>
Total	<u>10,50,000</u>	<u>30,000</u>	<u>10,80,000</u>	<u>10,00,000</u>	<u>20,80,000</u>

The entity's share in profit of associate for the year is ₹ 10,00,000. The entire profit is allocated to equity shares since there is no loss previously allocated to either preference shares or long-term loan.

There is no recognized loss at the end of year 5.

Year 1 to 5

The interest accrual on long-term loan would be done in each year at 10% p.a. This will be done without taking into account any adjustment done in the carrying value of long-term loan as per Ind AS 28. Hence, the entity will accrue interest of ₹ 30,000 (3,00,000 x 10%) in each year.



6.5 IMPAIRMENT LOSSES

After doing accounting as per equity method explained above, an entity shall determine whether there is **an objective evidence** that the entity's net investment in an associate or a joint venture is impaired.

The objective evidence of impairment can arise as a result of:

- one or more events that occurred after the initial recognition of the net investment (a '**loss event**') and
- that loss event (or events) has an **impact on the estimated future cash flows** from the net investment that can be reliably estimated.

It is not necessary to identify a single event that caused impairment. Rather, impairment can be a combined effect of several individual events.

Losses expected as a result of future events, no matter how likely, are not recognized.

Objective evidence that the net investment is impaired includes **observable data** about the following loss events:

Significant **financial difficulty** of the associate or joint venture

Breach of contract, such as a default in payments by the associate or joint venture

The entity **granting a concession** to associate or joint venture (because of its financial difficulties)

It becoming probable that the associate or joint venture will enter **bankruptcy or other financial reorganisation**

Disappearance of an active market for the net investment because of financial difficulties of the associate or joint venture

Adverse effect in the environment (technological, market, economic or legal) in which associate or joint venture operates

Significant or prolonged decline in the fair value of an investment in an equity instrument below its cost

It should be noted that the disappearance of an active market because the associate's or joint venture's equity or financial instruments are **no longer publicly traded is not evidence of impairment**.

A downgrade of an associate's or joint venture's credit rating or a decline in the fair value of the associate or joint venture, is not of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.

Impairment of goodwill included in carrying value of associate or joint venture

As discussed earlier in this unit, the goodwill on acquisition of associate or joint venture is recognized as part of the carrying amount of the net investment in associate or joint venture. Such goodwill is **not tested separately** for impairment, rather the entire carrying amount of the investment is **tested for impairment as a single asset** when there is objective evidence of impairment as mentioned above.

Any impairment loss recognized is **not allocated** to any asset, including goodwill, that forms part of the carrying amount of the net investment in the associate or joint venture.

Reversal of impairment loss

Any reversal of impairment loss is recognized in accordance with Ind AS 36 '*Impairment of Assets*' to the extent that the recoverable amount of the net investment subsequently increases.

Determining value in use

Impairment loss is provided by comparing the recoverable amount (higher of value in use and fair value less **costs of disposal**) with the carrying amount of the investment.

For above purpose, an entity can determine the value in use in **either** of the following ways:

- a) Method 1: Values in use shall include entity's share in the present value of estimated future cash flows expected to be generated by the associate or joint venture, including:
 - i. cash flows from the operations of the associate or joint venture and
 - ii. proceeds from the ultimate disposal of the investment
- b) Method 2: Value in use shall include the present value of estimated future cash flows expected to arise from:
 - i. dividends to be received and
 - ii. proceeds from the ultimate disposal of the investment.

If appropriate assumptions are used then both the above methods will give the same results.

The recoverable amount of an investment in an associate or a joint venture shall be assessed for each associate or joint venture separately, unless the associate or joint venture does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.



6.6 DISCONTINUING THE USE OF THE EQUITY METHOD

An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture

The accounting consequences when an investment ceases to be an associate or a joint venture are explained below.

Investment becomes a subsidiary

If the investment becomes a subsidiary, the entity shall account for its investment in accordance with Ind AS 103 and Ind AS 110. Ind AS 103 requires revaluation of the previously held interest in the equity accounted investment at its acquisition date fair value, with recognition of any gain or loss in profit or loss.

Retained interest in the former associate or joint venture is a financial asset

Retained interest in the former associate or joint venture that is a financial asset shall be measured at fair value. The entity shall recognise in profit or loss any difference between:

- the fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and
- the carrying amount of the investment at the date the equity method was discontinued.

Following illustration explains how an entity shall record in profit or loss any gain / loss on discontinuation of equity method in such case.

Illustration 16: Recording in profit or loss of the gain / loss on discontinuation of equity method

CD Ltd. held 50% of the voting power of RS Ltd. which is a joint venture of CD Ltd. The carrying value of the investment in RS Ltd. is ₹ 1,00,000. Now out of the 50% stake, CD Ltd. has sold 20% stake in RS Ltd. to a third party for a consideration of ₹ 80,000. The fair value of the retained 30% interest is ₹ 1,20,000. Determine how much gain / loss should be recorded in profit or loss of CD Ltd.

Solution:

CD Ltd. Shall record in profit or loss difference between below:

- the fair value of any retained interest (i.e. ₹ 1,20,000) and any proceeds from disposing of a part interest in the joint venture (i.e. ₹ 80,000); and
- the carrying amount of the investment at the date the equity method was discontinued (i.e. ₹ 1,00,000).

Hence, CD Ltd. Shall record gain of ₹ 1,00,000 in profit or loss.

Reclassification of items recorded in other comprehensive income

On discontinuation of equity method, any share in the other comprehensive income of associate or joint venture that was previously recognized by the entity shall be reclassified to profit or loss on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.

Example 5

An investor has recognised in past in its other comprehensive income its share of ₹ 10,000 in the cumulative exchange differences relating to a foreign operation of its associate. Now, the investment in that associate is sold and equity method of accounting is stopped. So, the investor shall reclassify the cumulative exchange differences of ₹ 10,000 recorded in its other comprehensive income to profit or loss.

The above principle also applies in case there is a reduction in the ownership interest in an associate or joint venture but the investee still continues to be an associate or joint venture. In that case, the reclassification should be done in proportion to the reduction in the ownership interest.

It may be noted that while it is not explicitly stated in Ind AS 28, it can be inferred that in case there is a reduction in the ownership interest in an associate or joint venture but the investee still continues to be an associate or joint venture, the entity should recognize gain or loss. This accounting treatment is different from the accounting for changes in ownership interest interests in a subsidiary, without losing control.

An associate becomes a joint venture and vice versa

If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.

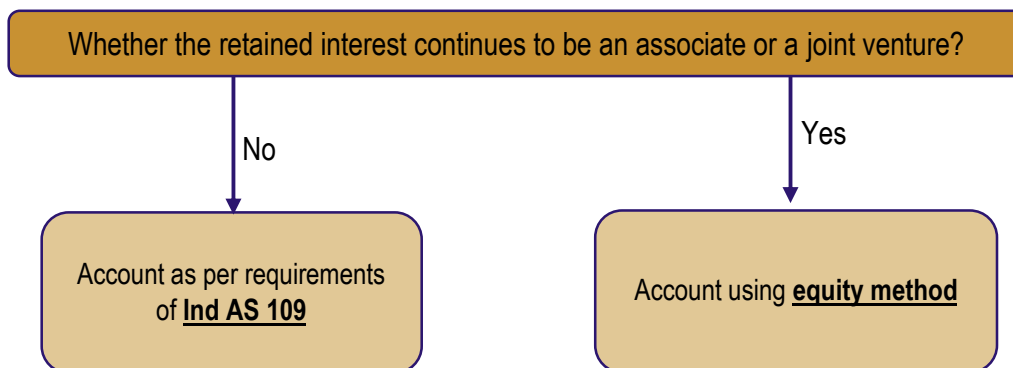


6.7 CLASSIFICATION OF INVESTMENT IN ASSOCIATE OR JOINT VENTURE AS HELD FOR SALE

An entity shall apply Ind AS 105 '*Non-current Assets Held for Sale and Discontinued Operations*' to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale.

Any **retained portion of an investment** in an associate or a joint venture that has not been classified as held for sale shall be accounted as follows:

- Till the time disposal of the portion that is classified as held for sale takes place:
 - Accounted using equity method
- After the disposal of the portion that is classified as held for sale takes place
 - Accounted as follows:



The above requirements are explained in below illustration:

Illustration 17: Investment in joint venture held for sale

Ram Ltd. holds 50% of the equity share capital of Shyam Ltd. The balance 50% equity share capital is held by another investor. Ram Ltd. has joint control over Shyam Ltd. and it is a joint venture of Ram Ltd., accounted using equity method. Now Ram Ltd. is planning to sell 10% of the equity share capital of Shyam Ltd. to a third party. Such 10% investment meets the criteria of an asset held for sale and has been measured and disclosed accordingly. Now determine how should Ram Ltd. account 40% interest retained in Shyam Ltd.

Solution:

Till the time 10% stake is sold, Ram Ltd. shall account for the retained interest of 40% as per equity method. After the sale of 10% investment, if Ram Ltd. still has joint control over Shyam Ltd. (e.g. through contractual arrangement) then it shall continue to measure that investment using equity method. However, if Ram Ltd. is not going to have joint control over Shyam Ltd. post the disposal of 10% investment then retained investment of 40% shall be accounted as per Ind AS 109.

When an investment, or a portion of investment, in associate or a joint venture previously classified as held for sale **no longer meets the criteria** to be so classified, it shall be accounted for using the **equity method retrospectively** as from the date of its classification as held for sale. Financial statements for the prior periods shall be amended accordingly.



6.8 SIGNIFICANT CHANGES IN IND AS 28 FROM IAS 28 RESULTING INTO CARVE OUT

As per IFRS

IAS 28 (paragraph 35) requires that for the purpose of applying equity method of accounting in the preparation of investor's financial statements, uniform accounting policies should be used. In other words, if the associate's accounting policies are different from those of the investor, the investor should change the financial statements of the associate by using same accounting policies.

Carve out

In Ind AS 28 (paragraph 35), the phrase, 'unless impracticable to do so' has been added in the relevant requirements.

Reason

Certain associates, e.g., regional rural banks (RRBs), being associates of nationalized banks,

may not be in a position to use the Ind AS as these may be too advanced for the RRBs. Accordingly, the above-stated words have been included to exempt such associates.



6.9 SIGNIFICANT DIFFERENCES BETWEEN IND AS 28 AND AS 23

S. No.	Topic	Ind AS 28	AS 23
1.	Significant Influence	In Ind AS 28, 'Significant Influence' has been defined as 'power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies'. Ind AS 28 defines joint control also.	In AS 23, 'Significant Influence' has been defined as 'power to participate in the financial and/or operating policy decisions of the investee but is not control over those policies'.
2.	Consideration for significant influence	As per Ind AS 28, existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether an entity has significant influence or not.	For considering share ownership for the purpose of significant influence, potential equity shares of the investee held by investor are not taken into account as per AS 23.
3.	Application of equity method	No exemption for applying equity method is provided in Ind AS 28.	One of the exemptions from applying equity method in AS 23 is where the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investee.
4.	Measurement of the investment in the associate at fair value through profit or loss as per Ind AS 109	Ind AS 28 permits an entity that has an investment in an associate, a portion of which is held indirectly through venture capital organisations, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, to elect to measure that portion of the investment in the associate at fair	AS 23 does not provide for the same.

		value through profit or loss in accordance with Ind AS 109 regardless of whether these entities have significant influence over that portion of the investment.	
5.	Held for sale	Ind AS 28 requires a portion of an investment in an associate or a joint venture to be classified as held for sale if the disposal of that portion of the interest would fulfil the criteria to be classified as held for sale in accordance with Ind AS 105.	AS 23 does not specifically deal with this aspect.
6.	Accounting of investment in an associate in separate financial statements	As per Ind AS 28, in separate financial statements, investment in an associate is to be accounted for at cost or in accordance with Ind AS 109, Financial Instruments.	As per AS 23, in separate financial statements, investment in an associate is not accounted for as per the equity method, the same is accounted for in accordance with AS 13, Accounting for Investments.
7.	Difference in reporting dates	There is no limit on the length of difference in the reporting dates of the investor and the associate. As per Ind AS 28, length of difference in the reporting dates of the associate or joint venture should not be more than three months.	AS 23 permits the use of financial statements of the associate drawn upto a date different from the date of financial statements of the investor when it is impracticable to draw the financial statements of the associate upto the date of the financial statements of the investor.
8.	Accounting Policies	Both AS 23 and Ind AS 28 require that similar accounting policies should be used for preparation of investor's financial statements and in case an associate uses different accounting policies for like transactions, appropriate	AS 23 provide exemption to this that if it is not possible to make adjustments to the accounting policies of the associate, the fact shall be disclosed along with a brief description of the differences

		adjustments shall be made to the accounting policies of the associate. Ind AS 28 provides that the entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances unless, in case of an associate, it is impracticable to do so.	between the accounting policies.
9.	Share of losses in the associate	As per Ind AS 28, carrying amount of investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture shall be considered for recognising entity's share of losses in the associate or joint venture.	As per AS 23, investor's share of losses in the associate is recognised to the extent of carrying amount of investment in the associate.
10.	Recognition of impairment loss on investment	Ind AS 28 requires that after application of equity method, including recognising the associate's or joint venture's losses, the requirements of Ind AS 109 shall be applied to determine whether it is necessary to recognise any additional impairment loss.	With regard to impairment, AS 23 requires that the carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment.
11.	When investment ceases to be an associate	Ind AS 28 provides that use of equity method will be discontinued from the date when investment ceases to be an associate and in case such associates become the subsidiary, it will be accounted in accordance with Business Combination (Ind AS 103) and if the retained interest becomes a financial asset, it will measure the retained interest at fair value.	AS 23 does not deal with the situation as to associate becoming a subsidiary. However, in other case (there is some retained interest), the investment will be accounted for in accordance with AS 13-Investments and retained interest will not be fair valued under AS 23.

UNIT 7:

IND AS 27: SEPARATE FINANCIAL STATEMENTS



7.1 OBJECTIVE OF IND AS 27

The objective of Ind AS 27 is to prescribe the accounting and disclosure requirements for **investments in subsidiaries, joint ventures and associates** when an entity prepares separate financial statements.



7.2 SCOPE OF IND AS 27

Ind AS 27 shall be applied in accounting for investments in subsidiaries, joint ventures and associates when an entity

- elects, or
- is required by law,

to present separate financial statements.

It is to be noted that **Ind AS 27 does not mandate which entities produce separate financial statements**. It applies when an entity prepares separate financial statements that comply with Ind AS. However, it may be noted that as per the Companies Act, 2013, all companies covered under that Act are required to prepare financial statements.



7.3 WHAT ARE SEPARATE FINANCIAL STATEMENTS AND HOW THEY ARE PRESENTED?

What are separate financial statements?

Separate financial statements are those presented by:

- a parent (i.e. an investor with control of a subsidiary) or
- an investor with investment in an associate or a joint venture,

in which the investments are accounted for at **cost or in accordance with Ind AS 109 'Financial Instruments'**.

How separate financial statements are presented?

Separate financial statements are presented:

- **in addition** to consolidated financial statements or

- **in addition** to financial statements of an investor that does not have investments in subsidiaries but has investments in associates or joint ventures in which investments in associates or joint ventures are accounted for using the equity method.

There are two more scenarios in which separate financial statements are prepared:

Scenario 1

An entity that is exempted from:

- preparation of consolidated financial statements in accordance with paragraph 4(a) of Ind AS 110 (explained in detail in unit 3) or
- applying equity method as per paragraph 17 of Ind AS 28 (explained in detail in unit 6)

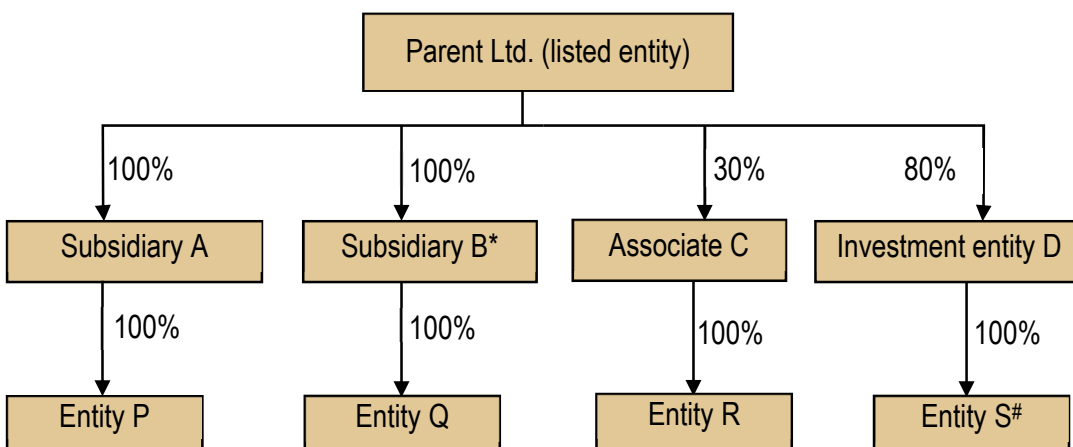
may present separate financial statements as its only financial statements.

Scenario 2

As per para 31 of Ind AS 110, an investment entity that has one or more subsidiaries and the purpose and activities of all those subsidiaries is not to provide services that relate to the investment entity's investment activities then such investment entity shall not prepare consolidated financial statements. Instead, such investments in subsidiaries are to be accounted at fair value through profit or loss as per Ind AS 109.

In such case, investment entity presents separate financial statements as its only financial statements.

Example: Following chart represents the group structure of Parent Ltd. and table below it explains the above requirements related to separate financial statements



* Subsidiary B has availed the exemption from preparation of consolidated financial statements as per paragraph 4(a) of Ind AS 110

Entity S does not provide services that relate to the Investment entity D's investment activities

All the above entities are incorporated under the Companies Act, 2013.

Name of the entity	Whether entity prepares consolidated financial statements?	Status for separate financial statements
Parent Ltd.	Yes	Will be prepared as it is required by Companies Act, 2013
Subsidiary A	Yes	Will be prepared as it is required by Companies Act, 2013
Subsidiary B	No	Will be prepared as it is required by Companies Act, 2013 (in this case, entity will present separate financial statements as its only financial statements)
Associate C	Yes	Will be prepared as it is required by Companies Act, 2013
Investment entity D	No	Will be prepared as it is required by Companies Act, 2013. Entity will present separate financial statements as its only financial statements
Entity P	No	These entities will prepare their financial statements as required by Companies Act 2013, however, they will not be termed as separate financial statements since these entities do not have subsidiary, associate or joint venture.
Entity Q	No	
Entity R	No	
Entity S	No	



7.4 PREPARATION OF SEPARATE FINANCIAL STATEMENTS

In this section, we will discuss about following concepts relating to accounting in separate financial statements:

- Accounting of investments in subsidiaries, associates and joint ventures
- Accounting when a parent ceases to be an investment entity or becomes an investment entity
- Accounting of dividend from subsidiary, associate or joint venture
- Reorganisation of the group structure

7.4.1 Accounting of investments in subsidiaries, associates and joint ventures

An entity shall prepare its separate financial statements in accordance with all the applicable Ind ASs except that it shall account for investments in subsidiaries, associates and joint ventures **in one of the following ways**:

- At cost, or
- In accordance with Ind AS 109 (i.e. either at fair value through profit or loss or at fair value through other comprehensive income)

The entity shall apply the same accounting for each category of investments.

Investments accounted for at cost shall be accounted for in accordance with Ind AS 105 '*Non-current Assets Held for Sale and Discontinued Operations*' when they are classified as held for sale. The measurement of investments accounted for in accordance with Ind AS 109 is not changed in such circumstances.

Example 1

An entity has invested in a subsidiary and a joint venture. Entity has elected to measure investment in subsidiary at cost and measure investment in joint venture at fair value through profit or loss in accordance with Ind AS 109. Now, at the end of the year, both these investments are held for sale. In such case, the investment in subsidiary will be measured as per Ind AS 105 i.e. at lower of its carrying amount and fair value less costs to sell. However, investment in joint venture is continued to be accounted at fair value through profit or loss as per Ind AS 109.

Investments held by investment entities and similar entities

Ind AS 110 requires an investment entity to measure its investment in subsidiaries at fair value through profit or loss as per Ind AS 109. Then the investment entity shall account for those investments **in the same i.e. at fair value through profit or loss** in the separate financial statements.

Further, Ind AS 28 provides that when an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital reorganization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with Ind AS 109. Hence, if an entity makes such election, then it shall also account for those investments **in the same way i.e. at fair value through profit or loss** in its separate financial statements.

7.4.2 Accounting when a parent ceases to be an investment entity or becomes an investment entity

When a parent ceases to be an investment entity, or becomes an investment entity, it shall account for the change from the date when the change in status occurred, as follows:

When an entity ceases to be an investment entity

In such case, the entity shall account for an investment in a subsidiary in either of the following ways:

Account at cost. The fair value of the subsidiary at the date of the change of status shall be used as the deemed cost at that date

OR

Continue to account in accordance with Ind AS 109

Example 2

A Ltd. was an investment entity and was measuring its investment in subsidiary X Ltd. at fair value. On 1 April 20X1, A Ltd. ceased to be an investment entity. On that date, the fair value of investment in X Ltd. recorded in its books was ₹ 1,00,000. Now, when A Ltd. ceased to be an investment entity, it can measure the investment in X Ltd. either:

- at cost (in such case, the carrying value of ₹ 1,00,000 will be its deemed cost at the date of change in status), or
- continue to measure in accordance with Ind AS 109

When an entity becomes an investment entity

In such case, the entity shall account for an investment in a subsidiary at fair value through profit or loss in accordance with Ind AS 109.

In that case, the difference between the previous carrying amount of the subsidiary and its fair value at the date of the change of status of the investor shall be recognized as a gain or loss in profit or loss. The cumulative amount of any fair value adjustment previously recognized in other comprehensive income in respect of those subsidiaries shall be reclassified to profit or loss as if the investment entity had disposed of those subsidiaries at the date of change in status.

Example 3

A Ltd. holds investment in a subsidiary X Ltd. and it measures its investment in subsidiary at cost. On 1 April 20X1, A Ltd. becomes an investment entity. On that date, the carrying value of investment in X Ltd. recorded in its books was ₹ 1,00,000. However, the fair value of that investment on the date of change in status was ₹ 1,50,000. Hence, A Ltd. should record a gain of ₹ 50,000 (1,50,000 – 1,00,000) in the profit or loss.

In this case, assume that A Ltd. was measuring the above investment at fair value through other comprehensive income in accordance with Ind AS 109 prior to change in status. The cumulative gain recorded in other comprehensive income was ₹ 50,000 and the carrying value of investment was ₹ 1,50,000. Hence, on the date of change in status, A Ltd. shall reclassify the gain of ₹ 50,000 from other comprehensive income to profit or loss as if the investment has been disposed by A Ltd. on that date.

7.4.3 Accounting of dividend from subsidiary, associate or joint venture

An entity shall recognise a dividend from a subsidiary, an associate or a joint venture in profit or loss in its separate financial statements when its right to receive the dividend is established.

Generally, the right to receive the dividend is established when the dividend is approved by the shareholders in their general meeting.

7.4.4 Reorganisation of the group structure

A parent reorganisation the structure of its group by establishing a new entity as its parent.

Ind AS 27 provides guidance on how to calculate the cost of investment when a parent reorganisation the structure of its group by establishing a new entity as its parent in a manner that satisfies the following criteria:

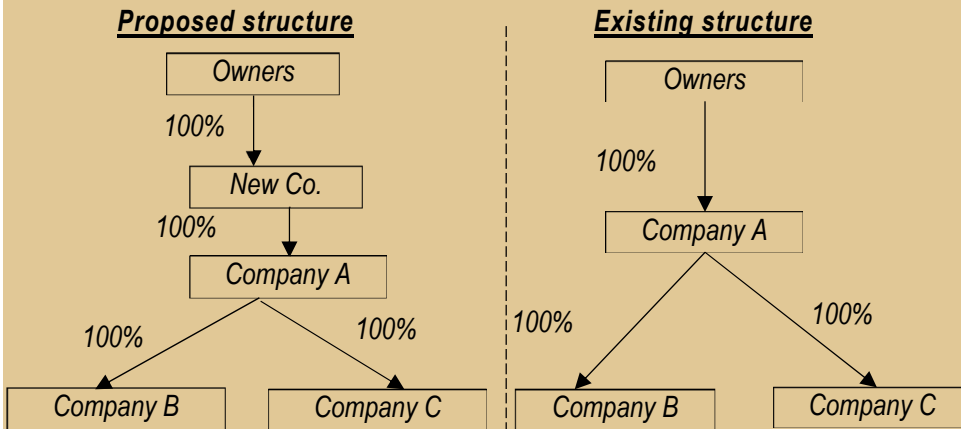
- a) the new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent;
- b) the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation; and
- c) the owners of the original parent before the reorganisation have the same absolute and relative interests in the net assets of the original group and the new group immediately before and after the reorganisation,

If above conditions are fulfilled and the new parent elects to account for its investment in the original parent at cost then the new parent shall measure cost at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

This is explained in following illustration:

Illustration 1: Reorganisation of the group structure

Following is the existing and proposed group structure of an original parent A Ltd.



As per the above structure, the Owners of Company A will transfer all their shareholding in Company A to New Co. in exchange of such shares, New Co. will issue its equity shares to the Owners. New Co. will issue the shares to the owners in the same ratio of their existing holding in Company A so that they have same absolute and relative interests in the net assets of the group immediately before and after the reorganisation. The assets and liabilities of the group immediately before and after the proposed restructuring will also be the same.

The cost of the investment in Company A in the books of the Owners is ₹ 10 lakh. Total equity of Company A (i.e. equity share capital and other equity attributable to the owners) as per its separate financial statements on the date of proposed restructuring is ₹ 15 lakh.

After the proposed restructuring, New Co. wants to record its investment in Company A at cost.

Determine how it should measure the cost of investment in Company A?

Solution:

In current case, New Co. should measure the cost of investment in Company A at the carrying amount of its share of the equity items shown in the separate financial statements of Company A at the date of the restructuring because:

- New Co. obtains control of Company A by issuing equity instruments to the Owners in exchange for their existing equity instruments of Company A;
- the assets and liabilities of the group immediately before and the proposed restructuring will be same; and
- the Owners will have the same absolute and relative interests in the net assets of the group immediately before and after the proposed restructuring.

Hence, New Co. will measure the cost of investment in Company A at ₹ 15 lakh.

A entity that is not a parent establishes a new entity as its parent

The requirements of measuring cost of investment by a new parent as discussed above will equally apply in case where an entity that is not a parent (i.e. it does not have a subsidiary) establishes a new parent between itself and its owners.

Hence, in illustration 1 above, the same accounting treatment will have to be followed by New Co. even if Company A does not have any subsidiary.

**7.5 MAJOR CHANGES IN IND AS 27 FROM IAS 27 NOT RESULTING INTO CARVE OUT**

Ind AS 27, 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 IAS 27, following are the carve outs given under Appendix 1 to Ind AS 27, keeping in mind, the requirements of other converged Ind AS and the economic environment in India.

IAS 27 allows the entities to use the equity method to account for investment in subsidiaries, joint ventures and associates in their Separate Financial Statements (SFS). Such option is not given in Ind AS 27, as the equity method is not a measurement basis like cost and fair value but is a manner of consolidation and therefore would lead to inconsistent accounting conceptually.

UNIT 8: DISCLOSURES



8.0 INTRODUCTION

This Unit is divided in two parts as follows:

- Part A: Disclosure of interest in other entities as per Ind AS 112
- Part B: Disclosure in separate financial statements as per Ind AS 27

Note: Only those disclosures which are significant from students' perspective have been covered here.

PART A:

DISCLOSURE OF INTERESTS IN OTHER ENTITIES AS PER IND AS 112



8.1 OBJECTIVE OF IND AS 112

Ind AS 112 require an entity to disclose information (related to its interests in other entities) that enables users of its financial statements to evaluate:

the nature of, and risks associated with, its **interests in other entities** (defined below)

AND

the **effects of those interests** on its financial position, financial performance and cash flows.

Interests in other entities

Definition: For the purpose of Ind AS 112, an interest in another entity refers to **contractual and non-contractual involvement that exposes an entity to variability of returns** from the performance of the other entity. Consideration of the purpose and design of the other entity may help the reporting entity when assessing whether it has an interest in that entity and, therefore, whether it is required to provide the disclosures in Ind AS 112. That assessment shall include consideration of the risks that the other entity was designed to create and the risks the other entity was designed to pass on to the reporting entity and other parties.

- An interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees.

- It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship.

A reporting entity is typically exposed to variability of returns from the performance of another entity by holding instruments (such as equity or debt instruments issued by the other entity) or having another involvement that absorbs variability.

Example 4

Assume a structured entity holds a loan portfolio. The structured entity obtains a credit default swap from another entity (the reporting entity) to protect itself from the default of interest and principal payments on the loans. The reporting entity has involvement that exposes it to variability of returns from the performance of the structured entity because the credit default swap absorbs variability of returns of the structured entity.

Some instruments are designed to transfer risk from a reporting entity to another entity. Such instruments create variability of returns for the other entity but do not typically expose the reporting entity to variability of returns from the performance of the other entity.

Example 5

Assume a structured entity is established to provide investment opportunities for investors who wish to have exposure to entity Z's credit risk (entity Z is unrelated to any party involved in the arrangement). The structured entity obtains funding by issuing to those investors notes that are linked to entity Z's credit risk (credit-linked notes) and uses the proceeds to invest in a portfolio of risk-free financial assets. The structured entity obtains exposure to entity Z's credit risk by entering into a credit default swap (CDS) with a swap counterparty. The CDS passes entity Z's credit risk to the structured entity in return for a fee paid by the swap counterparty. The investors in the structured entity receive a higher return that reflects both the structured entity's return from its asset portfolio and the CDS fee. The swap counterparty does not have involvement with the structured entity that exposes it to variability of returns from the performance of the structured entity because the CDS transfers variability to the structured entity, rather than absorbing variability of returns of the structured entity.

Meeting the objective

To meet the above objective, an entity shall disclose following:

Disclosures related to interests in other entities

Significant judgements and assumptions it has made in determining:

- the nature of its interest in another entity or arrangement;
- the type of joint arrangement in which it has an interest;
- that it meets the definition of an investment entity, if applicable

Information about its interests in

- Subsidiaries;
- arrangements and associates; and
- structured entities that are not controlled by the entity (unconsolidated structured entities)

Each of the above disclosures are explained in detail subsequently in this unit.

If the disclosures required by Ind AS 112, together with disclosures required by other Ind AS, do not meet the objective mentioned above, then an entity shall disclose whatever additional information is necessary to meet that objective.

Aggregation

An entity shall decide, in the light of its circumstances, how much detail it provides to satisfy the information needs of users, how much emphasis it places on different aspects of the requirements and how it aggregates the information. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation.

An entity may aggregate the disclosures required by Ind AS 112 for interests in similar entities if aggregation is consistent with the disclosure objective and the requirement in next paragraph and does not obscure the information provided. An entity shall disclose how it has aggregated its interests in similar entities.

An entity **shall** present information **separately** for interests in:

- a) subsidiaries;
- b) joint ventures;
- c) joint operations;
- d) associates; and
- e) unconsolidated structured entities (explained in this unit).

In determining whether to aggregate information, an entity shall consider quantitative and qualitative information about the different risk and return characteristics of each entity it is considering for aggregation and the significance of each such entity to the reporting entity. The entity shall present the disclosures in a manner that clearly explains to users of financial statements the nature and extent of its interests in those other entities.

Examples of aggregation levels **within the classes of entities mentioned above** that might be appropriate are:

- (a) nature of activities (e.g. a research and development entity, a revolving credit card securitisation entity).
- (b) industry classification.
- (c) geography (e.g. country or region)



8.2 SCOPE OF IND AS 112

Scope inclusions

Disclosure requirements of Ind AS 112 **applies** to an entity that has an interest in any of the following:

Subsidiaries	Joint arrangements (i.e. joint operations or joint ventures)	Associates	Unconsolidated structured entities

The disclosure requirements of Ind AS 112 also applies if an entity's interests listed as above are classified (or included in a disposal group that is classified) as held for sale or discontinued operations in accordance with Ind AS 105 '*Non-current Assets Held for Sale and Discontinued Operations*'.

Scope exclusions

Disclosure requirements of Ind AS 112 **does not apply** to the following:

Post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19 '*Employee Benefits*' applies.

- For example, Company A has set up an Employee Benefit Plan trust. So, Company A is not required to make disclosures as required by Ind AS 112 of its interest in such trust.

An entity's separate financial statements to which Ind AS 27 '*Separate Financial Statements*' applies. However,

- If an entity has interests in unconsolidated structured entities and prepares separate financial statements as its only financial statements then it shall apply the disclosure requirements of Ind AS 112
- An Investment entity that prepares financial statements in which all of its subsidiaries are measured at fair value through profit or loss in accordance with Ind AS 110 '*Consolidated Financial Statements*' shall present the disclosures relating to investment entities required by Ind AS 112

Interest held by an entity that participates in, but does not have joint control of, a joint arrangement unless that interest results in significant influence over the arrangement or is an interest in a structured entity.

Interest in another entity that is accounted for in accordance with Ind AS 109 '*Financial Instruments*'. However, an entity shall apply Ind AS 112:

- when that interest is an interest in an associate or a joint venture that, in accordance with Ind AS 28 '*Investments in Associates and Joint Ventures*' is measured at fair value through profit or loss; or
- when that interest is an interest in an unconsolidated structured entity



8.3 DISCLOSURES RELATED TO INTERESTS IN SUBSIDIARIES

An entity shall disclose information that enables users of its consolidated financial statements

to understand

- the composition of the group; and
- the interest that non-controlling interests have in the group's activities and cash flows; and

to evaluate

- the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group
- the nature of, and changes in, the risks associated with its interests in consolidated structured entities
- the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and
- the consequences of losing control of a subsidiary during the reporting period

When the financial statements of a subsidiary used in the preparation of consolidated financial statements are as of a date or for a period that is different from that of the consolidated financial statements, an entity shall disclose:

- the date of the end of the reporting period of the financial statements of that subsidiary; and
- the reason for using a different date or period.

8.3.1 The interest that non-controlling interests have in the group's activities and cash flows

An entity shall disclose for each of its subsidiaries that have non-controlling interests that are material to the reporting entity:

the name of the subsidiary.

the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary.

the proportion of ownership interests held by non-controlling interests.

the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held.

the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period.

accumulated non-controlling interests of the subsidiary at the end of the reporting period.

summarised financial information about the subsidiary (explained subsequently in this unit)

The nature and extent of significant restrictions

An entity shall disclose following:

Significant restrictions (eg statutory, contractual and regulatory restrictions) on its ability to access or use the assets and settle the liabilities of the group, such as:

- those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group.
- guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group.

The **nature and extent** to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group (such as when a parent is obliged to settle liabilities of a subsidiary before settling its own liabilities, or approval of non-controlling interests is required either to access the assets or to settle the liabilities of a subsidiary).

The **carrying amounts** in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

8.3.2 Nature of the risks associated with an entity's interests in consolidated structured entities

An entity shall disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g. liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support).

If during the reporting period a parent or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to a consolidated structured entity (e.g. purchasing assets of or instruments issued by the structured entity), the entity shall disclose:

- a) the type and amount of support provided, including situations in which the parent or its subsidiaries assisted the structured entity in obtaining financial support; and
- b) the reasons for providing the support.

If during the reporting period a parent or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to a previously unconsolidated structured entity and that provision of support resulted in the entity controlling the structured entity, the entity shall disclose an explanation of the relevant factors in reaching that decision.

An entity shall disclose any current intentions to provide financial or other support to a consolidated structured entity, including intentions to assist the structured entity in obtaining financial support.

8.3.3 Consequences of changes in a parent's ownership interest in a subsidiary that do not result in a loss of control

An entity shall present a schedule that shows the effects on the equity attributable to owners of the parent of any changes in its ownership interest in a subsidiary that do not result in a loss of control.

8.3.4 Consequences of losing control of a subsidiary during the reporting period

An entity shall disclose the gain or loss, if any, calculated in accordance with Ind AS 110, and:

- (a) the portion of that gain or loss attributable to measuring any investment retained in the former subsidiary at its fair value at the date when control is lost; and
- (b) the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).



8.4 DISCLOSURES RELATED TO INTERESTS IN JOINT ARRANGEMENTS AND ASSOCIATES

An entity shall disclose information that enables users of its financial statements to evaluate:

- (a) the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and
- (b) the nature of, and changes in, the risks associated with its interests in joint ventures and associates

The above disclosure requirements are discussed in detail in this section below.

8.4.1 Nature, extent and financial effects of an entity's interests in joint arrangements and associates

An entity shall disclose:

For each **joint arrangement and associate** that is material to the reporting entity:

- the name of the joint arrangement or associate.
- the nature of the entity's relationship with the joint arrangement or associate (by, for example, describing the nature of the activities of the joint arrangement or associate and whether they are strategic to the entity's activities).
- the principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement or associate.
- the proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).

For each **joint venture and associate** that is material to the reporting entity:*

- whether the investment in the joint venture or associate is measured using the equity method or at fair value.
- summarised financial information about the joint venture or associate (explained subsequently in this unit)
- if the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, if there is a quoted market price for the investment.

Financial information (explained subsequently in this unit) about the entity's investments in joint ventures and associates that are **not individually material**: *

- in aggregate for all individually immaterial joint ventures and, separately,
- in aggregate for all individually immaterial associates.

* This information is not required to be disclosed by an investment entity.



8.5 DISCLOSURES OF SUMMARISED FINANCIAL INFORMATION FOR SUBSIDIARIES, JOINT VENTURES AND ASSOCIATES

In this section, we will discuss disclosure requirements for following:

- Disclosures for subsidiary that has non-controlling interests that are material
- Disclosures for joint venture and associate

- Disclosure for subsidiary, associate or joint venture classified as held for sale

8.5.1 Disclosures for subsidiary that has non-controlling interests that are material

For each subsidiary that has non-controlling interests that are material to the reporting entity, an entity shall disclose:

- a) dividends paid to non-controlling interests.
- b) summarised financial information about the assets, liabilities, profit or loss and cash flows of the subsidiary that enables users to understand the interest that non-controlling interests have in the group's activities and cash flows. That information might include but is not limited to, for example, current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss and total comprehensive income. (This information shall be the amounts before inter-company eliminations).

8.5.2 Disclosures for joint venture and associate

For each joint venture and associate that is material to the reporting entity, an entity shall disclose:

Dividends received from the joint venture or associate.

Summarised financial information for the joint venture or associate including, but not necessarily limited to:

- current assets
- non-current assets
- current liabilities
- non-current liabilities
- revenue
- profit or loss from continuing operations
- post-tax profit or loss from discontinued operations
- other comprehensive income
- total comprehensive income

In addition to the summarised financial information mentioned above, an entity shall disclose for each joint venture that is material to the reporting entity the amount of:

Cash and cash equivalents
Current financial liabilities (excluding trade and other payables and provisions)
Non-current financial liabilities (excluding trade and other payables and provisions)
Depreciation and amortisation
Interest income
Interest expense
Income tax expense or income

The summarised financial information presented in accordance with above for joint venture and associate shall be the amounts included in the Ind AS financial statements of the joint venture or associate (and not the entity's share of those amounts). If the entity accounts for its interest in the joint venture or associate using the equity method:

- the amounts included in the Ind AS financial statements of the joint venture or associate shall be adjusted to reflect adjustments made by the entity when using the equity method, such as fair value adjustments made at the time of acquisition and adjustments for differences in accounting policies.
- the entity shall provide a reconciliation of the summarised financial information presented to the carrying amount of its interest in the joint venture or associate.

An entity may present the summarised financial information required for joint venture or associate on the basis of the joint venture's or associate's financial statements if:

- the entity measures its interest in the joint venture or associate at fair value in accordance with Ind AS 28; and
- the joint venture or associate does not prepare Ind AS financial statements and preparation on that basis would be impracticable or cause undue cost.

(In that case, the entity shall disclose the basis on which the summarised financial information has been prepared.)

An entity shall disclose, in aggregate, the **carrying amount of its interests in all individually immaterial joint ventures or associates** that are accounted for using the equity method. An

entity shall also disclose separately the aggregate amount of its share of those joint ventures' or associates':

- (a) profit or loss from continuing operations.
- (b) post-tax profit or loss from discontinued operations.
- (c) other comprehensive income.
- (d) total comprehensive income.

(An entity provides these disclosures separately for joint ventures and associates)

8.5.3 Disclosure for subsidiary, associate or joint venture classified as held for sale

When an entity's interest in a subsidiary, a joint venture or an associate (or a portion of its interest in a joint venture or an associate) is classified (or included in a disposal group that is classified) as **held for sale** in accordance with Ind AS 105, the entity is not required to disclose summarised financial information for that subsidiary, joint venture or associate as mentioned above.

PART B:

DISCLOSURE IN SEPARATE FINANCIAL STATEMENTS AS PER IND AS 27

An entity shall apply all applicable Ind AS when providing disclosures in its separate financial statements, including the requirements mentioned below.

When a parent, in accordance with paragraph 4(a) of Ind AS 110, **elects not to prepare consolidated financial statements** and instead prepares separate financial statements, it shall disclose in those separate financial statements:

Disclosures in separate financial statements

The fact that: • the financial statements are separate financial statements; • the exemption from consolidation has been used; • the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with Ind ASs have been produced for public use; and • the address where those consolidated financial statements are obtainable.	A list of significant investments in subsidiaries, joint ventures and associates, including: • the name of those investees. • the principal place of business (and country of incorporation, if different) of those investees. • its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.	A description of the method used to account for those investments.

When an investment entity that is a parent prepares separate financial statements as its only financial statements, it shall disclose that fact. The investment entity shall also present the disclosures relating to investment entities required by Ind AS 112.

When a parent (other than a parent covered by paragraphs mentioned above) or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, the parent or investor shall **identify the financial statements prepared in accordance with Ind AS 110, Ind AS 111 or Ind AS 28** to which they relate. The parent or investor shall also disclose in its separate financial statements:

- the fact that the statements are separate financial statements
- a list of significant investments in subsidiaries, joint ventures and associates, including:
 - the name of those investees.

- II. the principal place of business (and country of incorporation, if different) of those investees.
 - III. its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.
- c) a description of the method used to account for those investments.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



IND AS 27



IND AS 28



IND AS 110



IND AS 111

TEST YOUR KNOWLEDGE

Questions

1. X Limited was holding 100% of the equity share capital of Y Limited and Y Limited was treated as a subsidiary by X Limited. Now, Y Limited issues convertible preference shares to Z Limited. As per the issue document of convertible preference shares, Z Limited also gets the rights to participate in the relevant activities of Y Limited whereby Z Limited's consent is also necessary to pass any decision by the equity shareholder of Y Limited (i.e. X Limited). Determine how should X Limited account for its investment in Y Limited in its consolidated financial statements after the issue of convertible preference shares by Y Limited to Z Limited?
2. M Limited holds 90% interest in subsidiary N Limited. N Limited holds 25% interest in an associate O Limited. As at 31 March 20X1, the net assets of O Limited was ₹ 300 lakhs including profit of ₹ 40 lakhs for the year ended 31 March 20X1. Calculate how the investment in O Limited will be accounted in the consolidated financial statements of M Limited?
3. AB Limited holds 30% interest in an associate which it has acquired for a cost of ₹ 300 lakhs. On the date of acquisition of that stake, the fair value of net assets of the associate was ₹ 900 lakh. The value of goodwill on acquisition was ₹ 30 lakhs. After the acquisition, AB Limited accounted for the investment in the associate as per equity method of accounting and now the carrying value of such investment in the consolidated financial statements of AB Limited is ₹ 360 lakhs. The associate has now issued equity shares to some investors other than AB Limited for a consideration of ₹ 800 lakhs. This has effectively reduced the holding of AB Limited to 20%. Determine how AB Limited should account for such reduction in interest in the associate?
4. DEF Ltd. acquired 100% ordinary shares of ₹ 100 each of XYZ Ltd. on 1st October 20X1. On March 31, 20X2 the summarised Balance Sheets of the two companies were as given below:

	DEF Ltd.	XYZ Ltd.
Assets		
Property Plant Equipment		
Land & Buildings	15,00,000	18,00,000
Plant & Machinery	24,00,000	13,50,000
Investment in XYZ Ltd.	34,00,000	-
Inventory	12,00,000	3,64,000

Financial Assets		
Trade Receivable	5,98,000	4,00,000
Cash	<u>1,45,000</u>	<u>80,000</u>
Total	<u>92,43,000</u>	<u>39,94,000</u>
Equity & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	50,00,000	20,00,000
Other Equity		
Other reserves	24,00,000	10,00,000
Retained Earnings	5,72,000	8,20,000
Financial Liabilities		
Bank Overdraft	8,00,000	-
Trade Payable	<u>4,71,000</u>	<u>1,74,000</u>
Total	<u>92,43,000</u>	<u>39,94,000</u>

The retained earnings of XYZ Ltd. showed a credit balance of ₹ 3,00,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; DEF Ltd. has recognised the dividend received to profit or loss account; Fair Value of P&M as on 1st October 20X1 was ₹ 20,00,000. The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with Book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	1,00,000	Land & Buildings	10,00,000
		Inventories	1,50,000

Notes:

- I. It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.
- II. Also assume that the Other Reserves of both the companies as on 31st March 20X2 are the same as was on 1st April 20X1.
- III. All fair value adjustments have not yet started impacting consolidated post-acquisition profits.

Prepare consolidated Balance Sheet as at March 31, 20X2.

5. Ram Ltd. acquired 60% ordinary shares of ₹ 100 each of Krishan Ltd. on 1st October 20X1. On March 31, 20X2 the summarised Balance Sheets of the two companies were as given below:

	Ram Ltd.	Krishan Ltd.
Assets		
Property, Plant and Equipment		
Land & Buildings	3,00,000	3,60,000
Plant & Machinery	4,80,000	2,70,000
Investment in Krishan Ltd.	8,00,000	-
Inventory	2,40,000	72,800
Financial Assets		
Trade Receivables	1,19,600	80,000
Cash	<u>29,000</u>	<u>16,000</u>
Total	<u>19,68,600</u>	<u>7,98,800</u>
Equity & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	10,00,000	4,00,000
Other Equity		
Other Reserves	6,00,000	2,00,000
Retained earnings	1,14,400	1,64,000
Financial Liabilities		
Bank Overdraft	1,60,000	-
Trade Payable	<u>94,200</u>	<u>34,800</u>
Total	<u>19,68,600</u>	<u>7,98,800</u>

The Retained earnings of Krishan Ltd. showed a credit balance of ₹ 60,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; Ram Ltd. has credited the dividend received to its Retained earnings; Fair Value of P&M as on 1st October 20X1 was ₹ 4,00,000; The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	20,000	Land & Buildings	2,00,000
		Inventories	30,000

Notes:

- I. It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.
- II. Also assume that the Other Reserves as on 31st March 20X2 are the same as was on 1st April 20X1.

Prepare consolidated Balance Sheet as at March 31, 20X2.

6. On 31 March 20X2, Blue Heavens Ltd. acquired 100% ordinary shares carrying voting rights of Orange County Ltd. for ₹ 6,000 lakh in cash and it controlled Orange County Ltd. from that date. The acquisition-date statements of financial position of Blue Heavens Ltd. and Orange County Ltd. and the fair values of the assets and liabilities recognised on Orange County Ltd. balance sheet were:

	Blue Heavens Ltd.	Orange County Ltd.	
	Carrying Amount (₹ in lakh)	Carrying Amount (₹ in lakh)	Fair Value (₹ in lakh)
Assets			
Non-current assets			
Building and other PPE	7,000	3,000	3,300
Investment in Orange County Ltd.	6,000		
Current assets			
Inventories	700	500	600
Trade receivables	300	250	250
Cash	<u>1,500</u>	<u>700</u>	700
Total assets	<u>15,500</u>	<u>4,450</u>	
Equity and liabilities			
Equity			
Share capital	5,000	2,000	
Retained earnings	10,200	2,300	
Current liabilities			
Trade payables	<u>300</u>	<u>150</u>	150
Total liabilities and equity	<u>15,500</u>	<u>4,450</u>	

Prepare the Consolidated Balance Sheet as at March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.

7. The facts are the same as in Question 6 above. However, Blue Heavens Ltd. acquires only 75% of the ordinary shares, to which voting rights are attached of Orange County Ltd. Blue Heavens Ltd. pays ₹ 4,500 lakhs for the shares. Prepare the Consolidated Balance Sheet as at March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.
8. Facts are same as in Question 6 & 7, Blue Heavens Ltd. acquires 75% of Orange County Ltd. Blue Heavens Ltd. pays ₹ 4,500 lakhs for the shares. At 31 March 20X3, i.e one year after Blue Heavens Ltd. acquired Orange County Ltd., the individual statements of financial position and statements of comprehensive income of Blue Heavens Ltd. and Orange County Ltd. are:

	Blue Heavens Ltd. Carrying Amount (₹ in lakh)	Orange County Ltd. Carrying Amount (₹ in lakh)
Assets		
Non-current assets		
PPE (Building and others)	6,500	2,750
Investment in Orange County Ltd.	<u>4,500</u>	
	<u>11,000</u>	<u>2,750</u>
Current assets		
Inventories	800	550
Financial Asset - Trade receivables	380	300
Cash	<u>4,170</u>	<u>1,420</u>
	<u>5,350</u>	<u>2,270</u>
Total assets	<u>16,350</u>	<u>5,020</u>
Equity and liabilities		
Equity		
Share capital	5,000	2,000
Retained earnings	<u>11,000</u>	<u>2,850</u>
	<u>16,000</u>	<u>4,850</u>

Current liabilities		
Financial Liabilities-Trade payables	<u>350</u>	<u>170</u>
	<u>350</u>	<u>170</u>
Total liabilities and equity	<u>16,350</u>	<u>5,020</u>

Statements of Profit and Loss for the year ended 31 March 20X3:

	Blue Heavens Ltd. Carrying Amount (₹ in lakh)	Orange County Ltd. Carrying Amount (₹ in lakh)
Revenue	3,000	1,900
Cost of sales	(1,800)	(1,000)
Administrative expenses	<u>(400)</u>	<u>(350)</u>
Profit for the year	<u>800</u>	<u>550</u>

Note: Blue Heavens Ltd. estimates that goodwill has impaired by 98. The fair value adjustment to buildings and other PPE is in respect of a building; all buildings have an estimated remaining useful life of 20 years from 31 March 20X2 and estimated residual values of zero. Blue Heavens Ltd. uses the straight-line method for depreciation of PPE. All the inventory held by Orange County Ltd. at 31 March 20X2 was sold during 20X3.

Prepare the Consolidated Balance Sheet as at March 31, 20X3 of group of entities Blue Heavens Ltd. and Orange County Ltd.

9. P Pvt. Ltd. has a number of wholly-owned subsidiaries including S Pvt. Ltd. at 31st March 20X2. P Pvt. Ltd.'s consolidated balance sheet and the group carrying amount of S Pvt. Ltd.'s assets and liabilities (ie the amount included in the consolidated balance sheet in respect of S Pvt. Ltd.'s assets and liabilities) at 31st March 20X2 are as follows:

Particulars	Consolidated (₹ in millions)	Group carrying amount of S Pvt. Ltd. asset and liabilities Ltd. (₹ in millions)
Assets		
Non-Current Assets		
Goodwill	380	180
Buildings	3,240	1,340
Current Assets		

Inventories	140	40
Trade Receivables	1,700	900
Cash	<u>3,100</u>	<u>1000</u>
Total Assets	<u>8,560</u>	<u>3,460</u>
Equities & Liabilities		
Equity		
Share Capital	1600	
Other Equity		
Retained Earnings	4,260	
Current liabilities		
Trade Payables	<u>2,700</u>	<u>900</u>
Total Equity & Liabilities	<u>8,560</u>	<u>900</u>

Prepare consolidated Balance Sheet after disposal as at 31st March, 20X2 when P Pvt. Ltd. group sold 100% shares of S Pvt. Ltd. to independent party for ₹ 3,000 millions.

10. Reliance Ltd. has a number of wholly-owned subsidiaries including Reliance Jio Infocomm Ltd. at 31st March 20X2.

Reliance Ltd.'s consolidated balance sheet and the group carrying amount of Reliance Jio Infocomm Ltd. assets and liabilities (ie the amount included in that consolidated balance sheet in respect of Reliance Jio Infocomm Ltd. assets and liabilities) at 31st March 20X2 are as follows:

Particulars	Consolidated (₹ In '000)	Group carrying amount of Reliance Jio Infocomm Ltd. asset and liabilities Ltd. (₹ In '000)
Assets		
Non-current Assets		
Goodwill	190	90
Buildings	1,620	670
Current Assets		
Inventories	70	20

Financial Assets		
Trade Receivables	850	450
Cash	<u>1,550</u>	<u>500</u>
Total Assets	<u>4,280</u>	<u>1,730</u>
Equity & Liabilities		
Equity		
Share Capital	800	
Other Equity		
Retained Earnings	<u>2,130</u>	
	<u>2,930</u>	
Current liabilities		
Financial liabilities		
Trade Payables	<u>1,350</u>	<u>450</u>
Total Equity & Liabilities	<u>4,280</u>	<u>450</u>

Prepare consolidated Balance Sheet after disposal as at 31st March, 20X2 when Reliance Ltd. group sold 90% shares of Reliance Jio Infocomm Ltd. to independent party for ₹ 1000 thousand.

11. Airtel Telecommunications Ltd. owns 100% share capital of Airtel Infrastructures Pvt. Ltd. On 1 April 20X1 Airtel Telecommunications Ltd. acquired a building from Airtel Infrastructures Pvt. Ltd., for ₹ 11,00,000 that the group plans to use it as its new headquarters office.

Airtel Infrastructures Pvt. Ltd. had purchased the building from a third party on 1 April 20X0 for ₹ 10,25,000. At that time the building was assessed to have a useful life of 21 years and a residual value of ₹ 5,00,000. On 1 April 20X1 the carrying amount of the building was ₹ 10,00,000 in Airtel Infrastructures Pvt. Ltd.'s individual accounting records.

The estimated remaining useful life of the building measured from 1 April 20X1 is 20 years and the residual value of the building is now estimated at ₹ 3,50,000. The method of depreciation is straight-line.

Pass necessary accounting entries in individual and consolidation situations.

12. As at the beginning of its current financial year, AB Limited holds 90% equity interest in BC Limited. During the financial year, AB Limited sells 70% of its equity interest in BC Limited to PQR Limited for a total consideration of ₹ 56 crore and consequently loses

control of BC Limited. At the date of disposal, fair value of the 20% interest retained by AB Limited is ₹ 16 crore and the net assets of BC Limited are carry valued at ₹ 60 crore.

These net assets include the following:

- (a) Debt investments classified as fair value through other comprehensive income (FVOCI) of ₹ 12 crore and related FVOCI reserve of ₹ 6 crore.
- (b) Net defined benefit liability of ₹ 6 crore that has resulted in a reserve relating to net measurement losses of ₹ 3 crore.
- (c) Equity investments (considered not held for trading) of ₹ 10 crore for which irrevocable option of recognising the changes in fair value in OCI has been availed and related FVOCI reserve of ₹ 4 crore.
- (d) Net assets of a foreign operation of ₹ 20 crore and related foreign currency translation reserve of ₹ 8 crore.

In consolidated financial statements of AB Limited, 90% of the above reserves were included in equivalent equity reserve balances, with the 10% attributable to the non-controlling interest included as part of the carrying amount of the non-controlling interest.

What would be the accounting treatment on loss of control in the consolidated financial statements of AB Limited?

13. On 1st April 2019, Investor Ltd. acquires 35% interest in another entity, XYZ Ltd. Investor Ltd. determines that it is able to exercise significant influence over XYZ Ltd. Investor Ltd. has paid total consideration of ₹ 47,50,000 for acquisition of its interest in XYZ Ltd. At the date of acquisition, the book value of XYZ Ltd.'s net assets was ₹ 90,00,000 and their fair value was ₹ 1,10,00,000. Investor Ltd. has determined that the difference of ₹ 20,00,000 pertains to an item of property, plant and equipment (PPE) which has remaining useful life of 10 years.

During the year, XYZ Ltd. made a profit of ₹ 8,00,000. XYZ Ltd. paid a dividend of ₹ 12,00,000 on 31st March, 2020. XYZ Ltd. also holds a long-term investment in equity securities. Under Ind AS, investment is classified as at FVTOCI in accordance with Ind AS 109 and XYZ Ltd. recognized an increase in value of investment by ₹ 2,00,000 in OCI during the year. Ignore deferred tax implications, if any.

Calculate the closing balance of Investor Ltd.'s investment in XYZ Ltd. as at 31st March, 2020 as per the relevant Ind AS.

14. On 1st April 20X1 Alpha Ltd. commenced joint construction of a property with Gama Ltd. For this purpose, an agreement has been entered into that provides for joint operation and ownership of the property. All the ongoing expenditure, comprising maintenance plus borrowing costs, is to be shared equally. The construction was completed on 30th September

20X1 and utilisation of the property started on 1st January 20X2 at which time the estimated useful life of the same was estimated to be 20 years.

Total cost of the construction of the property was ₹ 40 crores. Besides internal accruals, the cost was partly funded by way of loan of ₹ 10 crores taken on 1st January 20X1. The loan carries interest at an annual rate of 10% with interest payable at the end of year on 31st December each year. The company has spent ₹ 4,00,000 on the maintenance of such property.

The company has recorded the entire amount paid as investment in Joint Venture in the books of accounts. Suggest the suitable accounting treatment of the above transaction as per applicable Ind AS.

15. Gamma Limited, a parent company, is engaged in manufacturing and retail activities. The group holds investments in different entities as follows:

- Gamma Limited holds 100% Investment in G Limited and D Limited;
- G Limited and D Limited hold 60% and 40% in GD Limited respectively;
- Delta Limited is a 100% subsidiary of GD Limited

Firstly, Gamma Limited wants you to suggest whether GD Limited can avail the exemption from the preparation and presentation of consolidated financial statements as per applicable Ind AS?

Secondly, if all other facts remain the same as above except that G Limited and D Limited are both owned by an Individual (say, Mr. X) instead of Gamma Limited, then explain whether GD Limited can avail the exemption from the preparation and presentation of consolidated financial statements.

Answers

1. As per the issue document of convertible preference shares, unanimous consent of both X Limited and Z Limited are required to pass any decision about the relevant activities of Y Limited. Hence, Y Limited is jointly controlled by X Limited and Z Limited and thereby, Y Limited becomes a joint arrangement between X Limited and Z Limited.

Y Limited is structured through a separate vehicle. The legal form of Y Limited, terms of the contractual arrangement or other facts and circumstances do not give X Limited and Z Limited rights to the assets, and obligations for the liabilities, relating to Y Limited. Hence, Y Limited is a joint venture between X Limited and Z Limited.

When the convertible preference shares are issued to Z Limited, X Limited loses control over Y Limited. Hence X Limited should derecognise the assets and liabilities of Y Limited from its consolidated financial statements. 100% equity shares in Y Limited is still held by X Limited. Hence such investment would be accounted at fair value on the date of loss of

control by X Limited. The difference between the fair value of 100% equity shares retained in Y Limited and the carrying value of assets and liabilities of Y Limited derecognised is recognised in profit or loss of X Limited. After the loss of control, the investment in Y Limited is accounted as per equity method of accounting by X Limited whereby the investment value in Y Limited will be adjusted for the change in the X Limited's share of the net assets Y Limited post the date of loss of control. Also, the difference between the fair value of investment in Y Limited and fair value of net identifiable assets of Y Limited shall be goodwill or capital reserve.

2. Since N Limited is a subsidiary of M Limited, the consolidated financial statements of M Limited will include 100% amounts of the consolidated financial statements of N Limited (including investment in O Limited accounted for using equity method). Accordingly, the investment in O Limited will be accounted as follows in the consolidated financial statements of M Limited:

	₹' lakh	
Investment in O Limited (300 x 25%)		75
Share in profit of O Limited		
Attributable to M Limited (40 x 25% x 90%)	9	
Attributable to Non-controlling interest of N Limited (50 x 25% x 10%)	1	10

3. Because of the issue of shares by associate to other investors, AB Limited has effectively sold 10% (30 – 20) of its interest in the associate. The gain / loss on reduction in interest in associate is calculated as follows:

	₹' lakhs
AB Limited's share in the consideration received by the associate for issue of shares (800 x 20%) ⁽¹⁾	160
Less: Carrying value of interest sold (360 x 1/3) ⁽²⁾	(120)
Gain on reduction in interest in associate⁽³⁾	40

Notes:

- (1) The share in the consideration received by associate on issue of shares (i.e. ₹ 160 lakhs) would be recorded as part of investment in associate.
- (2) The carrying amount of interest sold (i.e. ₹ 120 lakhs) will be derecognised, including proportionate goodwill of ₹ 10 lakhs (30 x 1/3).
- (3) Gain of ₹ 40 lakhs will be recorded in the profit or loss.

4. Consolidated Balance Sheet of DEF Ltd. and its subsidiary, XYZ Ltd. as at 31st March, 20X2

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	86,00,000
(2) Current Assets		
(i) Inventories	2	17,14,000
(ii) Financial Assets		
(a) Trade Receivables	3	9,98,000
(b) Cash & Cash equivalents	4	<u>2,25,000</u>
Total Assets		<u>1,15,37,000</u>
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	5	50,00,000
(ii) Other Equity	6	49,92,000
(2) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	7	7,45,000
(b) Short term borrowings	8	<u>8,00,000</u>
Total Equity & Liabilities		<u>1,15,37,000</u>

Notes to Accounts

			₹
1.	Property Plant & Equipment		
	Land & Building	43,00,000	
	Plant & Machinery	43,00,000	86,00,000
2.	Inventories		
	DEF Ltd.	12,00,000	
	XYZ Ltd.	<u>5,14,000</u>	17,14,000

3.	Trade Receivables		
	DEF Ltd.	5,98,000	
	XYZ Ltd.	<u>4,00,000</u>	9,98,000
4.	Cash & Cash equivalents		
	DEF Ltd.	1,45,000	
	XYZ Ltd.	<u>80,000</u>	2,25,000
7.	Trade payable		
	DEF Ltd.	4,71,000	
	XYZ Ltd.	<u>2,74,000</u>	7,45,000
8.	Shorter-term borrowings		
	Bank overdraft		8,00,000

Statement of Changes in Equity:
5. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
50,00,000	0	50,00,000

6. Other Equity

	Share application money pending allotment	Equity component of compound financial instrument	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning				0	24,00,000	24,00,000
Total comprehensive income for the year			0	5,72,000		5,72,000
Dividends			0	(2,00,000)		(2,00,000)
Total						

comprehensive income attributable to parent			0	3,35,000		3,35,000
Gain on Bargain purchase			18,85,000			18,85,000
Balance at the end of reporting period			18,85,000	7,07,000	24,00,000	49,92,000

It is assumed that there exists no clear evidence for classifying the acquisition of the subsidiary as a bargain purchase and, hence, the bargain purchase gain has been recognized directly in capital reserve. If, however, there exists such a clear evidence, the bargain purchase gain would be recognized in other comprehensive income and then accumulated in capital reserve. In both the cases, closing balance of capital reserve will be ₹ 18,85,000.

Working Notes:

1. Adjustments of Fair Value

The Plant & Machinery of XYZ Ltd. would stand in the books at ₹ 14,25,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 15,00,000 total depreciation being ₹ 1,50,000. The value put on the assets being ₹ 20,00,000 there is an appreciation to the extent of ₹ 5,75,000.

2. Acquisition date profits of XYZ Ltd.

₹

Reserves on 1.4. 20X1	10,00,000
Profit & Loss Account Balance on 1.4. 20X1 Profit for 20X2: Total ₹ 8,20,000 less ₹ 1,00,000 (3,00,000 – 2,00,000) i.e. ₹ 7,20,000; for 6 months i.e. up to 1.10.20X1	3,00,000
Total Appreciation including machinery appreciation (10,00,000 1,50,000 + 5,75,000 – 1,00,000)	3,60,000
Share of DEF Ltd.	<u>16,25,000</u>
	<u>32,85,000</u>

3. Post-acquisition profits of XYZ Ltd. ₹

Profit after 1.10. 20X1 [8,20,000-1,00,000]x 6/12	3,60,000
Less: 10% depreciation on ₹ 20,00,000 for 6 months less depreciation already charged for 2 nd half of 20X1-20X2 on ₹ 15,00,000 (1,00,000-75,000)	<u>(25,000)</u>
Share of DEF Ltd.	<u>3,35,000</u>

4. Consolidated total comprehensive income ₹

<i>DEF Ltd.</i>	
Retained earnings on 31.3.20X2	5,72,000
Less: Retained earnings as on 1.4.20X1	<u>(0)</u>
Profits for the year 20X1-20X2	5,72,000
Less: Elimination of intra-group dividend	<u>(2,00,000)</u>
Adjusted profit for the year	3,72,000
<i>XYZ Ltd.</i>	
Adjusted profit attributable to DEF Ltd. (W.N.3)	<u>3,35,000</u>
Consolidated profit or loss for the year	<u>7,07,000</u>

5. No Non-controlling Interest as 100% shares of XYZ Ltd. are held by DEF Ltd.

6. Gain on Bargain Purchase ₹

Amount paid for 20,000 shares		34,00,000
Par value of shares	20,00,000	
DEF Ltd.'s share in acquisition date profits of XYZ Ltd.	<u>32,85,000</u>	<u>(52,85,000)</u>
Gain on Bargain Purchase		<u>18,85,000</u>

7. Value of Plant & Machinery ₹

DEF Ltd.		24,00,000
XYZ Ltd.	13,50,000	
Add: Appreciation on 1.10. 20X1	<u>5,75,000</u>	
	19,25,000	
Add: Depreciation for 2nd half charged on pre-revalued value	75,000	
Less: Depreciation on ₹ 20,00,000 for 6 months	<u>(1,00,000)</u>	<u>19,00,000</u>
		<u>43,00,000</u>

8. Consolidated retained earnings

₹

	DEF Ltd.	XYZ Ltd.	Total
As given	5,72,000	8,20,000	13,92,000
<i>Consolidation Adjustments:</i>			
(i) Elimination of pre-acquisition element [3,00,000 + 3,60,000]	0	(6,60,000)	(6,60,000)
(ii) Elimination of intra-group dividend	(2,00,000)	2,00,000	0
(iii) Impact of fair value adjustments	<u>0</u>	<u>(25,000)</u>	<u>(25,000)</u>
Adjusted retained earnings consolidated	<u>3,72,000</u>	<u>3,35,000</u>	<u>7,07,000</u>

Assumptions:

- Investment in XYZ Ltd is carried at cost in the separate financial statements of DEF Ltd.
- Appreciation of ₹10 lakhs in land & buildings is entirely attributable to land element only.
- Depreciation on plant and machinery is on WDV method.
- Acquisition-date fair value adjustment to inventories of XYZ Ltd. existing at the balance sheet date does not result in need for any write-down.

5. Consolidated Balance Sheet of Ram Ltd. and its subsidiary, Krishan Ltd.

as at 31st March, 20X2

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property, Plant & Equipment	1	17,20,000
(ii) Goodwill	2	1,65,800
(2) Current Assets		
(i) Inventories	3	3,42,800
(ii) Financial Assets		
(a) Trade Receivables	4	1,99,600
(b) Cash & Cash equivalents	5	<u>45,000</u>
Total Assets		<u>24,73,200</u>

II. Equity and Liabilities		
(1) Equity	6	10,00,000
(i) Equity Share Capital	7	7,30,600
(ii) Other Equity		4,33,600
(2) Non-controlling Interest (WN 4)		
(3) Current Liabilities		
(i) Financial Liabilities	8	1,49,000
(a) Trade Payables	9	<u>1,60,000</u>
(b) Short term borrowings		<u>24,73,200</u>
Total Equity & Liabilities		

Notes to accounts

			₹
1.	Property Plant & Equipment		
	Land & Building	8,60,000	
	Plant & Machinery	<u>8,60,000</u>	17,20,000
2.	Goodwill		1,65,800
3.	Inventories		
	Ram Ltd.	2,40,000	
	Krishan Ltd.	<u>1,02,800</u>	3,42,800
4.	Trade Receivables		
	Ram Ltd.	1,19,600	
	Krishan Ltd.	<u>80,000</u>	1,99,600
5.	Cash & Cash equivalents		
	Ram Ltd.	29,000	
	Krishan Ltd.	<u>16,000</u>	45,000
8.	Trade Payables		
	Ram Ltd.	94,200	
	Krishan Ltd.	<u>54,800</u>	1,49,000
9.	Short-term borrowings		
	Bank overdraft		1,60,000

Statement of Changes in Equity:**6. Equity share Capital**

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
10,00,000	0	10,00,000

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning of the reporting period				0	6,00,000	6,00,000
Total comprehensive income for the year			0	1,14,400		1,14,400
Dividends			0	(24,000)		(24,000)
Total comprehensive income attributable to parent			0	40,200		40,200
Gain on Bargain purchase				0		0
Balance at the end of reporting period				1,30,600	6,00,000	7,30,600

Working Notes:**1. Adjustments of Fair Value**

The Plant & Machinery of Krishan Ltd. would stand in the books at ₹ 2,85,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 3,00,000 total depreciation being ₹ 30,000. The value put on the assets being ₹ 4,00,000 there is an appreciation to the extent of ₹ 1,15,000.

2. Acquisition date profits of Krishan Ltd.

Reserves on 1.4. 20X1		2,00,000
Profit & Loss Account Balance on 1.4. 20X1		60,000
Profit for 20X1-20X2: Total (₹ 1,64,000 less ₹ 20,000) x 6/12 i.e. ₹ 72,000;		
upto 1.10. 20X1		72,000
Total Appreciation		<u>3,25,000</u>
		<u>6,57,000</u>
Holding Co. Share (60%)		3,94,200

3. Post-acquisition profits of Krishan Ltd.

Profit after 1.10. 20X1 [1,64,000-20,000]x 6/12		72,000
Less: 10% depreciation on ₹ 4,00,000 for 6 months less depreciation already charged for 2 nd half of 20X1-20X2 on ₹ 3,00,000 (20,000-15,000)		<u>(5,000)</u>
Total		<u>67,000</u>
Share of holding Co. (60%)		40,200

4. Non-controlling Interest

Par value of 1600 shares		160,000
Add: 2/5 Acquisition date profits (6,57,000 – 40,000)		2,46,800
Add: 2/5 Post-acquisition profits [WN 3]		<u>26,800</u>
		<u>4,33,600</u>

5. Goodwill:

Amount paid for 2,400 shares		8,00,000
Par value of shares	2,40,000	
Acquisition date profits share of Ram Ltd.	<u>3,94,200</u>	<u>(6,34,200)</u>
Goodwill		<u>1,65,800</u>

6. Value of Plant & Machinery:

Ram Ltd.		4,80,000
Krishan Ltd.	2,70,000	
Add: appreciation on 1.10. 20X1	<u>1,15,000</u>	
	3,85,000	
Add: Depreciation for 2nd half charged on pre-revalued value	15,000	
Less: Depreciation on ₹ 4,00,000 for 6 months	<u>(20,000)</u>	<u>3,80,000</u>
		<u>8,60,000</u>

7. Profit & Loss account consolidated

Ram Ltd. (as given)	1,14,400	
Less: Dividend	<u>(24,000)</u>	90,400
Share of Ram Ltd. in post-acquisition profits		<u>40,200</u>
		<u>1,30,600</u>

6. Blue Heavens Ltd. consolidated balance sheet at 31 March 20X2 will be calculated as follows: (in lakhs)

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			1,300 (WN 1)	1,300
Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	6,000		(6,000)	
Current assets				
Inventories	700	500	100	1,300
Financial Assets				
Trade receivables	300	250		550
Cash	1,500	700		2,200
Total assets	15,500	4,450		15,650

Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	10,200	2,300	(2,300)	10,200
Trade payable	300	150		450
Total liabilities and equity	15,500	4,450		15,650

Consolidation involves:

- Adding the balance sheet of the parent and its subsidiary together line by line.
- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased) and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary.

1. Working for goodwill:	(₹ in lakhs)
Consideration paid	6,000
Less: Acquisition date fair value of Orange County Ltd. net assets	<u>(4,700)</u>
Goodwill	<u>1,300</u>

2. Working for the acquisition date fair value of Orange County Ltd. net assets:
Acquisition date fair value of acquiree (Orange County Ltd.) assets

Buildings and other PPE	3,300
Inventories	600
Trade receivables	250
Cash	700
Less: fair value of trade payables	<u>(150)</u>
Fair value of net assets acquired	<u>4,700</u>

7. Non-controlling interest

= 25 % × Orange County Ltd. identifiable net assets at fair value of ₹ 4,700

= ₹ 1,175.

Blue Heavens Ltd.'s consolidated balance sheet at 31 March 20X2 will be calculated as follows: (in lakhs)

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			975 (WN 1)	975
Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	4,500		(4,500)	
Current assets				
Inventories	700	500	100	1,300
Financial Assets				
Trade receivables	300	250		550
Cash	<u>3,000</u>	<u>700</u>		<u>3,700</u>
Total assets	<u>15,500</u>	<u>4,450</u>		<u>16,825</u>
Equity and liabilities				
Equity				
Share capital Other Equity	5,000	2,000	(2,000)	5,000
	10,200	2,300	(2,300)	10,200
Non-controlling interest			1,175	1,175
Current liabilities				
Financial Liabilities				
Trade payables	<u>300</u>	<u>150</u>		<u>450</u>
Total liabilities and equity	<u>15,500</u>	<u>4,450</u>		<u>16,825</u>

Note: In this question, Blue Heavens Ltd.'s (and consequently the group's) cash balance is ₹ 1,500 lakh higher than in Question above because, here Blue Heavens Ltd. paid ₹ 1,500 less to acquire Orange County Ltd. (i.e. ₹ 6,000 less ₹ 4,500).

1. <u>Working for goodwill:</u>	(₹ in lakhs)
Consideration paid	4,500
Non- controlling interest	1,175
Less: Acquisition date fair value of Orange County Ltd. net assets	
(cal. as above)	<u>4,700</u>
Goodwill	<u>975</u>
(Goodwill recognized in the consolidated balance sheet relates solely to the acquirer's proportion of the subsidiary; it does not include the non-controlling interest's share).	

8. Alternative I for calculation of Non-controlling Interest:

The Non-controlling Interest proportion of Orange County Ltd. is 25%.

At 31 March 20X3, the NCI in the consolidated balance sheet would be calculated as:

	₹ (lakh)
NCI at date of acquisition (31 March 20X2) (see solution to Question 7)	1,175
NCI's share of profit for the year ended 31 March 20X3, being 25% Of ₹ 435 lakh (being ₹ 550 profit of Orange County Ltd. as per Orange County Ltd. financial statements less ₹ 100 group inventory Fair value adjustment less ₹ 15 group depreciation on building fair value adjustment)*	<u>109</u>
NCI as at 31 March 20X3	<u>1,284</u>

*In calculating the NCI's share of profit for the year ended 31 March 20X3, no deduction is made for goodwill amortization because, as explained above, the goodwill arising on consolidation relates solely to the acquirer's proportion of the subsidiary and does not include the non-controlling interest's share.

Alternative II for calculation of Non-controlling Interest:

As an alternative to the above three-step approach, at 31 March 20X3 the NCI in the consolidated balance sheet is calculated as 25% (the NCI's proportion) of ₹ 5,135, which is ₹ 1,284. ₹ 5,135 is Orange County Ltd. net assets at 31 March 20X3 as shown in Orange County Ltd. balance sheet (₹ 4,850, being ₹ 5,020 assets less ₹ 170 liabilities) plus the fair value adjustment to those assets as made in preparing the group balance sheet (₹ 285, being the fair value adjustment in respect of Orange County Ltd. building, ₹ 300, less one year's depreciation of that adjustment, ₹ 15).

Blue Heavens Ltd. consolidated statement of comprehensive income for the year ended 31 March 20X3 will be computed as follows:

	Blue Heavens Ltd.	Orange County Ltd.	Consolidate adjustments	Consolidated
Revenue	3,000	1,900		4,900
Cost of sales	<u>(1,800)</u>	<u>(1,000)</u>	(100) (WN 1)	<u>(2,900)</u>
Profit for the year	1,200	900		2,000
Administrative expenses	<u>(400)</u>	<u>(350)</u>	(113) (WN 2)	<u>(863)</u>
Total comprehensive income for the year	800	550		1,137

Total comprehensive income attributable to:

Owners of the parent (75%)	1,028
Non-controlling interest (25%)	<u>109</u>
	<u>1,137</u>

Consolidation involves:

- Adding the statement of comprehensive income of the parent and its subsidiary together line by line
- Recognising the fair value adjustments and/ or amortisation thereof together with amortisation of the goodwill asset that arose on acquisition of the subsidiary.

Blue Heavens Ltd. consolidated balance sheet at 31 March 20X3 will be computed as follows: (₹ in lakh)

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			975-98 (WN 3)	877

Buildings and other PPE	6,500	2,750	285 (WN 4)	9,535
Financial Assets				
Investment in Entity B	4,500		(4,500)	
Current assets				
Inventories	800	550		1,350
Financial Assets				
Trade receivables	380	300		680
Cash	<u>4,170</u>	<u>1420</u>		<u>5,590</u>
Total assets	<u>16,350</u>	<u>5,020</u>		<u>18,032</u>
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	11,000	2,850	(2,622) (WN 5)	11,228
Non-controlling interest			1,284	1,284
Current liabilities				
Financial Liabilities				
Trade payables	<u>350</u>	<u>170</u>		<u>520</u>
Total liabilities and equity	<u>16,350</u>	<u>5,020</u>		<u>18,032</u>

Consolidation involves:

- Adding the balance sheet of the parent and its subsidiary together line by line.
- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased), and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary as adjusted to reflect the first year post-acquisition
- Recognising the non-controlling interest in the net assets of Entity B.

Working Notes:

(1) Cost of sales adjustment:

₹ 100 = fair value adjustment in respect of inventories at 31 March 20X2.

(2) Administrative expenses adjustment:

₹ 113 = Impairment of goodwill ₹ 98 (WN 3) + additional depreciation on building ₹ 15 (WN 4).

For simplicity it is assumed that all the goodwill impairment and the additional depreciation on buildings (on account of fair value adjustment) is adjusted against administrative expenses.

(3) Working for goodwill:

Goodwill at the acquisition date, ₹ 975, less accumulated impairment, ₹ 98 = ₹ 877.

(4) Working for building consolidation adjustment:

The fair value adjustment at 31 March 20X2 in respect of Orange County Ltd. building was ₹ 300, that is, the carrying amount at 31 March 20X2 was ₹ 300 lower than was recognized in the group's consolidated balance sheet. The building is being depreciated over 20 years from 31 March 20X2. Thus, at 31 March 20X3 the adjustment required on consolidation to the balance sheet will be ₹ 285, being ₹ 300 × 19/20 years' estimated useful life remaining. The additional depreciation recognized in the consolidated statement of comprehensive income is ₹ 15 (being ₹ 300 × 1/20).

(5) Reserves adjustment:

₹ 2,300 adjustment at the acquisition date (Question 7)

plus ₹ 98 (WN 3) impairment of goodwill

plus ₹ 15 (WN 4) additional depreciation on building

plus ₹ 100 (WN 1) fair value adjustment in respect of inventories

plus ₹ 109 NCI's share of Orange County Ltd. profit for the year (as included in the consolidated statement of comprehensive income)

= ₹ 2,622.

8. When 100% shares sold to independent party Consolidated Balance Sheet of P Pvt. Ltd. and its remaining subsidiaries as at 31st March, 20X2

Particulars	Note No.	(₹ in millions)
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	1,900
(ii) Goodwill	2	200
(2) Current Assets		
(i) Inventories	3	100

(ii) Financial Assets		
(a) Trade Receivables	4	800
(b) Cash & Cash equivalents	5	<u>5,100</u>
Total Assets		<u>8,100</u>
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	6	1,600
(ii) Other Equity	7	4,700
(2) Non-controlling Interest		
(3) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	8	<u>1,800</u>
Total Equity & Liabilities		<u>8,100</u>

Notes to accounts:

			(₹ in millions)
1.	Property Plant & Equipment		
	Land & Building	3,240	
	Less: S Pvt. Ltd.	<u>(1,340)</u>	1,900
2.	Goodwill	380	
	Less: S Pvt. Ltd.	<u>(180)</u>	200
3.	Inventories		
	Group	140	
	Less: S Pvt. Ltd.	<u>(40)</u>	100
4.	Trade Receivables		
	Group	1,700	
	Less: S Pvt. Ltd.	<u>(900)</u>	800
5.	Cash & Cash equivalents		
	Group (WN 2)	5,100	5,100
6.	Trade Payables		
	Group	2,700	
	Less: S Pvt. Ltd.	<u>900</u>	1,800

Statement of changes in Equity:**6. Equity share Capital**

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
1600	0	1600

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				4,260		4,260
Total comprehensive income for the year			0			
Dividends			0			
Total comprehensive income attributable to parent			0			
Gain on disposal of S Pvt. Ltd.				440		440
Balance at the end of reporting period			0	4,700		4,700

Working Notes:

- When sold, the carrying amount of all assets and liabilities attributable to S Pvt. Ltd. were eliminated from the consolidated balance sheet.
- Cash on hand (in millions):

Cash before disposal of S Pvt. Ltd.	3,100
Less: S Pvt. Ltd. Cash	(1,000)
Add: Cash realized from disposal	<u>3,000</u>
Cash on Hand	<u>5,100</u>

- Gain/ Loss on disposal of entity (in millions):

Proceeds from disposal	3,000
Less: Net assets of S Pvt. Ltd.	<u>(2,560)</u>
Gain on disposal	<u>440</u>

4. Retained Earnings (in millions):

Retained Earnings before disposal	4,260
Add: Gain on disposal	<u>440</u>
Retained earnings after disposal	<u>4,700</u>

10. When 90% shares sold to independent party Consolidated Balance Sheet of Reliance Ltd. and its remaining subsidiaries as at 31st March, 20X2

Particulars	Note No.	(₹ In '000)
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	950
(ii) Goodwill	2	100
(iii) Financial Assets		
(a) Investments	3	128
(2) Current Assets		
(i) Inventories	4	50
(ii) Financial Assets		
(b) Trade Receivables	5	400
(c) Cash & Cash equivalents	6	<u>2,050</u>
Total Assets		<u>3,678</u>
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	7	800
(ii) Other Equity	8	1,978
(2) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	9	<u>900</u>
Total Equity & Liabilities		<u>3,678</u>

Notes to accounts:

			(₹ In '000)
1.	Property Plant & Equipment		
	Land & Building	1620	
	Less: Reliance Jio Infocomm Ltd.	<u>(670)</u>	950

2.	Goodwill	190	
	Less: Reliance Jio Infocomm Ltd.	<u>(90)</u>	100
3.	Investments		
	Investment in Reliance Jio Infocomm Ltd. (WN 2)	<u>128</u>	128
4.	Inventories		
	Group	70	
	Less: Reliance Jio Infocomm Ltd.	<u>(20)</u>	50
5.	Trade Receivables		
	Group	850	
	Less: Reliance Jio Infocomm Ltd.	<u>(450)</u>	400
6.	Cash & Cash equivalents		
	Group (WN 3)	2,050	2,050
9.	Trade Payables		
	Group	1,350	
	Less: Reliance Jio Infocomm Ltd.	<u>450</u>	900

Statement of changes in Equity:

7. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
800	0	800

8. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				2,130		2,130
Total comprehensive income for the year			0			
Dividends			0			
Total			0			

comprehensive						
Income attributable to parent						
Loss on disposal of Reliance Jio Infocomm Ltd.				(152)		(152)
Balance at the end of reporting period			0	1,978		1,978

Working Notes:

- When 90% being sold, the carrying amount of all assets and liabilities attributable to Reliance Jio Infocomm Ltd. were eliminated from the consolidated balance sheet and further financial asset is recognized for remaining 10%.

- Carrying value of remaining investment (in '000):

Net Assets of Reliance Ltd.	1,280
Less: 90% disposal	<u>(1152)</u>
Financial Asset	<u>128</u>

- Cash on hand (in '000):

Cash before disposal of Reliance Jio Infocomm Ltd.	1,550
Less: Reliance Jio Infocomm Ltd. Cash	(500)
Add: Cash realized from disposal	<u>1,000</u>
Cash on Hand	<u>2,050</u>

- Gain/ Loss on disposal of entity (in '000):

Proceeds from disposal	1,000
Less: Proportionate (90%) Net assets of Reliance Jio Infocomm Ltd. (90% of 1,280)	<u>(1,152)</u>
Loss on disposal	<u>(152)</u>

- Retained Earnings (in '000):

Retained Earnings before disposal	2,130
Less: Loss on disposal	<u>(152)</u>
Retained earnings after disposal	<u>1,978</u>

11. Journal Entries in Airtel Infrastructures Pvt. Ltd.

1.	Assets (Building) A/c	Dr.	10,25,000	
	To Cash			10,25,000
2.	Depreciation (P/L) A/c	Dr.	25,000	
	To Asset (Building)			25,000
3.	Cash A/c	Dr.	11,00,000	
	To Asset (Building)			10,00,000
	To Gain on sale of asset (P/L)			1,00,000

Journal Entries in Airtel Telecommunications Ltd.

1.	Asset (Building) A/c	Dr.	11,00,000	
	To Cash			11,00,000
2.	Depreciation (P/L) A/c	Dr.	37,500	
	To Assets (Building)			37,500

Journal entry for consolidation:

1.	Gain on sale of asset (P/L)	Dr.	1,00,000	
	To Asset (Building) A/c			1,00,000
2.	Asset (Building) A/c	Dr.	5,000 (WN 1)	
	To Consolidated P&L			5,000

Working Note:

To be depreciated on original value	$(10,00,000 - 3,50,000)/20$	32,500
Depreciation charged	$(11,00,000 - 3,50,000)/20$	<u>37,500</u>
Reversal of depreciation		<u>5,000</u>

Particulars	Consolidated financial statements	Individual Financial statements	
		Airtel Telecommunications Ltd.	Airtel Infrastructures Pvt. Ltd.
31 st March 20X1	10,00,000	0	10,00,000
1 st April 20X1 purchase	0	11,00,000	(10,00,000)
sale			
Depreciation	<u>(32,500)</u>	<u>(37,500)</u>	0
31 st March 20X2	<u>9,67,500</u>	<u>10,62,500</u>	0

12. Paragraph 25 of Ind AS 110 states that if a parent loses control of a subsidiary, the parent:
- (a) derecognises the assets and liabilities of the former subsidiary from the consolidated balance sheet.
 - (b) recognises any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant Ind ASs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with Ind AS 109 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.
 - (c) recognises the gain or loss associated with the loss of control attributable to the former controlling interest.”

Paragraph B98(c) of Ind AS 110 states that on loss of control over a subsidiary, a parent shall reclassify to profit or loss, or transfer directly to retained earnings if required by other Ind AS, the amounts recognized in other comprehensive income in relation to the subsidiary on the basis specified in paragraph B99.

As per paragraph B99, if a parent loses control of a subsidiary, the parent shall account for all amounts previously recognized in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.

Therefore, if a gain or loss previously recognized in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. If a revaluation surplus previously recognized in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

In view of the basis in its consolidated financial statements, AB Limited shall:

- (a) re-classify the FVOCI reserve in respect of the debt investments of ₹ 5.4 crore (90% of ₹ 6 crore) attributable to the owners of the parent to the statement of profit or loss in accordance with paragraph B5.7.1A of Ind AS 109, Financial Instruments which requires that the cumulative gains or losses previously recognised in OCI shall be recycled to profit and loss upon derecognition of the related financial asset. This is reflected in the gain on disposal. Remaining 10% (i.e., ₹ 0.6 crore) relating to non-controlling interest (NCI) is included as part of the carrying amount of the non-controlling interest that is derecognised in calculating the gain or loss on loss of control of the subsidiary;
- (b) transfer the reserve relating to the net measurement losses on the defined benefit liability of ₹ 2.7 crore (90% of ₹ 3 crore) attributable to the owners of the parent within

- equity to retained earnings. It is not reclassified to profit or loss. The remaining 10% (i.e., ₹ 0.3 crore) attributable to the NCI is included as part of the carrying amount of NCI that is derecognised in calculating the gain or loss on loss of control over the subsidiary. No amount is reclassified to profit or loss, nor is it transferred within equity, in respect of the 10% attributable to the non-controlling interest.
- (c) reclassify the cumulative gain on fair valuation of equity investment of ₹ 3.6 crore (90% of ₹ 4 crore) attributable to the owners of the parent from OCI to retained earnings under equity as per paragraph B5.7.1 of Ind AS 109, Financial Instruments, which provides that in case an entity has made an irrevocable election to recognise the changes in the fair value of an investment in an equity instrument not held for trading in OCI, it may subsequently transfer the cumulative amount of gains or loss within equity. Remaining 10% (i.e., ₹ 0.4 crore) related to the NCI are derecognised along with the balance of NCI and not reclassified to profit and loss.
- (d) reclassify the foreign currency translation reserve of ₹ 7.2 crore (90% × ₹ 8 crore) attributable to the owners of the parent to statement of profit or loss as per paragraph 48 of Ind AS 21, The Effects of Changes in Foreign Exchange Rates, which specifies that the cumulative amount of exchange differences relating to the foreign operation, recognised in OCI, shall be reclassified from equity to profit or loss on the disposal of foreign operation. This is reflected in the gain on disposal. Remaining 10% (i.e., ₹ 0.8 crore) relating to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss on the loss of control of subsidiary, but is not reclassified to profit or loss in pursuance of paragraph 48B of Ind AS 21, which provides that the cumulative exchange differences relating to that foreign operation attributed to NCI shall be derecognised on disposal of the foreign operation, but shall not be reclassified to profit or loss.

The impact of loss of control over BC Limited on the consolidated financial statements of AB Limited is summarized below:

(₹ in crore)

Particular	Amount (Dr)	Amount (Cr)	PL Impact	RE Impact
Gain/Loss on Disposal on Investments				
Bank Dr.	56			
Non-controlling interest (Derecognised) Dr.	6			
Investment at FV (20% Retained) Dr.	16			
To Gain on Disposal (PL) - balancing figure		18	18	
To De-recognition of total net assets of subsidiary		60		

Reclassification of FVTOCI reserve on debt instruments to profit or loss				
FVTOCI reserve on debt instruments Dr. (6 cr. x 90%)	5.4			
To Profit and loss		5.4	5.4	
Reclassification of net measurement loss reserve to profit or loss				
Retained Earnings Dr.	2.7			-2.7
To Net measurement loss reserve (FVTOCI) [(3 cr. x 90%)]		2.7		
Reclassification of FVTOCI reserve on equity instruments to retained earnings				
FVTOCI reserve on equity instruments Dr. (4 cr.x 90%)	3.6			
To Retained earnings		3.6		3.6
Foreign currency translation reserve reclassified to profit or loss				
Foreign currency translation reserve (FVOCI) [8 cr. x 90%] Dr.	7.2			
To Profit and loss		7.2	7.2	
Total			30.6	0.9

13. Calculation of Investor Ltd.'s investment in XYZ Ltd. under equity method:

	₹	₹
Acquisition of investment in XYZ Ltd.		
Share in book value of XYZ Ltd.'s net assets (35% of ₹ 90,00,000)	31,50,000	
Share in fair valuation of XYZ Ltd.'s net assets [35% of (₹ 1,10,00,000 – ₹ 90,00,000)]	7,00,000	
Goodwill on investment in XYZ Ltd. (balancing figure)	<u>9,00,000</u>	
Cost of investment		47,50,000
Profit during the year		
Share in the profit reported by XYZ Ltd. (35% of ₹ 8,00,000)	2,80,000	

Adjustment to reflect effect of fair valuation [35% of (₹ 20,00,000/10 years)]	(70,000)	
Share of profit in XYZ Ltd. recognised in income by Investor Ltd.		2,10,000
Long term equity investment		
FVTOCI gain recognised in OCI (35% of ₹ 2,00,000)		70,000
Dividend received by Investor Ltd. during the year [35% of ₹ 12,00,000]		(4,20,000)
Closing balance of Investor Ltd.'s investment in XYZ Ltd.		46,10,000

14. As provided in Ind- AS 111 - Joint Arrangements - this is a joint arrangement because two or more parties have joint control of the property under a contractual arrangement. The arrangement will be regarded as a joint operation because Alpha Ltd. and Gama Ltd. have rights to the assets and obligations for the liabilities of this joint arrangement. This means that the company and the other investor will each recognise 50% of the cost of constructing the asset in property, plant and equipment.

The borrowing cost incurred on constructing the property should under the principles of Ind AS 23 'Borrowing Costs', be included as part of the cost of the asset for the period of construction.

In this case, the relevant borrowing cost to be included is ₹ 50,00,000 (₹ 10,00,00,000 x 10% x 6/12).

The total cost of the asset is ₹ 40,50,00,000 (₹ 40,00,00,000 + ₹ 50,00,000) ₹ 20,25,00,000 crores is included in the property, plant and equipment of Alpha Ltd. and the same amount in the property, plant and equipment of Gama Ltd.

The depreciation charge for the year ended 31 March 20X2 will therefore be ₹ 1,01,25,000 (₹ 40,50,00,000 x 1/20 x 6/12) ₹ 50,62,500 will be charged in the statement of profit or loss of the company and the same amount in the statement of profit or loss of Gama Ltd.

The other costs relating to the arrangement in the current year totalling ₹ 54,00,000 (finance cost for the second half year of ₹ 50,00,000 plus maintenance costs of ₹ 4,00,000) will be charged to the statement of profit or loss of Alpha Ltd. and Gama Ltd. in equal proportions- ₹ 27,00,000 each.

15. As per paragraph 4(a) of Ind AS 110, an entity that is a parent shall present consolidated financial statements. This Ind AS applies to all entities, except as follows:

A parent need not present consolidated financial statements if it meets all the following conditions:

- (i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
- (ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
- (iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- (iv) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind ASs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this Ind AS.

In accordance with the above, it may be noted that as per paragraph 4(a)(i) above, a parent need not present consolidated financial statements if it is a:

- wholly-owned subsidiary; or
- is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.

Although GD Limited is a partly-owned subsidiary of G Limited, it is the wholly-owned subsidiary of Gamma Limited (and therefore satisfies the condition 4(a)(i) of Ind AS 110 without regard to the relationship with its immediate owners, i.e. G Limited and D Limited). Thus, GD Limited being the wholly owned subsidiary fulfils the conditions as mentioned under paragraph 4(a)(i) and is not required to inform its other owner D Limited of its intention not to prepare the consolidated financial statements.

Thus, in accordance with the above, GD Limited may take the exemption given under paragraph 4(a) of Ind AS 110 from presentation of consolidated financial statements.

In Alternative Scenario, where both G Limited and D Limited are owned by an individual Mr. X, then GD Limited is ultimately wholly in control of Mr. X (i.e., an individual) and hence it cannot be considered as a wholly owned subsidiary of an entity.

This is because Ind AS 110 makes use of the term 'entity' and the word 'entity' includes a company as well as any other form of entity. Since, Mr. X is an 'individual' and not an 'entity', therefore, GD Limited cannot be considered as wholly owned subsidiary of an entity.

Therefore, in the given case, GD Limited is a partially-owned subsidiary of another entity. Accordingly, in order to avail the exemption under paragraph 4(a), its other owner, D Limited should be informed about and do not object to GD Limited not presenting consolidated financial statements. Further, for the purpose of consolidation of G Limited and D Limited, GD Limited will be required to provide relevant financial information as per Ind AS.

[illegible]

INDIAN ACCOUNTING STANDARD 101: FIRST-TIME ADOPTION OF IND AS

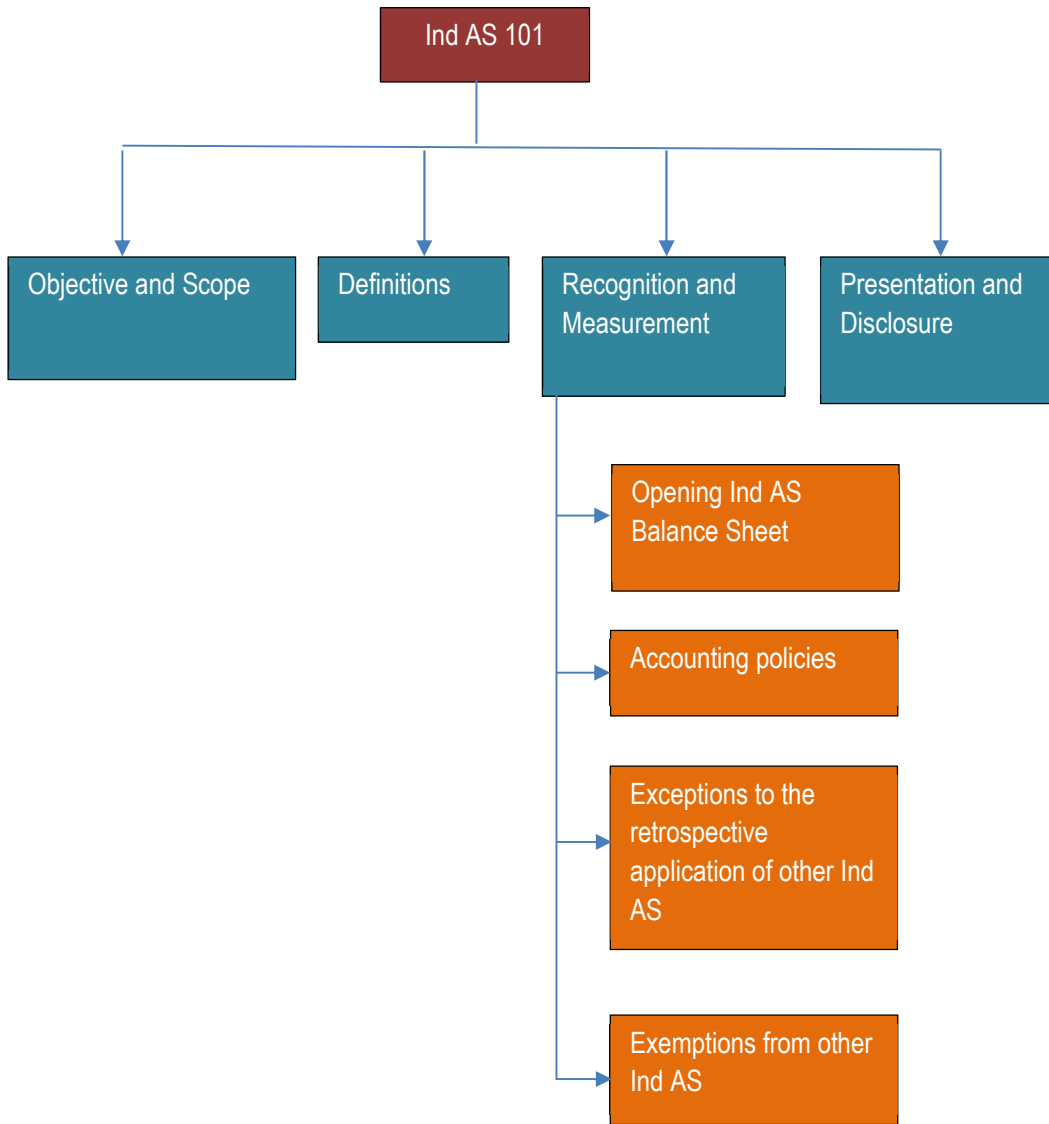


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the objective for issuing this standard
- ❑ Appreciate the applicability and non-applicability of this standard
- ❑ Define the relevant terms like 'First Ind AS Financial Statements', 'First-time adopter', 'Opening Ind AS Balance sheet', 'Date of Transition to Ind AS', 'First Ind AS reporting period', 'Deemed cost' and 'Previous GAAP'
- ❑ Apply the recognition and measurement principles in the preparation of opening Ind AS Balance Sheets
- ❑ Evaluate the mandatory exceptions in which Ind AS prohibits retrospective application of Ind AS
- ❑ Examine when Ind AS 101 grants voluntary exemptions from some specific requirements of other Ind AS
- ❑ Know the carve outs in Ind AS 101 from IFRS 1

CHAPTER OVERVIEW





1. INTRODUCTION

Ind AS 101 prescribes the accounting principles for first - time adoption of Ind AS. It lays down various 'transition' requirements when a company adopts Ind AS for the first time, i.e., a move from Accounting Standards (Indian GAAP) to Ind AS.

Conceptually, the accounting under Ind AS should be applied retrospectively at the time of transition to Ind AS. However, Ind AS 101 grants limited **exemptions** from these requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. Ind AS 101 also prohibits retrospective application of Ind AS in some areas (called **exceptions**), particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known.

Ind AS 101 also prescribes presentation and disclosure requirements to explain the transition to the users of financial statements including explaining how the transition from Indian GAAP to Ind AS affected the company's financial position, financial performance and cash flows.

Ind AS 101 does not provide any exemption from the disclosure requirements in other Ind AS.



2. OBJECTIVE

The objective of this Ind AS is to ensure that an entity's first Ind-AS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that:

- is transparent for users and comparable;
- provides a suitable starting point; and
- at a cost that does not exceed the benefits.



3. DEFINITIONS

1. First Ind AS Financial Statements

- The first annual financial statements in which an entity adopts Ind AS, by an explicit and unreserved statement of compliance with Ind AS.
- This means compliance with ALL Ind-AS, partial compliance is not enough to make entity Ind AS compliant.

2. First –time adopter

An entity that presents its first Ind AS financial statements, that entity is known as first time adopter

3. Opening Ind AS Balance sheet

An entity's balance sheet at the date of transition to Ind AS

4. Date of Transition to Ind AS

The beginning of the earliest period for which an entity presents full comparative information under Ind ASs in first Ind AS Financial statements.

Illustration 1

X Ltd. is required to adopt Ind AS from April 1, 20X1, with comparatives for one year, i.e., for 20X0-20X1.

What will be its date of transition?

Solution

The date of transition for X Ltd. will be April 1, 20X0 being the beginning of the earliest comparative period presented. To explain it further, X Ltd. is required to adopt an Ind AS from April 1, 20X1 (i.e. year 20X1-20X2), and it will give comparatives as per Ind AS for 20X0-20X1. Accordingly, the beginning of the comparative period will be April 1, 20X0 which will be considered as date of transition.

5. First Ind AS reporting period

- The latest reporting period covered by an entity's first Ind AS financial statements

Example 1

XYZ Ltd. is a BSE listed company having net worth of ₹ 100 cr. XYZ Ltd. has to prepare financial statements as per Ind AS from 1st April 20X1.

The first Ind AS Financial Statements would be for period ending as on 31.3.20X2

First-time adopter - "XYZ Ltd" with effect from 1.4.20X1

Opening Ind AS Balance sheet – 1.4.20X0

Date of Transition to Ind AS – 1.4.20X0

First Ind AS reporting period – 1.4.20X1 to 31.3.20X2

The financial statements for the period 1.4.20X0 to 31.3.20X1 shall be the comparative period for the first Ind AS reporting period.

6. Deemed cost

An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost. This definition will be used in measurement, at the date of transition to Ind AS, of

- (i) investments in subsidiaries, joint ventures and associates
- (ii) property, plant and equipment, an investment property, an intangible asset or a right-of-use asset
- (iii) assets acquired and liabilities assumed in a business combination when the exemption under Ind AS 101 is availed.

7. Previous GAAP

The basis of accounting that a first-time adopter used for its statutory reporting requirements in India immediately before adopting Ind AS. For instance, companies required to prepare their financial statements in accordance with Section 133 of the Companies Act, 2013, shall consider those financial statements as previous GAAP financial statements. Those previous GAAP financial statements were prepared as per the Companies (Accounting Standards) Rules, 2006 and hence such accounting standards are the “Previous GAAP” for those companies in India.

Illustration 2

Company B is a foreign subsidiary of Company A and has adopted IFRS as issued by IASB as its primary GAAP for its local financial reporting purposes. Company B prepares its financial statements as per Accounting Standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 for the purpose of consolidation with Company A.

On transition of Company A to Ind-AS, what would be the previous GAAP of the foreign subsidiary Company B for its financial statements prepared for consolidation with Company A?

Solution

Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its statutory reporting requirements in India (**emphasis added**) immediately before adopting Ind AS. For instance, companies preparing their financial statements in accordance with the Accounting Standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 shall consider those financial statements as previous GAAP financial statements.

Accordingly, the previous GAAP of the foreign subsidiary for the purpose of consolidation under Ind-AS with the parent company would be accounting standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 and not the IFRS as issued by the IASB since the first time adoption has to be considered in the context of India only.



4. SCOPE

Ind AS 101 applies to:

- First Ind AS financial statements
- Each interim financial report for part of the period covered by its first Ind AS financial statements. For example, if the period covered by the first Ind AS financial statements is year ended 31 March 20X2 and the company prepares quarterly financial results (i.e. interim financial report) for each quarter of that year, Ind AS 101 shall be applied in preparation of those financial results.

However, it does not apply to:

- Changes in accounting policies made by an entity that already applied Ind AS.

Illustration 3

E Ltd. is required to first time adopt Indian Accounting Standards (Ind AS) from 1 April 20X1. The management of E Ltd. has prepared its financial statements in accordance with Ind AS and an explicit and unreserved statement of compliance with Ind AS has been given by the management. However, there is a disagreement on application of one Ind AS between the management and the auditor.

Can such financial statements of E Ltd. be treated as first Ind AS financial statements?

Solution

Ind AS 101 defines first Ind AS financial statements as “The first annual financial statements in which an entity adopts Indian Accounting Standards (Ind AS), by an explicit and unreserved statement of compliance with Ind AS.” In accordance with the above definition, if an explicit and unreserved statement of compliance with Ind AS has been given in the financial statements, even if the auditor’s report contains a qualification because of disagreement on application of Indian Accounting Standard(s), it would be considered that E Ltd. has done the first time adoption of Ind AS. In such a case, exemptions given under Ind AS 101 cannot be availed again. If, however, the unreserved statement of compliance with Ind AS is not given in the

financial statements, such financial statements would not be considered to be first Ind AS financial statements.



5. RECOGNITION AND MEASUREMENT

5.1 Opening Ind AS Balance Sheet

An entity shall prepare and present an opening Ind AS balance sheet at the date of transition to Ind AS. This is the starting point for its accounting in accordance with Ind AS.

5.2 Accounting policies

Entity uses the same accounting policies in its opening Ind AS Balance Sheet and through all periods presented in its first Ind AS financial statements. Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, subject to:

- Mandatory exceptions and
- Optional exemptions

Example 2: Consistent application of latest version of Ind AS

The end of entity A's first Ind AS reporting period is 31 March 20X2. Entity A decides to present comparative information in those financial statements for one year only. Therefore, its date of transition to Ind AS is the beginning of business on 1 April 20X0 (or, equivalently, close of business on 31 March 20X0).

Entity A presented financial statements in accordance with its previous GAAP annually to 31 March each year up to, and including, 31 March 20X1.

Application of requirements:

Entity A is required to apply the Ind AS effective for periods ending on 31 March 20X2 in:

- a) preparing and presenting its opening Ind AS balance sheet at 1 April 20X0; and
- b) preparing and presenting its balance sheet for 31 March 20X2 (including comparative amounts for the year ended 31 March 20X1), statement of profit and loss, statement of changes in equity and statement of cash flows for the year to 31 March 20X2 (including comparative amounts for the year ended 31 March 20X1) and disclosures (including comparative information for the year ended 31 March 20X1).

If a new Ind AS is not yet mandatory but permits early application, entity A is permitted, but not required, to apply that Ind AS in its first Ind AS financial statements.

The general principle of Ind AS 101

It may be noted that the way Ind AS 101 is structured, it first lays down the general principle that all Ind AS, as effective for the first Ind AS reporting period, should be applied retrospectively i.e. at the starting point, which is the opening Ind AS balance sheet, should carry the balances as if Ind AS has always been applied by the company in the past.

Once the general principle has been specified, Ind AS 101 then talks about certain (a) exemptions and (b) exceptions, the former being voluntary and the latter being mandatory, as mentioned above.

So let's talk of the general principle first - an entity shall, in its opening Ind AS Balance sheet:

- Recognise all assets and liabilities whose recognition is required by Ind AS. For example, recognition of derivative assets and liabilities for which a different guidance was followed under Indian GAAP or intangible assets arising in a business combination, which were not carried in the books of the acquiree entity under Indian GAAP;
- Not recognise items as assets or liabilities if Ind AS do not permit such recognition. For example, Ind AS 115, Revenue from Contracts with Customers, has different thresholds for revenue recognition as compared to AS 9 under Indian GAAP and hence an item that is recognized as a trade receivable in Indian GAAP, may not be so recognized under Ind AS;
- Reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS. For example, Ind AS requires classification of assets given on operating lease as investment property whereas the same are presented as property, plant and equipment under Indian GAAP; and
- Apply Ind AS in measuring all recognised assets and liabilities. For example, Ind AS has well-defined measurement principles for financial assets and liabilities, like certain investments are measured at fair value under Ind AS, whereas the same are measured at lower of cost and fair value under Indian GAAP.



6. EXCEPTIONS/ EXEMPTIONS

There are two categories of provisions in Ind AS 101 under which the general principle mentioned above is applied in a modified manner:

1. Mandatory exceptions to the retrospective application of other Ind AS
2. Optional exemptions from retrospective application of other Ind AS

6.1 Mandatory exceptions to the retrospective application of other Ind AS

1. Estimates

An entity's estimates in accordance with Ind AS at the date of transition to Ind AS shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

Step 1 Estimates required by previous GAAP? If yes, then go to Step 2 otherwise Step 3.

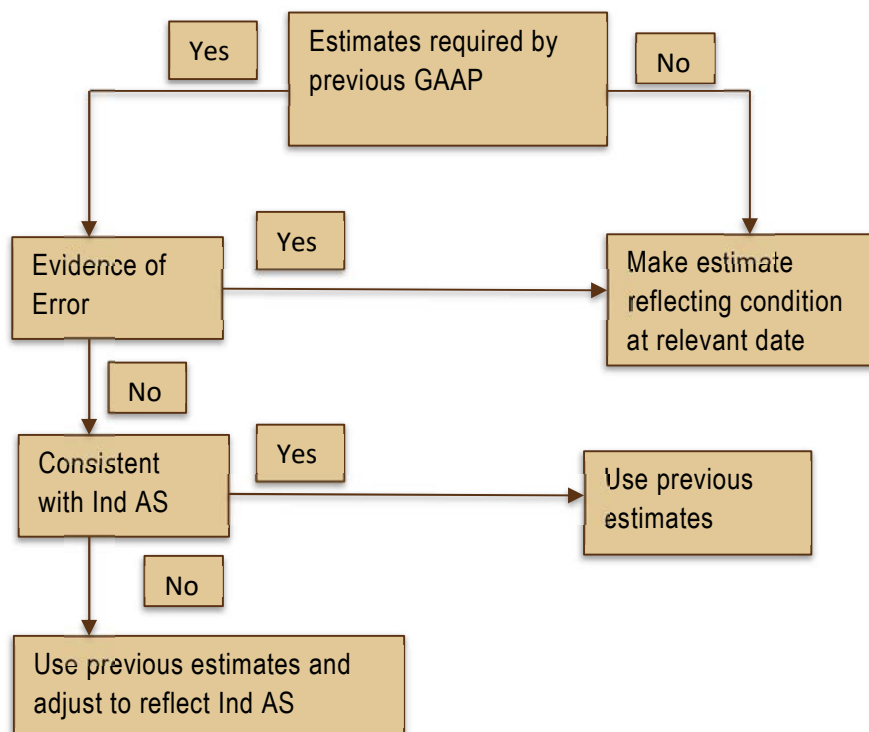
Step 2 Evidence of Error? If yes then go to Step 3 otherwise Step 4.

Step 3 Make estimate reflecting condition at relevant date i.e. the date to which the estimate relates.

Step 4 Consistent with Ind AS? If yes then go to step 5 otherwise Step 6

Step 5 Use previous estimates

Step 6 Use previous estimates and adjust to reflect Ind AS.



2. Derecognition of financial assets and liabilities

A first-time adopter shall apply the derecognition requirements in Ind AS 109 **prospectively** for transactions occurring on or after the date of transition to Ind AS.

Example 3

If a first time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to Ind AS, it shall not recognise those assets and liabilities in accordance with Ind AS (unless they qualify for recognition as a result of a later transaction or event). A practical example of such financial assets could be securitization of a loan portfolio by a NBFC to a Trust before the date of transition resulting in derecognition of the same from books under Indian GAAP, whereas under Ind AS, the derecognition criteria may not have been met.

An entity may apply the derecognition requirements in Ind AS 109 **retrospectively** from a date of the entity's choosing, provided that the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

3. Hedge accounting

At the date of transition to Ind AS an entity shall:

- (a) measure all derivatives at fair value; and
- (b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

An entity shall not reflect in its opening Ind AS Balance Sheet a hedging relationship of a type that does not qualify for hedge accounting in accordance with Ind AS 109 (for example, many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk). In other words, if the hedge relationship:

- (A) is of a type that qualifies for hedge accounting (i.e. hedge relationship consists of eligible hedging instruments and eligible hedged items as per Ind AS 109), and
- (B) is designated under Indian GAAP

then:

- (1) the hedge relationship is required to be reflected in the opening Ind AS Balance Sheet, irrespective of whether other conditions for applying hedge accounting (i.e. documentation and effectiveness) are met; and
- (2) if those conditions are not met, requirements of Ind AS 109 with respect to discontinuance of hedge accounting are applied subsequently.

As a corollary to this principle, if either of (A) or (B) above are not met, barring a specific exception (dealt with in subsequent paragraph), the hedge relationship is required to be removed from the opening Ind AS Balance Sheet.

If an entity designated a net position as a hedged item in accordance with previous GAAP, which is not a qualifying hedged item otherwise under Ind AS 109, it may designate as a hedged item in accordance with Ind AS an individual item within that net position, or a net position if that meets the requirements in Ind AS 109, provided that it does so no later than the date of transition to Ind AS.

Hedge accounting is followed only from the date the qualifying criteria are met, irrespective of the conditions stated at (A) and (B) above. Transactions entered into before the date of transition to Ind AS shall not be retrospectively designated as hedges.

4. Non-controlling interests

A first-time adopter shall apply the following requirements of Ind AS 110 prospectively from the date of transition to Ind AS:

- a) Total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;
- b) Accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and
- c) Accounting for a loss of control over a subsidiary, and the related requirements of Ind AS 105, Non-current Assets Held for Sale and Discontinued operations i.e. classification of all the assets and liabilities of that subsidiary as held for sale.

However, if a first-time adopter elects to apply Ind AS 103 retrospectively to past business combinations, it shall also apply Ind AS 110 from that date.

Illustration 4

Ind AS requires allocation of losses to the non-controlling interest, which may ultimately lead to a debit balance in non-controlling interests, even if there is no contract with the non-controlling interest holders to contribute assets to the Company to fund the losses.

Whether this adjustment is required or permitted to be made retrospectively?

Solution

In case an entity elects not to restate past business combinations, Ind AS 101 requires the measurement of non-controlling interests (NCI) to follow from the measurement of other assets and liabilities on transition to Ind AS. However, Ind AS 101 contains a mandatory exception that prohibits retrospective allocation of accumulated profits between the owners of the parent and the NCI. In case an entity elects not to restate past business

combinations, the previous GAAP carrying value of NCI is not changed other than for adjustments made (remeasurement of the assets and liabilities subsequent to the business combination) as part of the transition to Ind AS. As such, the carrying value of NCI in the opening Ind AS balance sheet cannot have a deficit balance on account of recognition of the losses attributable to the non-controlling interest, which was not recognised under the previous GAAP as part of NCI in the absence of contract to contribute assets to fund such a deficit.

However, the NCI could have a deficit balance due to remeasurement of the assets and liabilities subsequent to the business combination as part of the transition to Ind AS.

In case an entity restates past business combination, Ind AS 101 requires that the balance in NCI as at the date of transition shall be determined retrospectively in accordance with Ind AS, taking into account the impact of other elections made as part of the adoption of Ind AS.

As such, the NCI could have a deficit balance on account of losses attributable to the NCI, even if there is no obligation on the holders of NCI to contribute assets to fund such a deficit.

5. Classification and measurement of financial instruments

Ind AS 109 contains principles for classification of a financial asset as at (a) amortised cost or (b) fair value through other comprehensive income or (c) fair value through profit or loss. Such classification depends on assessment of features of the financial asset on the date of its initial recognition.

Ind AS 101 provides an exception to this general principle by requiring that such assessment should be done on the date of transition to Ind AS.

Ind AS 101 further provides that if it is impracticable to assess the below mentioned features of a financial asset as at the date of transition to Ind AS, the “contractual cash flow characteristics test” shall be done without taking into account those features:

- ◆ Modified time value of money element
- ◆ Significance of the fair value of a prepayment feature

An entity shall disclose the carrying amount of such financial assets until those financial assets are derecognized.

Ind AS 109 requires the measurement of amortised cost of a financial asset or a financial liability using effective interest method. As an exception to this general measurement principle, Ind AS 101 provides that if it is impracticable (as defined in Ind AS 8) for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind AS shall be the new

gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to Ind AS.

6. Impairment of financial assets

An entity shall apply the impairment requirements of Ind AS 109 retrospectively subject to the below:

- ◆ At the date of transition to Ind AS, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that financial instruments were initially recognised.
- ◆ An entity is not required to undertake an exhaustive search for information when determining, at the date of transition to Ind AS, whether there have been significant increases in credit risk since initial recognition.
- ◆ If, at the date of transition to Ind ASs, determining whether there has been a significant increase in credit risk since the initial recognition of a financial instrument would require undue cost or effort, an entity shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised, unless that financial instrument is low credit risk at a reporting date.

7. Embedded derivatives

A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of (a) the date it first became a party to the contract and (b) the date a reassessment is required by Ind AS 109 i.e. when there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

8. Government loans

A first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with Ind AS 32, Financial Instruments: Presentation.

A first-time adopter shall apply the requirements in Ind AS 109, Financial Instruments, and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, **prospectively** to government loans existing at the date of transition to Ind AS and **shall not recognise the corresponding benefit** of the government loan at a below-market rate of interest **as a government grant**.

Example 4

Government of India provides loans to MSMEs at a below-market rate of interest to fund the set-up of a new manufacturing facility.

Company A's date of transition to Ind AS is 1 April 20X5.

In 20X2, Company A had received a loan of ₹ 1 crore at a below-market rate of interest from the government. Under Indian GAAP, Company A accounted for the loan as equity and the carrying amount was ₹ 1 crore at the date of transition. The amount repayable at 31 March 20X9 will be ₹ 1.25 crore.

The loan meets the definition of a financial liability in accordance with Ind AS 32. Company A therefore reclassifies it from equity to liability. It also uses the previous GAAP carrying amount of the loan at the date of transition as the carrying amount of the loan in the opening Ind AS balance sheet. It calculates the annual effective interest rate (EIR) starting 1 April 20X5 as below:

$EIR = \text{Amount} / \text{Principal}^{(1/t)}$ i.e. $1.25/1^{(1/4)}$ i.e. 5.74% approx.

At this rate, ₹ 1 crore will accrete to ₹ 1.25 crore as at 31 March 20X9.

During the next 4 years, the interest expense charged to statement of profit and loss shall be:

Year ended	Opening amortised cost (₹)	Interest expense for the year (₹) @ 5.74% p.a. approx.	Closing amortised cost (₹)
31 March 20X6	1,00,00,000	5,73,713	1,05,73,713
31 March 20X7	1,05,73,713	6,06,627	1,11,80,340
31 March 20X8	1,11,80,340	6,41,430	1,18,21,770
31 March 20X9	1,18,21,770	6,78,230	1,25,00,000

Calculations have been done on full scale calculator. However, in case calculations are done taking EIR as exact 5.74%, then there will be difference of a few ₹ due to rounding off.

An entity may apply the requirements in Ind AS 109 and Ind AS 20 retrospectively to any government loan originated before the date of transition to Ind AS, provided that the information needed to do so had been obtained at the time of initially accounting for that loan.

6.2 Optional exemptions from retrospective application of other Ind AS

1. Business combination

Ind AS 103 need not be applied to business combinations before date of transition. But, if one business combination is restated to comply with Ind AS 103, all subsequent business combinations are restated.

When the exemption is used:

- ◆ There won't be any change in classification from previous GAAP.

For **example**, if the "pooling of interests" method is applied as per AS 14, the balances of assets and liabilities arising therefrom shall be carried forward.

Another **example** is regarding the identification of the acquirer – irrespective of the fact that a business combination could have been a reverse acquisition as per Ind AS 103, the accounting adopted in previous GAAP shall be continued.

❖ Recognition exemptions:

The table below summarises the provisions of paragraph C4(b) and (c) of Ind AS 101:

Case	Asset / liability recognised in previous GAAP	Asset / liability qualifies for recognition in Ind AS	Is the change an intangible asset?	Result: whether asset or liability recognised in opening Ind AS Balance Sheet?	How is the resulting change accounted for?
1	No	No	Not Applicable		
2	No	Yes	No	Yes*	Retained Earnings
3	No	Yes	Yes	Yes	Goodwill
4	Yes	No	Yes	No	Goodwill**
5	Yes	No	No	No	Retained Earnings

* Unless a financial asset or financial liability was derecognised in previous GAAP (refer mandatory exception below)

** Including any resulting changes to deferred tax and non-controlling interests

❖ Measurement exemptions:

- If an asset acquired or liability assumed was not recognized in previous GAAP but would have been recognised in Ind AS, it shall not have a deemed cost of zero and shall be measured at the amount at which Ind AS would require it to be measured. The resulting change is recognised in retained earnings.
- If an asset acquired or liability assumed was recognized in previous GAAP but Ind AS would require its subsequent measurement at other than original cost (for example, investments in certain equity instruments as per Ind AS 109), it shall be measured at such basis and not its original cost. The resulting change is recognised in retained earnings. Refer Example 5 below.

In all other cases, no measurement adjustment shall be made to the carrying amounts of the assets acquired and liabilities assumed.

- Therefore, it should be evident that the balance of goodwill or capital reserve as per previous GAAP is not adjusted for any reason other than:
 - Recognition of an intangible asset that was earlier subsumed in goodwill or capital reserve but Ind AS requires it to be recognised separately; or
 - Vice versa, an asset that was recognised as an intangible asset under previous GAAP but is not permitted to be recognised as an asset under Ind AS.
- ◆ Regardless of whether there is any indication that the goodwill may be impaired, the goodwill has to be tested for impairment at the date of transition to Ind AS and any resulting impairment loss is to be recognised in retained earnings (or, if so required by Ind AS 36, in revaluation surplus). The impairment test is based on conditions at the date of transition to Ind AS.

Example 5

If the acquirer had not, in accordance with its previous GAAP, capitalised leases acquired in a past business combination in which acquiree was a lessee, it shall capitalise those leases in its consolidated financial statements, as Ind AS 116, would require the acquiree to do in its Ind AS Balance Sheet.

Similarly, if the acquirer had not, in accordance with its previous GAAP, recognised a contingent liability that still exists at the date of transition to Ind AS, the acquirer shall recognise that contingent liability at that date unless Ind AS 37 would prohibit its recognition in the financial statements of the acquiree.

As discussed in the chapter on consolidation, Ind AS 110 requires an entity to be consolidated based on assessment of “control”. This assessment may sometimes result in consolidation of entities which were not consolidated in the previous GAAP financial statements.

Let's understand the implications of this in the context of first Ind AS financial statements through an illustration.

Illustration 5

A Ltd. had made certain investments in B Ltd.'s convertible debt instruments. The conversion rights are substantive rights and would provide A Ltd. with a control over B Ltd. A Ltd. has evaluated that B Ltd. would be treated as its subsidiary under Ind AS and, hence, would require consolidation in its Ind AS consolidated financial statements. B Ltd. was not considered as a subsidiary, associate or a joint venture under previous GAAP.

How should B Ltd. be consolidated on transition to Ind AS assuming that A Ltd. has opted to avail the exemption from retrospective restatement of past business combinations?

Solution

Ind AS 101 prescribes an optional exemption from retrospective restatement in relation to past business combinations. Ind AS 101 prescribes that when the past business combinations are not restated and a parent entity had not consolidated an entity as a subsidiary in accordance with its previous GAAP (either because it was not regarded as a subsidiary or no consolidated financial statements were required under previous GAAP), then the subsidiary's assets and liabilities would be included in the parent's opening consolidated financial statements at such values as would appear in the subsidiary's separate financial statements if the subsidiary were to adopt the Ind AS as at the parent's date of transition. For this purpose, the subsidiary's separate financial statements would be prepared as if it was a first-time adopter of Ind AS i.e. after applying the relevant first-time adoption mandatory exceptions and voluntary exemptions. In other words, the parent will adjust the carrying amount of the subsidiary's assets and liabilities to the amounts that Ind AS would require in the subsidiary's balance sheet.

The deemed cost of goodwill equals the difference at the date of transition between:

- (a) the parent's interest in those adjusted carrying amounts; and
- (b) the cost in the parent's separate financial statements of its investment in the subsidiary.

The measurement of non-controlling interest and deferred tax follows from the measurement of other assets and liabilities.

It may be noted here that the above exemption is available only under those circumstances where the parent, in accordance with the previous GAAP, has not presented consolidated financial statements for the previous year; or where the consolidated financial statements were prepared in accordance with the previous GAAP but the entity was not treated as a subsidiary, associate or joint venture under the previous GAAP.

Illustration 6

A Ltd. has a subsidiary B Ltd. On first time adoption of Ind AS by B Ltd., it availed the optional exemption of not restating its past business combinations. However, A Ltd. in its consolidated financial statements has decided to restate all its past business combinations.

Whether the amounts recorded by subsidiary need to be adjusted while preparing the consolidated financial statements of A Ltd. considering that A Ltd. does not avail the business combination exemption? Will the answer be different if A Ltd. adopts Ind AS after B Ltd?

Solution

As per Ind AS 101: "A first-time adopter may elect not to apply Ind AS 103 retrospectively to past business combinations (business combinations that occurred before the date of transition to Ind AS). However, if a first-time adopter restates any business combination to comply with Ind AS 103, it shall restate all later business combinations and shall also apply Ind AS 110 from that same date.

For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X0, it shall restate all business combinations that occurred between 30 June 20X0 and the date of transition to Ind AS, and it shall also apply Ind AS 110 from 30 June 20X0." Based on the above, if A Ltd. restates past business combinations, it would have to be applied to all business combinations of the group including those by subsidiary B Ltd. for the purpose of Consolidated Financial Statements. Ind AS 101 states, "However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary." Thus, in case where the parent adopts Ind AS later than the subsidiary (for example, if the parent is a non-banking financial company and the subsidiary is a trading or manufacturing company) then it does not change the amounts already recognised by the subsidiary.

2. Insurance contracts

Ind AS 104 will apply for annual periods beginning on or after date of transition to Ind AS.

If an insurer changes its accounting policies for insurance liabilities, it is permitted to reclassify some or all of its financial assets as FVTPL (fair value through profit or loss).

3. Share based payment transactions

A first-time adopter is encouraged, but not required, to apply Ind AS 102, Share-based Payment, to equity instruments that vested before date of transition to Ind AS.

However, a first-time adopter may apply Ind AS 102 to equity instruments, if it has disclosed publicly the fair value of those equity instruments, determined at the measurement date.

It is encouraged to apply Ind AS 102 to liabilities arising from share-based payment transactions that were settled before the date of transition to Ind AS.

Illustration 7

X Ltd. is a first-time adopter of Ind AS. The date of transition is April 1, 20X1. It has given 200 stock options to its employees. Out of these, 75 options have vested on November 30, 20X0 and the remaining 125 will vest on November 30, 20X1.

What are the options available to X Ltd. at the date of transition?

Solution

Ind AS 101 provides that a first-time adopter is encouraged, but not required, to apply Ind AS 102 on 'Share-based Payment' to equity instruments that vested before the date of transition to Ind AS. However, if a first-time adopter elects to apply Ind AS 102 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.

Having regard to the above, X Ltd. has the following options:

- For 75 options that vested before the date of transition:
 - (a) To apply Ind AS 102 and account for the same accordingly, provided it has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.
 - (b) Not to apply Ind AS 102.

However, for all grants of equity instruments to which Ind AS 102 has not been applied, i.e., equity instruments vested but not settled before date of transition to Ind AS, X Ltd. would still need to disclose the information.
- For 125 options that will vest after the date of transition: X Ltd. will need to account for the same as per Ind AS 102.

4. Deemed cost for PPE, intangible assets and right of use assets

An entity has the following options with respect to measurement of its property, plant and equipment (Ind AS 16), intangible assets (Ind AS 38) and right of use assets (Ind AS 116) in the opening Ind AS balance sheet:

- ◆ Measurement basis as per the respective standards applied retrospectively. This measurement option can be applied on an item-by-item basis. For example, Plant A can be measured applying Ind AS 16 retrospectively and Plant B can be measured applying the "fair value" or "revaluation" options mentioned below.
- ◆ Fair value at the date of transition to Ind AS. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.

- ◆ Previous GAAP revaluation, if such revaluation was, at the date of revaluation, broadly comparable to (a) fair value or (b) cost or depreciated cost in accordance with other Ind AS adjusted to reflect changes in general or specific price index. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.
- ◆ Previous GAAP carrying amounts (provided there is no change in functional currency). This measurement option can be applied only if applied to “all” of the assets classes and items therein. In addition, this measurement option can be applied to investment property (Ind AS 40) as well.

For Investment Property

Ind AS 40, Investment Property permits only the cost model. Therefore, option of availing fair value as deemed cost for investment property is not available for first time adopters of Ind AS for its financial statements.

Illustration 8

X Ltd. is the holding company of Y Ltd. X Ltd. is required to adopt Ind AS from April 1, 20X1. X Ltd. wants to avail the optional exemption of using the previous GAAP carrying values in respect of its property, plant and equipment whereas Y Ltd. wants to use fair value of its property, plant and equipment as its deemed cost on the date of transition.

Examine whether X Ltd. can do so for its consolidated financial statements. Also, examine whether different entities in a group can use different basis for arriving at deemed cost for property, plant and equipment in their respective standalone financial statements

Solution

Where there is no change in its functional currency on the date of transition to Ind AS, a first-time adopter to Ind AS may elect to continue with the carrying value of all of its property, plant and equipment as at the date of transition measured as per the previous GAAP and use that as its deemed cost at the date of transition after making necessary adjustments. If a first-time adopter chooses this option then the option of applying this on selective basis to some of the items of property, plant and equipment and using fair value for others is not available. Nothing prevents different entities within a group to choose different basis for arriving at deemed cost for the standalone financial statements. However, in Consolidated Financial Statements, the entire group should be treated as one reporting entity. Accordingly, it will not be permissible to use different basis for arriving at the deemed cost of property, plant and equipment on the date of transition by different entities of the group for the purpose of preparing Consolidated Financial Statements.

Illustration 9

For the purpose of deemed cost on the date of transition, an entity has the option of using the carrying value as the deemed cost.

In this context, suggest which carrying value is to be considered as deemed cost: original cost or net book value? Also examine whether this would have any impact on future depreciation charge?

Solution

For the purpose of deemed cost on the date of transition, if an entity uses the carrying value as the deemed cost, then it should consider the net book value on the date of transition as the deemed cost and not the original cost because carrying value here means net book value. The future depreciation charge will be based on the net book value and the remaining useful life on the date of transition. Further, as per the requirements of Ind AS 16, the depreciation method, residual value and useful life need to be reviewed atleast annually. As a result of this, the depreciation charge may or may not be the same as the depreciation charge under the previous GAAP.

Illustration 10

Is it possible for an entity to allocate cost as per the previous GAAP to a component based on its fair value on the date of transition even when it does not have the component-wise historical cost?

Solution

Yes, an entity can allocate cost to a component based on its fair value on the date of transition. This is permissible even when the entity does not have component-wise historical cost.

Illustration 11

Revaluation under previous GAAP can be considered as deemed cost if the revaluation was, at the date of the revaluation, broadly comparable to fair value or cost or depreciated cost of assets in accordance with Ind AS, adjusted to reflect, e.g., changes in a general or specific price index.

What is the acceptable time gap of such revaluation from the date of transition? Can adjustments be made to take effects of events subsequent to revaluation?

Solution

There are no specific guidelines in Ind AS 101 to indicate the acceptable time gap of such revaluation from the date of transition. The management of an entity needs to exercise judgement in this regard. However, generally, a period of 2–3 years may be treated as an acceptable time gap of such revaluation from the date of transition. In any case,

adjustments should be made to reflect the effect of material events subsequent to revaluation.

5. Cumulative translation difference

No need to:

- ◆ Recognise some translation differences in other comprehensive income.
- ◆ Reclassify cumulative translation differences for foreign operation from entity to profit or loss as part of gain or loss on its disposal

If first time adopter uses this exemption:

- ◆ Cumulative translation differences set to zero for all foreign operations.
- ◆ Gain / loss on subsequent disposal of a foreign operation shall exclude these differences that arose before transition

6. Long-term foreign currency monetary items

Paragraph 46A of AS 11 notified under the Companies (Accounting Standards) Rules, 2006 permitted companies to recognise foreign currency exchange gain / loss arising on long-term foreign currency monetary items in either of the following ways:

- ◆ In profit or loss
- ◆ If such monetary item was entered into to acquire property, plant and equipment or intangible asset - in the cost thereof
- ◆ If such monetary item was entered into for any other purpose – accumulated in foreign currency monetary item translation difference account (FCMITDA)

A first time adopter may continue the accounting policy adopted for accounting for exchange differences arising from long term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period, as per previous GAAP.

To be clear, this exemption is not a permanent exemption from the requirements of Ind AS 21. It is available only for those long-term foreign currency monetary items which are recognised before the first Ind AS reporting period began. For example, if the transition date is 1 April 20X5, the first reporting period will be 1 April 20X6 to 31 March 20X7. Therefore, this exemption is available only if such monetary items were recognised in the last previous GAAP financial statements i.e. financial statements for the year ended 31 March 20X6.

Illustration 12

Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X1. On the date of transition, there is a long- term foreign currency monetary liability of ₹ 60 crores (US \$ 10 million converted at an exchange rate of US \$ 1 = ₹ 21 60). The accumulated exchange difference on the date of transition is nil since Y Ltd. was following AS 11 notified under the Companies (Accounting Standards) Rules, 2006 and has not exercised the option provided in paragraph 46/46A of AS 11. The Company wants to avail the option under paragraph 46A of AS 11 prospectively or retrospectively on the date of transition to Ind AS.

How should it account for the translation differences in respect of this item under Ind AS 101?

Solution

Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

If the Company wants to avail the option prospectively

The Company cannot avail the exemption given in Ind AS 101 and cannot exercise option under paragraph 46/46A of AS 11, prospectively, on the date of transition to Ind AS in respect of Long term foreign currency monetary liability existing on the date of transition as the company has not availed the option under paragraph 46/46A earlier. Therefore, the Company need to recognise the exchange differences in accordance with the requirements of Ind AS 21, The Effects of Changes in Foreign Exchange Rates which requires all foreign exchange differences to be recognised in profit or loss, except such foreign exchange differences which are accounted for as an adjustment to borrowing costs in accordance with Ind AS 23.

If the Company wants to avail the option retrospectively

The Company cannot avail the exemption given in Ind AS 101 and cannot exercise the option under paragraph 46/46A of AS 11 retrospectively on the date of transition to Ind AS in respect of long-term foreign currency monetary liability that existed on the date of transition since the option is available only if it is in continuation of the accounting policy followed in accordance with the previous GAAP. Y Ltd. has not been using the option provided in Para 46/ 46A of AS 11, hence, it will not be permitted to use the option given in Ind AS 101 retrospectively.

Illustration 13

Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X5. On April 1, 20X1, it obtained a 7 year US\$ 1,00,000 loan. It has been exercising the option provided in Paragraph 46/46A of AS 11 and has been amortising the exchange differences in respect of this loan over the balance period of such loan. On the date of transition, the company wants to continue the same accounting policy with regard to amortising exchange differences.

Whether the Company is permitted to do so?

Solution

Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. In view of the above, the Company can continue to follow the existing accounting policy of amortising the exchange differences in respect of this loan over the balance period of such long-term liability.

7. Investment in subsidiaries, joint ventures and associates

Ind AS 27 requires measurement of investments in subsidiaries, joint ventures and associates either at (a) cost or (b) in accordance with Ind AS 109 (i.e. at fair value, either through other comprehensive income or through profit or loss).

Ind AS 101 permits a first-time adopter to measure such investments at:

- ◆ Cost determined in accordance with Ind AS 27 (as above) or
- ◆ Deemed cost:
 - Fair value at the date of transition; or
 - Previous GAAP carrying amount at the date of transition.

Illustration 14

A Ltd. acquired B Ltd. in a business combination transaction. A Ltd. agreed to pay certain contingent consideration (liability classified) to B Ltd. As part of its investment in its separate financial statements, A Ltd. did not recognise the said contingent consideration (since it was not considered probable). A Ltd. considered the previous GAAP carrying amounts of investment as its deemed cost on first-time adoption.

In that case, does the carrying amount of investment required to be adjusted for this transaction?

Solution

In accordance with Ind AS 101, an entity has an option to treat the previous GAAP carrying values, as at the date of transition, of investments in subsidiaries, associates and joint ventures as its deemed cost on transition to Ind AS. If such an exemption is adopted, then the carrying values of such investments are not adjusted. Accordingly, any adjustments in relation to recognition of contingent consideration on first time adoption shall be made in the statement of profit and loss.

8. Compound financial instruments

A first time adopter need not split the compound financial instruments into separate liability and equity component, if liability component is not outstanding as at transition date.

Illustration 15

On April 1, 20X1, Sigma Ltd. issued 30,000 6% convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31 March 20X5 or these may be converted into ordinary shares at the option of the holder. The interest rate for equivalent debentures without conversion rights would have been 10%. The date of transition to Ind AS is 1 April 20X3.

Suggest how should Sigma Ltd. account for this compound financial instrument on the date of transition. The present value of ₹ 1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:

End of year	6%	10%
1	0.94	0.91
2	0.89	0.83
3	0.84	0.75
4	0.79	0.68

Solution

The carrying amount of the debenture on the date of transition under previous GAAP, assuming that all interest accrued other than premium on redemption have been paid, will be ₹ 31,50,000 $[(30,000 \times 100) + (30,000 \times 100 \times 10/100 \times 2/4)]$. The premium payable on redemption is being recognised as borrowing costs as per para 4(b) of AS 16 ie under previous GAAP on straight-line basis.

As per para D18 of Ind AS 101, Ind AS 32, Financial Instruments: Presentation, requires an entity to split a compound financial instrument at inception into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of Ind AS 32 would involve separating two portions of equity. The first portion is recognised in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, in accordance with this Ind AS, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to Ind AS.

In the present case, since the liability is outstanding on the date of transition, Sigma Ltd. will need to split the convertible debentures into debt and equity portion on the date of transition. Accordingly, we will first measure the liability component by discounting the contractually determined stream of future cash flows (interest and principal) to present value by using the discount rate of 10% p.a. (being the market interest rate for similar debentures with no conversion option).

	(₹)
Interest payments p.a. on each debenture	6
Present Value (PV) of interest payment for years 1 to 4 (6×3.17) (Note 1)	19.02
PV of principal repayment (including premium) 110×0.68 (Note 2)	74.80
Total liability component per debenture	93.82
Equity component per debenture (Balancing figure)	6.18
Face value of debentures	100.00
Total equity component for 30,000 debentures	1,85,400
Total debt amount ($30,000 \times 93.82$)	28,14,600

Thus, on the date of initial recognition, the amount of ₹ 30,00,000 being the amount of debentures will be split as under:

Debt	₹ 28,14,600
Equity	₹ 1,85,400

However, on the date of transition, unwinding of ₹ 28,14,600 will be done for two years as follows:

Year	Opening balance	Finance cost @ 10%	Interest paid	Closing balance
1	28,14,600	2,81,460	1,80,000	29,16,060
2	29,16,060	2,91,606	1,80,000	30,27,666

Therefore, on transition date, Sigma Ltd. shall –

- a. recognise the carrying amount of convertible debentures at ₹ 30,27,666;
- b. recognise equity component of compound financial instrument of ₹ 1,85,400;
- c. debit ₹ 63,066 to retained earnings being the difference between the previous GAAP amount of ₹ 31,50,000 and ₹ 30,27,666 and the equity component of compound financial instrument of ₹ 1,85,400; and
- d. derecognise the debenture liability in previous GAAP of ₹ 31,50,000.

Notes:

1. 3.17 is present value of annuity factor of ₹ 1 at a discount rate of 10% for 4 years.
2. On maturity, ₹ 110 will be paid (₹ 100 as principal payment + ₹ 10 as premium)

9. Fair value measurement of financial assets or financial liabilities

As per Ind AS 109, if:

- ◆ the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, and
- ◆ such fair value is not based on:
 - Level 1 inputs (refer Ind AS 113), or
 - Valuation technique that uses only data from observable markets

then, such difference (referred to in first bullet above) is deferred and amortised in profit or loss on the basis stated in Ind AS 109.

Ind AS 101 permits an entity to apply this requirement of Ind AS 109 prospectively to transactions entered into on or after the date of transition.

10. Decommissioning liabilities included in Property, Plant and Equipment

Appendix 'A' to Ind AS 16 "Changes in Existing Decommissioning, Restoration and Similar Liabilities" requires specified changes in a decommissioning, restoration or similar liability to be added to or deducted from the cost of the asset to which it relates; the adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life.

An entity need not comply with this requirement for changes in such liabilities that occurred before the date of transition. If an entity avails of this exemption, it shall:

- ◆ Measure the liability as at the transition date as per Ind AS 37 i.e. based on the facts and circumstances, including the risk-adjusted discount rate, as at the transition date,
- ◆ If the liability is in the scope of Appendix A to Ind AS 16, roll-back that liability to the

date that liability first arose using best estimate of historical risk-adjusted discount rate and include it in the cost of the asset, and

- ◆ Calculate accumulated depreciation on the transition date on the basis of estimated useful life as at that date.

11. Designation of previously recognised financial instruments

All financial instruments are initially measured at fair value. As regards subsequent measurement, Ind AS 109 permits that upon initial recognition, an entity may designate financial instruments as subsequently measured at fair value if certain criteria are met. Ind AS 101 exempts an entity from retrospective designation of financial instruments and permits that such designation be done on the basis of the facts and circumstances that exist at the date of transition to Ind AS. In particular the exemption is provided for below mentioned financial instruments:

- ◆ Designation of any financial liability or asset at fair value through profit or loss
- ◆ Designation of investment in an equity instrument at fair value through other comprehensive income

12. Extinguishing financial liabilities with equity instruments

Appendix D of Ind AS 109 provides for accounting principles to be applied when an entity's equity instruments are issued to extinguish all or part of its financial liability. A first time adopter may apply Appendix D of Ind AS 109 from the date of transition to Ind AS.

13. Severe Hyperinflation

In hyperinflationary economy, when an entity's date of transition to Ind AS, is on, or after, the functional currency normalization date, then all assets and liabilities held before the functional currency normalization date may be measured at fair value on the date of transition.

This fair value may be used as deemed cost of those assets and liabilities in the opening Ind AS statement of financial position.

When the functional currency normalisation date falls within a 12- month comparative period, the comparative period may be less than 12 months, provided that a complete set of financial statements (as required by paragraph 10 of Ind AS 1) is provided for that shorter period.

14. Leases

A first time adopter may determine whether an arrangement existing at the date of transition to Ind AS contain a lease (including classification by a lessor of each land and building element as finance or an operating lease) on the basis of facts and circumstances existing on the date of transition.

A lessee which is a first-time adopter of Ind AS shall recognise lease liabilities and right-of-use assets, by applying the following approach to all of its leases at the date of transition to Ind AS:

- (a) measure a lease liability at the present value of the remaining lease payments discounted using the lessee's incremental borrowing rate at the date of transition to Ind AS;
- (b) measure a right-of-use asset on a lease-by-lease basis either at:
 - (i) its carrying amount as if Ind AS 116 had been applied since the commencement date of the lease, but discounted using the lessee's incremental borrowing rate at the date of transition to Ind AS; or
 - (ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the Balance Sheet immediately before the date of transition to Ind AS.
- (c) apply Ind AS 36 to right-of-use assets.

A first-time adopter that is a lessee may do one or more of the following at the date of transition to Ind AS, applied on a lease-by lease basis:

- (1) apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
- (2) elect not to apply the above requirements given in (a) to (c) to leases for which the lease term ends within 12 months of the date of transition to Ind AS. Instead, the entity shall account for (including disclosure of information about) these leases as if they were short-term leases accounted as per Ind AS 116.
- (3) elect not to apply the above requirements given in (a) to (c) to leases for which the underlying asset is of low value. Instead, the entity shall account for (including disclosure of information about) these leases as per Ind AS 116.
- (4) exclude initial direct costs from the measurement of the right-of-use asset at the date of transition to Ind AS.
- (5) use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

15. Financial asset or intangible assets accounted for in accordance with Appendix D to Ind AS 115, Service Concession Arrangements

Change in accounting policy pursuant to the requirements of this Appendix to be accounted for retrospectively except for amortization policy for intangible assets relating to toll roads adopted as per previous GAAP.

If impracticable for an operator to apply the requirements of the Ind AS retrospectively at the date of transition to Ind AS, it shall recognise financial assets and intangible assets that existed at the date of transition to Ind AS using the previous carrying amounts.

16. Designation of contracts to buy or sell a non-financial item

Ind AS 109 permits some contracts to buy or sell a non-financial item to be designated **at inception** as measured at fair value through profit or loss (see paragraph 2.5 of Ind AS 109). Despite this requirement an entity is permitted to designate, **at the date of transition to Ind AS**, contracts that already exist on that date as measured at fair value through profit or loss but only if they meet the requirements of paragraph 2.5 of Ind AS 109 at that date and the entity designates all similar contracts.

17. Stripping costs in the production of surface mine

A first time adopter may apply Appendix B to Ind AS 16, Stripping costs in the production phase of a surface mine, from the date of transition to Ind AS. As at the transition date to Ind AS, any previously recognised asset balance that resulted from stripping activity undertaken during the production phase shall be reclassified as a part of an existing asset to which the stripping activity related, to the extent that there remains an identifiable component of the ore body with which the predecessor stripping asset can be associated.

18. Non-current assets held for sale and discounted operations

A first time adopter can:

- ◆ Measure noncurrent assets held for sale or discontinued operation at the lower carrying value and fair value less cost to sell at the date of transition to Ind AS in accordance with Ind AS 105; and
- ◆ Recognize directly in retain earnings any difference between that amount and the carrying amount of those assets at the date of transition to Ind AS determined under the entity's previous GAAP

19. Assets and liabilities of subsidiaries, associates and joint ventures

If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall measure its assets and liabilities at either:

- ◆ The carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to Ind AS. or
- ◆ The carrying amounts required by Ind AS 101, based on the subsidiary's date of transition to Ind AS.

If an entity becomes first time adopter later than its subsidiary, the entity shall measure the assets and liabilities at the subsidiary at the same carrying amounts as in the financial statements of the subsidiary, after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary.

20. Revenue from Contract with Customers

Any of the following exemption may be used in applying Ind AS 115 retrospectively:

- ◆ For completed contracts: Need not restate contracts that begin and end within the same annual reporting period;
- ◆ For completed contracts that have variable consideration: Option to use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods;
- ◆ For all reporting periods presented before the beginning of the first Ind AS reporting period, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

21. Joint arrangements:

Transition from Proportionate Consolidation to Equity Method

- ◆ To measure initial investment at transition date at the aggregate of carrying amount of assets and liabilities that the entity had previously proportionately consolidated including goodwill arising on acquisition.
- ◆ To test the investment for impairment, regardless of whether there are indicators of such impairment. Any resulting impairment shall be recognised as an adjustment to retained earnings at the date of transition to Ind AS.
- ◆ If aggregate of all previously recognized assets/liabilities results in negative asset and if having legal or constructive obligation, then recognize corresponding liability otherwise adjust retained earnings.

Transition from Equity Method to accounting for assets and liabilities

- ◆ To derecognize previous investment and recognize share of each asset and liability in respect of its interest in joint operation.
- ◆ Difference between amount of net assets (including goodwill) as per Ind AS and previously recognized;
 - (a) If carrying amount of previous investment is lower:
Offset against goodwill relating to investment and thereafter retained earning
 - (b) If carrying amount of previous investment is higher:
Adjust against retained earning

Transitional provisions in entity's Separate FS

- ◆ To derecognise the investment and recognise assets and liabilities as per transition from equity method to accounting for assets and liabilities

- ◆ Provide reconciliation between amount derecognized, recognized and adjustment to retained earnings.



7. PRESENTATION AND DISCLOSURE

I. Comparative Information

- Ind AS does not require historical summaries to comply with the recognition and measurement requirement of Ind AS.
- In any financial statements containing historical summaries or comparative information in accordance with previous GAAP, an entity shall:
 - ◆ Label the previous GAAP information prominently as not being prepared in accordance with Ind AS; and
 - ◆ Disclose the nature of the main adjustments that would make it comply with Ind AS. An entity need not quantify those adjustments.

II. Explanation of transition to Ind AS

- Reconciliation of
 - (a) Equity from previous GAAP to Ind AS at transition and last year end;
 - (b) Last year's total comprehensive income under previous GAAP to Ind AS.
- Sufficient detail to understand adjustments to each line item.
- Reconciliation to distinguish correction of errors identified during transition from change in accounting policy.
- Fair value as deemed cost and the amount of the adjustment.
- Ind AS 36 disclosures for impairment during transition.
- If adopted first time exemption option, to disclose the fact and accounting policy until such time those PPE, Intangible Assets, investment properties or intangible assets significantly depreciated/impaired/derecognized.
- Interim financial reports to include reconciliation with equity and profit or loss under previous GAAP.
- Further information to comply with Ind AS 34.

Illustration 16

H Ltd. has the following assets and liabilities as at March 31, 20X1, prepared in accordance with previous GAAP:

Particulars	Notes	Amount (₹)
Property, Plant & Equipment	1	1,34,50,000
Investments in S. Ltd.	2	48,00,000
Trade Receivables		2,00,000
Advances for purchase of inventory		50,00,000
Inventory		8,00,000
Cash		<u>49,000</u>
Total assets		<u>2,42,99,000</u>
VAT deferral loan	3	60,00,000
Creditors		30,00,000
Short term borrowing		8,00,000
Provisions		<u>12,00,000</u>
Total liabilities		<u>1,10,00,000</u>
Share capital		1,30,00,000
Reserves:		2,99,000
Cumulative translation difference	4	1,00,000
ESOP reserve	4	20,000
Retained earnings		<u>1,79,000</u>
Total equity		<u>1,32,99,000</u>
Total equity and liabilities		<u>2,42,99,000</u>

The following GAAP differences were identified by the Company on first-time adoption of Ind AS with effect from April 1, 20X1:

- In relation to property, plant and equipment, the following adjustments were identified:
 - Property, plant and equipment comprise land held for capital appreciation purposes costing ₹ 4,50,000 and was classified as investment property as per Ind AS 40.
 - Exchange differences of ₹ 1,00,000 were capitalised to depreciable property, plant and equipment on which accumulated depreciation of ₹ 40,000 was recognised.
 - There were no asset retirement obligations.
 - The management intends to adopt deemed cost exemption for using the previous GAAP carrying values as deemed cost as at the date of transition for PPE and investment property.
- The Company had made an investment in S Ltd. (subsidiary of H Ltd.) for ₹ 48,00,000 that carried a fair value of ₹ 68,00,000 as at the transition date. The Company intends to recognise the investment at its fair value as at the date of transition.

3. *Financial instruments:*

◆ **VAT deferral loan ₹ 60,00,000 :**

The VAT deferral loan of ₹ 60,00,000 was obtained on March 31, 20X1, for setting up a business in a backward region with a condition to create certain defined targets for employment of local population of that region. The loan does not carry any interest and is repayable in full at the end of 5 years. In accordance with Ind AS 109, the discount factor on the loan is to be taken as 10%, being the incremental borrowing rate. Accordingly, the fair value of the loan as at March 31, 20X1, is ₹ 37,25,528. The entity chooses to exercise the option given in paragraph B11 of Ind AS 101, i.e., the entity chooses to apply the requirements of Ind AS 109, Financial Instruments and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, retrospectively as required information had been obtained at the time of initially accounting for VAT deferral loan

4. *The retained earnings of the Company contained the following:*

◆ **ESOP reserve of ₹ 20,000:**

The Company had granted 1,000 options to employees out of which 800 have already vested. The Company followed an intrinsic value method for recognition of ESOP charge and recognised ₹ 12,000 towards the vested options and ₹ 8,000 over a period of time as ESOP charge and a corresponding reserve. If fair value method had been followed in accordance with Ind AS 102, the corresponding charge would have been ₹ 15,000 and ₹ 9,000 for the vested and unvested shares respectively. The Company intends to avail Ind AS 101 exemption for share-based payments for not restating the ESOP charge as per previous GAAP for vested options.

◆ **Cumulative translation difference :**

The Company had a non-integral foreign branch in accordance with AS 11 and had recognised a balance of ₹ 1,00,000 as part of reserves. On first-time adoption of Ind AS, the Company intends to avail Ind AS 101 exemption of resetting the cumulative translation difference to zero.

Prepare transition date Ind AS balance sheet of Company H showing adjustments to the values of assets and liabilities.

Solution

Adjustments for opening balance sheet as per Ind AS 101

1. **Property, Plant & Equipment:** As the land held for capital appreciation purposes qualifies as investment property, such investment property should be reclassified from property, plant and equipment (PPE) to investment property and presented separately. As the Company has adopted the previous GAAP carrying values as deemed cost, all items of PPE and investment property should be carried at its previous GAAP carrying values. As such, the past capitalised exchange differences require no adjustment in this case.

2. **Investment in subsidiary:** On first time adoption of Ind AS, a parent company has an option to carry its investment in subsidiary at fair value as at the date of transition in its separate financial statements. As such, the company can recognise such investment at a value of ₹ 68,00,000.
3. **Financial instruments:** As the VAT deferral loan is a financial liability under Ind AS 109, that liability should be recognised at its present value discounted at an appropriate discounting factor. Consequently, the VAT deferral loan should be recognised at ₹ 37,25,528 and the remaining ₹ 22,74,472 would be recognised as deferred government grant.
4. **ESOPs:** Ind AS 101 provides an exemption of not restating the accounting as per the previous GAAP in accordance with Ind AS 102 for all options that have vested by the transition date. Accordingly, out of 1000 ESOPs granted, the first-time adoption exemption is available on 800 options that have already vested. As such, its accounting need not be restated. However, the 200 options that are not vested as at the transition date, need to be restated in accordance with Ind AS 102. As such, the additional impact of ₹ 1,000 (i.e., 9,000 less 8,000) would be recognised in the opening Ind AS balance sheet.
5. **Cumulative translation difference :** As per paragraph D12 of Ind AS 101, the first-time adopter can avail an exemption regarding requirements of Ind AS 21 in context of cumulative translation differences. If a first-time adopter uses this exemption the cumulative translation differences for all foreign operation are deemed to be zero as at the transition date. In that case, the balance is transferred to retained earnings. As such, the balance of ₹ 1,00,000 should be transferred to retained earnings
6. **Retained earnings:**

	₹
Increase in fair value of investment in subsidiary (note 2)	20,00,000
Additional ESOP charge on unvested options (note 4)	(1,000)
Transfer of cumulative translation difference balance to retained earnings (note 5)	<u>1,00,000</u>
Increase in Retained Earnings	<u>20,99,000</u>

The transition date Ind AS Balance Sheet after the above adjustments in the carrying values of assets and liabilities is as under:

Transition date Ind AS Balance Sheet of H Ltd. as at 1st April, 20X1

Particular	Notes	Previous GAAP	Adjustments	Ind AS GAAP
Non-Current Assets				
Property, Plant & Equipment	1	1,34,50,000	(4,50,000)	1,30,00,000
Investment property	1	0	4,50,000	4,50,000

Current Assets				
Inventory		8,00,000		8,00,000
Financial assets:				
Investment in S Ltd.	2	48,00,000	20,00,000	68,00,000
Trade Receivables		2,00,000		2,00,000
Cash		49,000		49,000
Other current asset – (Advances for purchase of inventory)		<u>50,00,000</u>		<u>50,00,000</u>
Total assets		<u>2,42,99,000</u>	<u>20,00,000</u>	<u>2,62,99,000</u>
Share capital		1,30,00,000		1,30,00,000
Other Equity:				
Cumulative translation difference	5	1,00,000	(1,00,000)	0
ESOP reserve	4	20,000	1,000	21,000
Retained earnings	6	<u>1,79,000</u>	<u>20,99,000</u>	<u>22,78,000</u>
Total equity		<u>1,32,99,000</u>	<u>20,00,000</u>	<u>1,52,99,000</u>
Non-current Liabilities				
Financial liability:				
VAT deferral loan	3	60,00,000	(22,74,472)	37,25,528
Deferred government grant	3	0	22,74,472	22,74,472
Current Liabilities				
Financial Liabilities				
Trade payables		30,00,000		30,00,000
Short term borrowings		8,00,000		8,00,000
Provisions		<u>12,00,000</u>		<u>12,00,000</u>
Total liabilities		<u>1,10,00,000</u>		<u>1,10,00,000</u>
Total equity and liabilities		<u>2,42,99,000</u>	<u>20,00,000</u>	<u>2,62,99,000</u>

Illustration 17

Shaurya Limited is the company having its registered and corporate office at New Delhi. 60% of Shaurya Limited's shares are held by the Government of India and rest by other investors.

This is the first time that Shaurya limited would be applying Ind AS for the preparation of its financials for the current financial year 2019-2020. Following balance sheet is prepared as per earlier GAAP as at the beginning of the preceding period along with the additional information:

Balance Sheet as at 31 March 2018

(All figures are in '000, unless otherwise specified)

Particulars	Amount
EQUITY AND LIABILITIES	
(1) Shareholders' Funds	
(a) Share Capital	10,00,000
(b) Reserves & Surplus	25,00,000
(2) Non-Current Liabilities	
(a) Long Term Borrowings	4,50,000
(b) Long Term Provisions	3,50,000
(c) Deferred tax liabilities	3,50,000
(3) Current Liabilities	
(a) Trade Payables	22,00,000
(b) Other Current Liabilities	4,50,000
(c) Short Term Provisions	12,00,000
TOTAL	85,00,000
ASSETS	
(1) Non-Current Assets	
(a) Property, Plant & Equipment (net)	20,00,000
(b) Intangible assets	2,00,000
(c) Goodwill	1,00,000
(d) Non-current Investments	5,00,000
(e) Long Term Loans and Advances	1,50,000
(f) Other Non-Current Assets	2,00,000
(2) Current Assets	
(a) Current Investments	18,00,000
(b) Inventories	12,50,000

(c) Trade Receivables	9,00,000
(d) Cash and Bank Balances	10,00,000
(e) Other Current Assets	4,00,000
TOTAL	85,00,000

Additional Information (All figures are in '000) :

1. Other current liabilities include ₹ 3,90,000 liabilities to be paid in cash such as expense payable, salary payable etc. and ₹ 60,000 are statutory government dues.
2. Long term loans and advances include ₹ 40,000 loan and the remaining amount consists Advance to staff of ₹ 1,10,000.
3. Other non-current assets of ₹ 2,00,000 consists Capital advances to suppliers.
4. Other current assets include ₹ 3,50,000 current assets receivable in cash and Prepaid expenses of ₹ 50,000.
5. Short term provisions include Dividend payable of ₹ 2,00,000. The dividend payable had been as a result of board meeting wherein the declaration of dividend for financial year 2017-2018 was made. However, it is subject to approval of shareholders in the annual general meeting.

Chief financial officer of Shaurya Limited has also presented the following information against corresponding relevant items in the balance sheet:

- a) Property, Plant & Equipment consists a class of assets as office buildings whose carrying amount is ₹ 10,00,000. However, the fair value of said office building as on the date of transition is estimated to be ₹ 15,00,000. Company wants to follow revaluation model as its accounting policy in respect of its property, plant and equipment for the first annual Ind AS financial statements.
- b) The fair value of Intangible assets as on the date of transition is estimated to be ₹ 2,50,000. However, the management is reluctant to incorporate the fair value changes in books of account.
- c) Shaurya Ltd. had acquired 80% shares in a company, Excel private limited few years ago thereby acquiring the control upon it at that time. Shaurya Ltd. recognised goodwill as per erstwhile accounting standards by accounting the excess of consideration paid over the net assets acquired at the date of acquisition. Fair value exercise was not done at the time of acquisition.
- d) Trade receivables include an amount of ₹ 20,000 as provision for doubtful debts measured in accordance with previous GAAP. Now as per latest estimates using hindsight, the provision needs to be revised to ₹ 25,000.

- e) Company had given a loan of ₹ 1,00,000 to an entity for the term of 10 years six years ago. Transaction costs were incurred separately for this loan. The loan carries an interest rate of 7%. The principal amount is to be repaid in equal installments over the period of ten years at the year end. Interest is also payable at each year end. The fair value of loan as on the date of transition is ₹ 50,000 as against the carrying amount of loan which at present amounts to ₹ 40,000. However, Ind AS 109 mandates to recognise the interest income as per effective interest method after the adjustment of transaction costs. Management says it is tedious task in the given case to apply the effective interest rate changes with retrospective effect and hence is reluctant to apply the same retrospectively in its first-time adoption.
- f) In the long-term borrowings, ₹ 4,50,000 of component is due towards the State Government. Interest is payable on the government loan at 4%, however the prevailing rate in the market at present is 8%. The fair market value of loan stands at ₹ 4,20,000 as on the relevant date.
- g) Under Previous GAAP, the mutual funds were measured at cost or market value, whichever is lower. Under Ind AS, the Company has designated these investments at fair value through profit or loss. The value of mutual funds as per previous GAAP is ₹ 2,00,000 as included in 'current investment'. However, the fair value of mutual funds as on the date of transition is ₹ 2,30,000.
- h) Ignore separate calculation of deferred tax on above adjustments. Assume the net deferred tax income to be ₹ 50,000 on account of Ind AS transition adjustments.

Requirements:

- Prepare transition date balance sheet of Shaurya Limited as per Indian Accounting Standards
- Show necessary explanation for each of the items presented by chief financial officer in the form of notes, which may or may not require the adjustment as on the date of transition.

Solution

Transition date (opening) IND-AS Balance Sheet of Shaurya Limited

As at 1 April 2018

(All figures are in '000, unless otherwise specified)

Particulars	Previous GAAP	Transitional Ind AS adjustments	Opening Ind AS Balance Sheet
ASSETS			
Non-current assets			
Property, plant and equipment (Note 1)	20,00,000	5,00,000	25,00,000

Goodwill (Note 2)	1,00,000	-	1,00,000
Other Intangible assets (Note 3)	2,00,000	-	2,00,000
Financial assets:			
Investment	5,00,000	-	5,00,000
Loans (Note 4)	40,000	10,000	50,000
Other financial assets	1,10,000	-	1,10,000
Other non-current assets	2,00,000	-	2,00,000
Current assets			
Inventories	12,50,000	-	12,50,000
Financial assets			
Investment (Note 5)	18,00,000	30,000	18,30,000
Trade receivables (Note 6)	9,00,000	-	9,00,000
Cash and cash equivalents/Bank	10,00,000	-	10,00,000
Other financial assets	3,50,000	-	3,50,000
Other current assets	<u>50,000</u>	<u>-</u>	<u>50,000</u>
TOTAL ASSETS	<u>85,00,000</u>	<u>5,40,000</u>	<u>90,40,000</u>
EQUITY AND LIABILITIES			
Equity			
Equity share capital	10,00,000	-	10,00,000
Other equity	25,00,000	7,90,000	32,90,000
Non-current liabilities			
Financial liabilities			
Borrowings (Note-7)	4,50,000	-	4,50,000
Provisions	3,50,000	-	3,50,000
Deferred tax liabilities (Net)	3,50,000	(50,000)	3,00,000
Current liabilities			
Financial liabilities			
Trade payables	22,00,000	-	22,00,000
Other financial liabilities	3,90,000	-	3,90,000
Other current liabilities	60,000	-	60,000
Provisions (Note-8)	<u>12,00,000</u>	<u>(2,00,000)</u>	<u>10,00,000</u>
TOTAL EQUITY AND LIABILITIES	<u>85,00,000</u>	<u>5,40,000</u>	<u>90,40,000</u>

OTHER EQUITY

	Retained Earnings (₹)	Fair value reserve	Total
As at 31 March, 2018	27,90,000 (W.N.1)	5,00,000	32,90,000

Working Note 1:

Retained earnings balance:	
Balance as per Earlier GAAP	25,00,000
Transitional adjustment due to loan's fair value	10,000
Transitional adjustment due to increase in mutual fund's fair value	30,000
Transitional adjustment due to decrease in deferred tax liability	50,000
Transitional adjustment due to decrease in provisions (dividend)	<u>2,00,000</u>
Total	<u>27,90,000</u>

Disclosure forming part of financial statements:

Proposed dividend on equity shares is subject to the approval of the shareholders of the company at the annual general meeting and should not be recognized as liability as at the Balance Sheet date.

Note 1: Property, plant & Equipment:

As per para D5 of Ind AS 101, an entity may elect to measure an item of property, plant and equipment at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date.

Para D7AA has to be applied for all items of property, plant and equipment. So, if D5 exemption is taken for buildings, Ind AS will have to be applied retrospectively for other assets as well. Since, an entity elects to measure an item of property, plant and equipment at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date, it is assumed that the carrying amount of other assets based on retrospective application of Ind AS is equal to their fair value of ₹ 10 lakhs.

Note 2: Goodwill:

Ind AS 103 mandatorily requires measuring the assets and liabilities of the acquiree at its fair value as on the date of acquisition. However, a first time adopter may elect to not apply the provisions of Ind AS 103 with retrospective effect that occurred prior to the date of transition to Ind AS.

Hence company can continue to carry the goodwill in its books of account as per the previous GAAP.

Note 3: Intangible assets:

Para D7 read with D6 of Ind AS 101 states that a first-time adopter may elect to use a previous GAAP revaluation at, or before, the date of transition to Ind AS as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to:

- (a) Fair value; or
- (b) Cost or depreciated cost in accordance with Ind AS, adjusted to reflect, for example, changes in a general or specific price index.

However, there is a requirement that Intangible assets must meet the definition and recognition criteria as per Ind AS 38.

Hence, company can avail the exemption given in Ind AS 101 as on the date of transition to use the carrying value as per previous GAAP.

Note 4: Loan:

Para B8C of Ind AS 101 states that if it is impracticable (as defined in Ind AS 8) for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind ASs shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to Ind AS.

Accordingly, ₹ 50,000 would be the gross carrying amount of loan and difference of ₹ 10,000 (₹ 50,000 – ₹ 40,000) would be adjusted to retained earnings.

Note 5: Mutual Funds:

Para 29 of Ind AS 101 states that an entity is permitted to designate a previously recognised financial asset as a financial asset measured at fair value through profit or loss in accordance with paragraph D19A. The entity shall disclose the fair value of financial assets so designated at the date of designation and their classification and carrying amount in the previous financial statements.

D19A states that an entity may designate a financial asset as measured at fair value through profit or loss in accordance with Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind AS.

Note 6: Trade receivables:

Para 14 of Ind AS 101 states that an entity's estimates in accordance with Ind AS at the date of transition to Ind AS shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

Para 15 of Ind AS 101 further states that an entity may receive information after the date of transition to Ind AS about estimates that it had made under previous GAAP. In accordance with

paragraph 14, an entity shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with Ind AS 10, Events after the Reporting Period.

The entity shall not reflect that new information in its opening Ind AS Balance Sheet (unless the estimates need adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the entity shall reflect that new information in profit or loss (or, if appropriate, other comprehensive income) for the year ended 31 March 2019.

Note 7: Government Grant:

Para 10A of Ind AS 20 states that the benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with Ind AS 109, Financial Instruments. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109, and the proceeds received. The benefit is accounted for in accordance with this Standard.

However, Para B10 of Ind AS 101 states, a first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with Ind AS 32, Financial Instruments: Presentation. Except as permitted by paragraph B11, a first-time adopter shall apply the requirements in Ind AS 109, Financial Instruments, and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, *prospectively* to government loans existing at the date of transition to Ind ASs and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant. Consequently, if a first-time adopter did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with Ind AS requirements, it shall use its previous GAAP carrying amount of the loan at the date of transition to Ind AS as the carrying amount of the loan in the opening Ind AS Balance Sheet. An entity shall apply Ind AS 109 to the measurement of such loans after the date of transition to Ind AS.

Note 8: Dividend

Dividend should be deducted from retained earnings during the year when it has been declared and approved. Accordingly, the provision declared for preceding year should be reversed (to rectify the wrong entry). Retained earnings would increase proportionately due to such adjustment.



8. CARVE OUTS IN IND AS 101 FROM IFRS 1

(i) Definition of previous GAAP under Ind AS 101

As per IFRS

IFRS 1 defines previous GAAP as the basis of accounting that a first - time adopter used immediately before adopting IFRS.

Carve out

Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its reporting requirement in India immediately before adopting Ind AS. The change made it mandatory for Indian entities to consider the financial statements prepared in accordance with notified Accounting Standards as was applicable to them as previous GAAP when it transitions to Ind AS.

Reason

The change makes it mandatory for Indian companies to consider the financial statements prepared in accordance with Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 as previous GAAP when it transitions to Ind AS as the law prevailing in India recognises only the financial statements prepared in accordance with the Companies Act, 2013.

(ii) Allowing the use of carrying cost of Property, Plant and Equipment (PPE) on the date of transition of Ind AS 101

As per IFRS

IFRS 1 *First time Adoption of International Accounting Standards* provides that on the date of transition, either the items of Property, Plant and Equipment shall be determined by applying IAS 16 *Property, Plant and Equipment* retrospectively or the same should be recorded at fair value or a previous GAAP revaluation, subject to certain requirements.

Carve out

Paragraph D7AA of Ind AS 101 provides an additional option to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

Reason

In case of old companies, retrospective application of Ind AS 16 or fair values at the date of transition to determine deemed cost may not be possible for old assets. Accordingly, Ind AS 101 provides relief to an entity to use carrying values of all items of property, plant

and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

(iii) Long Term Foreign Currency Monetary Items

As per IFRS

No provision in IFRS 1.

Carve out

Paragraph D13AA of Appendix D to Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Consequently, Ind AS 21 also provides that it does not apply to long-term foreign currency monetary items for which an entity has opted for the exemption given in paragraph D13AA of Appendix D to Ind AS 101. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items.

Reason

Para 46A of AS 11 provides an option to recognise long term foreign currency monetary items as a part of the cost of property, plant and equipment or to defer its recognition in the statement of profit and loss over the period of loan in case the loan is not related to acquisition of fixed assets. To provide transitional relief, such entities have been given an option to continue the capitalisation or deferment of exchange differences, as the case may be, on foreign currency borrowings obtained before the beginning of first Ind AS reporting period.

(iv) Intangible assets arising from service concession arrangements related to toll roads accounted for in accordance with Appendix D, Service Concession Arrangements to Ind AS 115, Revenue from Contracts with Customers

As per IFRS

No provision in IFRS 1.

Carve Out

Ind AS 101 permits a first-time adopter to continue with the policy adopted for amortization of intangible assets arising from service concession arrangements related to toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

As a consequence to the above, paragraph 7AA has been inserted in Ind AS 38 to scope out the entity, to apply amortisation method, that opts to amortise the intangible assets arising from service concession arrangements in respect of toll roads recognised in the

financial statements for the period ending immediately before the beginning of the first Ind AS reporting period as per the exception given in paragraph D22 of Appendix D to Ind AS 101.

Reason

Schedule II to the Companies Act, 2013, allows companies to use revenue based amortisation of intangible assets arising from service concession arrangements related to toll roads while Ind AS 38, Intangible Assets, allows revenue based amortisation only in the circumstances in which the predominant limiting factor that is inherent in an intangible asset is the achievement of revenue threshold. In order to provide relief to such entities, Ind AS 38 and Ind AS 101 have been amended to allow the entities to continue to use the accounting policy adopted for amortization of intangible assets arising from service concession arrangements related to toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial statements. In other words, Ind AS 38 would be applicable to the amortisation of intangible assets arising from service concession arrangements related to toll roads entered into after the implementation of Ind AS.

(v) Land and building element in lease contracts

As per IFRS

No provisions under IFRS 1.

Carve Out

Paragraph D9AA provides that an entity which is a lessor can use the transition date facts and circumstances for lease arrangements which includes both land and building elements to assess the classification of each element as finance or an operating lease at the transition date to Ind AS. Also, if there is any land lease newly classified as finance lease then the first time adopter may recognise assets and liability at fair value on that date; any difference between those fair values is recognised in retained earnings.

Reason

This aspect is quite common in the Indian environment and it was felt that the first time adopters may face hardship if they were to retrospectively assess the two elements of the contract.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Company A intends to restate its past business combinations with effect from 30 June 20X0 (being a date prior to the transition date).

If business combinations are restated, whether certain other exemptions, such as the deemed cost exemption for property, plant and equipment (PPE), can be adopted?

2. X Ltd. was using cost model for its property, plant and equipment till March 31, 20X2 under previous GAAP. The Ind AS become applicable to the company for financial year beginning April 1, 20X2. On April 1, 20X1, i.e., the date of its transition to Ind AS, it used fair value as the deemed cost in respect of its property, plant and equipment. X Ltd. wants to follow revaluation model as its accounting policy in respect of its property, plant and equipment for the first annual Ind AS financial statements.

Whether use of fair values as deemed cost on the date of transition and use of revaluation model in the first annual Ind AS financial statements would amount to a change in accounting policy?

3. Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X5. On April 1, 20X0, it obtained a 7 year US \$ 1,00,000 loan. It has been exercising the option provided in Paragraph 46/46A of AS 11 and has been amortising the exchange differences in respect of this loan over the balance period of such loan. On the date of transition to Ind AS, Y Ltd. wants to discontinue the accounting policy as per the previous GAAP and follow the requirements of Ind AS 21 with respect to recognition of foreign exchange differences.

Whether the Company is permitted to do so?

4. A company has chosen to elect the deemed cost exemption in accordance with Ind AS 101. However, it does not wish to continue with its existing policy of capitalising exchange

fluctuation on long term foreign currency monetary items to property, plant and equipment i.e. it does not want to elect the exemption available as per Ind AS 101.

In such a case, how would the company be required to adjust the foreign exchange fluctuation already capitalised to the cost of property, plant and equipment under previous GAAP?

5. XYZ Pvt. Ltd. is a company registered under the Companies Act, 2013 following Accounting Standards notified under Companies (Accounting Standards) Rules, 2006. The Company has decided to voluntarily adopt Ind AS w.e.f 1st April, 20X2 with a transition date of 1st April, 20X1.

The Company has one Wholly Owned Subsidiary and one Joint Venture which are into manufacturing of automobile spare parts.

The consolidated financial statements of the Company under Indian GAAP are as under:

Consolidated Financial Statements

(₹ in Lakhs)

Particulars	31.03.20X2	31.03.20X1
Shareholder's Funds		
Share Capital	7,953	7,953
Reserves & Surplus	16,547	16,597
Non-Current Liabilities		
Long Term Borrowings	1,000	1,000
Long Term Provisions	1,101	691
Other Long-Term Liabilities	5,202	5,904
Current Liabilities		
Trade Payables	9,905	8,455
Short Term Provisions	500	475
Total	42,208	41,075
Non-Current Assets		
Property Plant & Equipment	21,488	22,288
Goodwill on Consolidation of subsidiary and JV	1,507	1,507
Investment Property	5,245	5,245
Long Term Loans & Advances	6,350	6,350
Current Assets		
Trade Receivables	4,801	1,818

Investments	1,263	3,763
Other Current Assets	1,554	104
Total	42,208	41,075

Additional Information:

The Company has entered into a joint arrangement by acquiring 50% of the equity shares of ABC Pvt. Ltd. Presently, the same has been accounted as per the proportionate consolidated method. The proportionate share of assets and liabilities of ABC Pvt. Ltd. included in the consolidated financial statement of XYZ Pvt. Ltd. is as under:

Particulars	₹ in Lakhs
Property, Plant & Equipment	1,200
Long Term Loans & Advances	405
Trade Receivables	280
Other Current Assets	50
Trade Payables	75
Short Term Provisions	35

The Investment is in the nature of Joint Venture as per Ind AS 111.

Suggest the accounting adjustments which are required to be made in the opening Balance Sheet as on 1st April, 20X1.

6. Mathur India Private Limited has to present its first financials under Ind AS for the year ended 31st March, 20X3. The transition date is 1st April, 20X1.

The following adjustments were made upon transition to Ind AS:

- The Company opted to fair value its land as on the date on transition.
The fair value of the land as on 1st April, 20X1 was ₹ 10 crores. The carrying amount as on 1st April, 20X1 under the existing GAAP was ₹ 4.5 crores.
- The Company has recognised a provision for proposed dividend of ₹ 60 lacs and related dividend distribution tax of ₹ 18 lacs during the year ended 31st March, 20X1. It was written back as on opening balance sheet date.
- The Company fair values its investments in equity shares on the date of transition. The increase on account of fair valuation of shares is ₹ 75 lacs.
- The Company has an Equity Share Capital of ₹ 80 crores and Redeemable Preference Share Capital of ₹ 25 crores.
- The reserves and surplus as on 1st April, 20X1 before transition to Ind AS was ₹ 95 crores representing ₹ 40 crores of general reserve and ₹ 5 crores of capital

reserve acquired out of business combination and balance is surplus in the Retained Earnings.

- (f) The company identified that the preference shares were in nature of financial liabilities.

What is the balance of total equity (Equity and other equity) as on 1st April, 20X1 after transition to Ind AS? Show reconciliation between total equity as per AS (Accounting Standards) and as per Ind AS to be presented in the opening balance sheet as on 1st April, 20X1.

Ignore deferred tax impact.

7. 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. If not, then what will be the accounting treatment of such grants recognised in capital reserve as per previous GAAP on the date of transition to Ind AS.

Answers

1. Ind-AS 101 prescribes that an entity may elect to use one or more of the exemptions of the Standard. As such, an entity may choose to adopt a combination of optional exemptions in relation to the underlying account balances.

When the past business combinations after a particular date (30 June 20X0 in the given case) are restated, it requires retrospective adjustments to the carrying amounts of acquiree's assets and liabilities on account of initial acquisition accounting of the acquiree's net assets, the effects of subsequent measurement of those net assets (including amortisation of non-current assets that were recognised at its fair value), goodwill on consolidation and the consolidation adjustments. Therefore, the goodwill and equity (including non-controlling interest (NCI)) cannot be computed by considering the deemed cost exemption for PPE. However, the entity may adopt the deemed cost exemption for its property, plant and equipment other than those acquired through business combinations.

2. In the instant case, X Ltd. is using revaluation model for property, plant and equipment for the first annual Ind AS financial statements and using fair value of property, plant and equipment on the date of the transition, as deemed cost. Since the entity is using fair value at the transition date as well as in the first Ind AS financial statements, there is no change in accounting policy and mere use of the term 'deemed cost' would not mean that there is a change in accounting policy.

3. Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Ind AS 101 gives an option to continue the existing accounting policy. Hence, Y Ltd. may opt for discontinuation of accounting policy as per previous GAAP and follow the requirements of Ind AS 21. The cumulative amount lying in the Foreign Currency Monetary Item Translation Difference Account (FCMITDA) as per AS 11 should be derecognised by an adjustment against retained earnings on the date of transition.
4. Ind AS 101 permits to continue with the carrying value for all of its property, plant and equipment as per the previous GAAP and use that as deemed cost for the purposes of first time adoption of Ind AS. Accordingly, the carrying value of property, plant and equipment as per previous GAAP as at the date of transition need not be adjusted for the exchange fluctuations capitalized to property, plant and equipment. Separately, it allows a company to continue with its existing policy for accounting for exchange differences arising from translation of long term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Accordingly, given that Ind AS 101 provides these two choices independent of each other, it may be possible for an entity to choose the deemed cost exemption for all of its property, plant and equipment and not elect the exemption of continuing the previous GAAP policy of capitalising exchange fluctuation to property, plant and equipment. In such a case, in the given case, a harmonious interpretation of the two exemptions would require the company to recognise the property, plant and equipment at the transition date at the previous GAAP carrying value (without any adjustment for the exchanges differences capitalized under previous GAAP) but for the purposes of the first (and all subsequent) Ind AS financial statements, foreign exchange fluctuation on all long term foreign currency borrowings that arose after the transition date would be recognised in the statement of profit and loss.
5. As per paras D31AA and D31AB of Ind AS 101, when changing from proportionate consolidation to the equity method, an entity shall recognise its investment in the joint venture at transition date to Ind AS.

That initial investment shall be measured as the aggregate of the carrying amounts of the assets and liabilities that the entity had previously proportionately consolidated, including any goodwill arising from acquisition. If the goodwill previously belonged to a larger cash-generating unit, or to a group of cash-generating units, the entity shall allocate goodwill to the joint venture on the basis of the **relative** carrying amounts of the joint venture and the cash-generating unit or group of cash-generating units to which it belonged. The balance of the investment in joint venture at the date of transition to Ind AS, determined in accordance with paragraph D31AA above is regarded as the deemed cost of the investment at initial recognition.

Accordingly, the deemed cost of the investment will be

Property, Plant & Equipment	1,200
Goodwill (Refer Note below)	119
Long Term Loans & Advances	405
Trade Receivables	280
Other Current Assets	<u>50</u>
Total Assets	2,054
Less: Trade Payables	75
Short Term Provisions	<u>35</u>
Deemed cost of the investment in JV	<u>1,944</u>

Calculation of proportionate goodwill share of Joint Venture ie ABC Pvt. Ltd.

Property, Plant & Equipment	22,288
Goodwill	1,507
Long Term Loans & Advances	6,350
Trade Receivables	1,818
Other Current Assets	<u>104</u>
Total Assets	32,067
Less: Trade Payables	8,455
Short Term Provisions	<u>475</u>
	<u>23,137</u>

Note: Only those assets and liabilities have been taken into account for calculation of 'proportionate goodwill share of Joint Venture', which were given in the question as 'proportionate share of assts and liabilities of ABC Ltd. added to XYZ Ltd.'

Proportionate Goodwill of Joint Venture

$$= [(Goodwill \text{ on consolidation of subsidiary and JV} / \text{Total relative net asset}) \times \text{Net asset of JV}]$$

$$= (1507 / 23,137) \times 1825 = 119 \text{ (approx.)}$$

Accordingly, the proportional share of assets and liabilities of Joint Venture will be removed from the respective values assets and liabilities appearing in the balance sheet on 31.3.20X1 and Investment in JV will appear under non-current asset in the transition date balance sheet as on 1.4.20X1.

Adjustments made in previous GAAP balance sheet to arrive at Transition date Ind AS Balance Sheet

Transition Date Ind AS Balance Sheet of XYZ Pvt. Ltd. as at 1st April, 20X1

Particulars	Previous GAAP	Ind AS Adjustment	Ind AS GAAP
Non-Current Assets			
Property, Plant & Equipment	22,288	(1,200)	21,088
Investment Property	5,245	-	5,245
Intangible assets - Goodwill on Consolidation	1,507	(119)	1,388
Financial Assets			
Long Term Loans & Advances	6,350	(405)	5,945
Non- current investment in JV	-	1,944	1,944
Current Assets	-		
Financial Assets			
Investments	3,763	-	3,763
Trade Receivables	1,818	(280)	1,538
Other Current Assets	104	(50)	54
Total	41,075	(110)	40,965
Equity and liabilities			
Equity			
Share Capital	7,953	-	7,953
Other equity	16,597	-	16,597
Non-Current Liabilities			
Financial Liabilities			
Borrowings	1,000		1,000
Long Term Provisions	691		691
Other Long-Term Liabilities	5,904		5,904
Current Liabilities			
Financial Liabilities			
Trade Payables	8,455	(75)	8,380
Short Term Provisions	475	(35)	440
Total	41,075	(110)	40,965

6. Computation of balance total equity as on 1st April, 20X1 after transition to Ind AS

			₹ in crore
Share capital- Equity share Capital			80
Other Equity			
General Reserve		40	
Capital Reserve		5	
Retained Earnings (95-5-40)	50		
Add: Increase in value of land (10-4.5)	5.5		
Add: De recognition of proposed dividend (0.6 + 0.18)	0.78		
Add: Increase in value of Investment	<u>0.75</u>	<u>57.03</u>	<u>102.03</u>
Balance total equity as on 1st April, 20X1 after transition to Ind AS			<u>182.03</u>

Reconciliation between Total Equity as per AS and Ind AS to be presented in the opening balance sheet as on 1st April, 20X1

		₹ in crore
Equity share capital		80
Redeemable Preference share capital		<u>25</u>
		105
Reserves and Surplus		<u>95</u>
Total Equity as per AS		200
Adjustment due to reclassification		
Preference share capital classified as financial liability		(25)
Adjustment due to derecognition		
Proposed Dividend not considered as liability as on 1 st April 20X1		0.78
Adjustment due to remeasurement		
Increase in the value of Land due to remeasurement at fair value	5.5	
Increase in the value of investment due to remeasurement at fair value	<u>0.75</u>	<u>6.25</u>
Equity as on 1st April, 20X1 after transition to Ind AS		<u>182.03</u>

7. 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, 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.

Where it is concluded that the contributions are in the nature of shareholder contributions and are recognised in capital reserve under previous GAAP, the provisions of paragraph 10 of Ind AS 101 would be applied which states that except in certain cases, an entity shall in its opening Ind AS Balance Sheet:

- (a) recognise all assets and liabilities whose recognition is required by Ind AS;
- (b) not recognise items as assets or liabilities if Ind AS do not permit such recognition;
- (c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS; and
- (d) apply Ind AS in measuring all recognised assets and liabilities.

Accordingly, as per the above requirements of paragraph 10(c) in the given case, contributions recognised in the Capital Reserve should be transferred to appropriate category under 'Other Equity' at the date of transition to Ind AS.

[illegible]

ANALYSIS OF FINANCIAL STATEMENTS

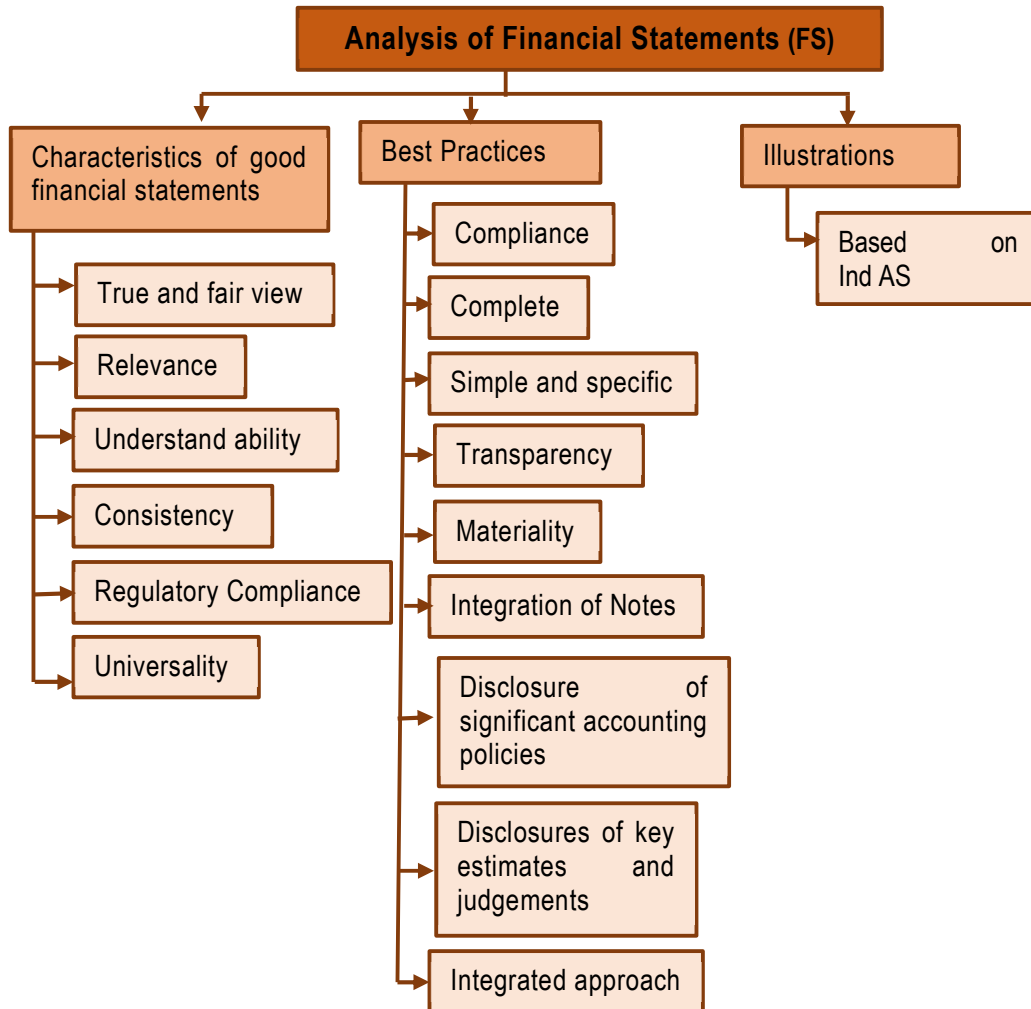


LEARNING OUTCOMES

After studying this chapter, you would be able to:

- ☐ Examine the key features of the financial statements and its relevancy for better reporting.
- ☐ Examine the key factors to be kept in mind in the preparation of financial statements.
- ☐ Follow the best practices in the preparation of financial statements.
- ☐ Analyse the common mistakes incurred by the preparers of the financial statements in the presentation of financial statements with respect to Schedule III.
- ☐ Rectify the mistakes found in the financial statements by addressing the issues and prescribing the correct presentation and disclosures.

CHAPTER OVERVIEW





1. INTRODUCTION

Business is important organ of society that helps in its overall development. A typical business has a variety of stakeholder that include its employees, owners, banks, trade associations, government, general public and so on. These stakeholders, particularly investors are keenly interested in knowing about the financial well-being of business organisations.

Financial reporting is an important means of communication for entities to disseminate information of its operations to various stakeholders. With the increased focus on governance the significance of financial reporting has exponentially increased. The importance of robust financial reporting cannot be emphasized enough. As India and Indian enterprises move ahead in the growth path at much faster pace and exposure of Indian entities to global environment expands, ever increasing complexities of transactions throws up newer challenges in financial reporting and related guidance. Presentation and disclosures, in this context, are assuming greater significance as enterprises aim to achieve excellence in financial reporting. Today, there are a number of requirements mandated by the regulators. It has now become imperative for entities to keep pace with the fast evolving requirements in the area of financial reporting.

The financial statements are a source of critical communication between an entity and the investors and other stakeholders. They act as the barometer to assess the performance, both past and future, for any enterprise. Decades back when enterprises were mostly proprietary owned, the financial statements were simpler in content and were presented annually just to provide the historical data. However, with globalization and increased dependence on technology, where companies are expanding both horizontally and vertically, many even spanning across geographies; the number of stakeholders – be it be investors, suppliers, employees, or even tax authorities, have increased manifold.

The financial statements are supplemented with the disclosures which are the key source of information and help the users in interpreting the financial statements in a better manner in taking appropriate decisions. Therefore, one can say that disclosures are added for good reasons. Disclosures are not the only requirement which will make a financial statement to be a good financial statement. The presentation and the compliance of formats are also the important factors which are taken into consideration in the evaluation of a financial statement.

This chapter enumerates some of the practices currently being followed in financial reporting and sets out suggested 'best practice' to enhance the quality of financial reporting to enable preparers of financial statements in benchmarking their financial statements. It intends to bring to the notice of the preparers and reviewers of the financial statements some common errors or omissions which they shall avoid while preparing the financial statements.



2. FINANCIAL STATEMENTS OF CORPORATE ENTITIES

The format and content of the financial statements for companies is required to be in accordance with Schedule III to the Companies Act, 2013. Further, there are several additional disclosure requirements both with respect to the balance sheet and statement of profit and loss.

Certain industries have formats specified by their industry regulators, which need to be followed by them. This fact has also been recognised in the Companies Act, 2013 in the proviso to Section 129(1) which implies that the format set out in Schedule III will not be applicable to insurance companies and banking companies. The formats for these companies are prescribed by specific regulators.

In terms of format, Schedule III only prescribes the vertical format of balance sheet and does not provide the alternative of using the horizontal format. Further, Schedule III sets out the minimum requirements for disclosure on the face of the balance sheet and the statement of profit and loss. It allows line items, sub-line items and sub-totals to be presented as an addition or substitution on the face of the financial statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Standards. Schedule III now requires all disclosures to be made as a part of the notes.

Apart from granting an overriding status to the Standards, cognizance has also been given to the requirements of Standards in the format of the balance sheet and accordingly elements such as deferred tax assets and intangible assets have been included in the balance sheet. Also, it has been clearly stated that the disclosure requirements specified in Part I and Part II or Part III of the Schedule III are in addition to and not in substitution of the disclosure requirements specified in the respective notified Standards. The terms used in Schedule III are to be considered as per the respective notified Standards.

One of the pertinent aspects which needs to be considered in the preparation of financial statements with regard to Schedule III is that it does not prescribe the accounting treatment to be adopted by the entity; it only prescribes the format and content. Consequently, the fact that a particular item has been included in the format of the balance sheet in Schedule III does not imply that the particular item can be recognized in the balance sheet. Schedule III prescribes only presentation and not treatment which is a subject matter of Standards, which has also been specifically acknowledged in Schedule III.



3. CHARACTERISTICS OF GOOD FINANCIAL STATEMENTS

In the Indian scenario, the ICAI has been the recognized accounting body issuing generally accepted accounting policies and has made the standards mandatory for enterprises operating within India. Besides Accounting Standards, ICAI has also issued the converged set of Ind AS

that is adopted and notified by MCA, and many large entities have already implemented it or are in the transition phase for adoption (depending on the net worth or other specified criteria).

The key features to any set of financial statements are:

1. **True and fair view of the affairs of the enterprise:** This is the most important feature of any set of financial statements. The user of the financial statements depends fully on the same and hence the reliability factor is supreme.
2. **Relevance:** The financial statements should provide the relevant information for the period it is presented. There is no point in presenting historical data of past several years that are redundant as of date. The key here is that the user of the financial statements should be in a position to take independent decision after reading the financial statements. This decision can be different for different users – for an investor the decision whether to hold the shares of the enterprise will stem from the set of statements, for a senior employee of the company it can be the future growth prospects of the company etc. But what is important is that the users should be empowered to make decisions through the financial statements
3. **Understandability:** For the user to make sense, the financial statements should be readable and content lucid to digest. Even a layman should be able to read the same, and understand the basic information, if not the accounting policies and procedures.
4. **Consistency:** The users of the financial statements will be benefitted only if the statements are released in periodic intervals and in standard formats. Else, the entire purpose of furnishing financials will be defeated. That is the reason that laws are prescribed for presentation formats and periodicity.
5. **Regulatory Compliance:** Needless to say, the tax authorities, market regulators etc. rely hugely on financial statements to understand and gauge the compliances met by the enterprise.
6. **Universality:** Last but not the least; the financial statements should be comparable both within the industry and outside. So financial statements by two different companies should look in similar lines if both are engaged in, say, manufacturing steel. Likewise, the financials of a company manufacturing steel in India should be comparable to the set of financial statements of a company based out of US engaged in the similar line of business.

The need to have the above key characteristics have brought the accounting bodies world over to come together to have a set of common standards for better integration and harmonization of accounting principles and practices.



4. BEST PRACTICES - APPLICABLE TO ALL COMPANIES

Following are some of the practices, if followed by the preparers of the financial statements, it would lead to better presentation and disclosure and will also serve the meaningful purpose for various stakeholders in understanding the functioning, financial position and financial performance of the entity and in appropriate decision making:

1. Compliance

Financial reporting is a regulated activity and compliance with the requirements is a must. Comply with the standards and regulations but also ensure your financial statements are an effective part of your wider communication with your stakeholders. It should be simple and understandable without any change in the interpretation.

2. Complete

The information disclosed in the financial statements should be complete and should not lead to any further cross questioning in the mind of the users. Ensure consistency of disclosures across the financial statements.

Example :

Where the accounting policy states that “Balances of debtors, creditors and loans and advances are subject to reconciliations and confirmations”. This indicates that these

balances may or may not be appropriately stated as well as raising questions regarding the appropriateness of the audit process.

3. Simple and specific

- Draft your notes, accounting policies, commentary on more complex areas in simple and plain English. Ensuring that there are no vague or ambiguous notes.

Example :

The definition of a derivative and a hedged item and how the company uses such items:

“A derivative is a type of financial instrument the company uses to manage risk. It is something that derives its value based on an underlying asset. It's generally in the form of a contract between two parties entered into for a fixed period. Underlying variables, such as exchange rates, will cause its value to change over time. A hedge is where the company uses a derivative to manage its underlying exposure. The company's main exposure is to fluctuation in foreign exchange risk. We manage this risk by hedging forex movements, in effecting the boundaries of exchange rate changes to manageable, affordable amounts.”

- Make your policies clear and specific.
- Ensure that there should not be any vague or ambiguous notes, with no further information or explanation which may lead to misinterpretation of information.
- Reduce generic disclosures and focus on company specific disclosures that explain how the company applies the policies.

Example :

A note stated “Land not registered in the name of the company has been given for the use of group companies”. However, there are no disclosures regarding such lease elsewhere in the financial statements. This leads to ambiguity regarding whether the land has been capitalized in the books of account or not.

A better disclosure would be to include this note in the note relating to ‘Property, plant and Equipment’ with an asterisk against land and a note which states “Land includes area measuring XX acres, towards which the registration process is still in progress. This land has been given on lease to group companies.”

4. Transparency

In preparation of financial statements many a times certain assumptions, or other bases are taken. Disclose those assumptions and bases transparently, so that they users are not misled. Rather such transparency shall provide useful additional information and substantiate your decision/judgement.

5. Materiality

- The lack of clarity in how to apply the concept of materiality is perceived to be one of the main drivers for overloaded financial statements. Make effective use of materiality to enhance the clarity and conciseness of your financial statements.
- Information should only be disclosed if it is material. It is material if it could influence users' decisions which are based on the financial statements.
- Your materiality assessment is the 'filter' in deciding what information to disclose and what to omit.
- Once you have determined which specific line items require disclosure, you should assess what to disclose about these items, including how much detail to provide and how best to organise the information.

Example: Capital Commitments

A company has committed to purchase several items of property, plant and equipment. Individually each purchase is immaterial. However, the total amounts to a material commitment for the company and therefore some disclosure should be made regarding this commitment.

Example : New Revenue Stream

A company in the software sector has communicated to its stakeholders a strategic intention to focus its new development efforts in cloud-based solutions. In a particular financial year cloud-based revenues are less than 5% of the total but have grown rapidly. The company therefore decides to provide separate disclosure about this revenue stream in accordance with Ind AS 108 'Operating Segments' even though other revenue streams of similar size are typically combined into 'other revenue.'

6. Integration of Notes

- Notes cover the largest portion of the financial statements. They are an effective tool of communication and have the greatest impact on the effectiveness of your financial statements.
- Group notes into categories, place the most critical information more prominently or a combination of both.
- Integrate your main note of a line item with its accounting policy and any relevant key estimates and judgements.

Example: Inventories

1. Accounting Policy

Inventories are stated at the lower of cost and net realisable value. Cost includes all expenses directly attributable to the manufacturing process as well as suitable portions

of related production overheads, based on normal operating capacity. Costs of ordinarily interchangeable items are assigned using the first in, first out cost formula. Net realisable value is the estimated selling price in the ordinary course of business less any applicable selling expenses.

2. Significant Estimation of Uncertainty

Management estimates the net realisable values of inventories, taking into account the most reliable evidence available at each reporting date. The future realisation of these inventories may be affected by future technology or other market-driven changes that may reduce future selling prices.

3. Inventories consist of the following:	(₹ in crores)	
	31 st March, 20X2	31 st March, 20X1
Raw materials and consumables	7,000	6,000
Merchandise	<u>11,000</u>	<u>9,000</u>
	<u>18,000</u>	<u>15,000</u>

- Ensuring that the accounting policies are disclosed in one place and not scattered across various notes.

For example, in one case it was observed that the policy of recognizing 100% depreciation on assets costing less than ₹ 5,000 was specified in the note on fixed assets, rather than in the accounting policy for fixed assets.

7. Disclosure of Material Accounting Policies

- The financial statements should disclose your material accounting policies. Disclose only your material accounting policies – remove your non-material disclosures that do not add any value.
- Your disclosures should be relevant, specific to your company and explain how you apply your policies.
- The aim of accounting policy disclosures is to help your investors and other stakeholders to properly understand your financial statements.
- Use judgement to determine whether your accounting policies are material, considering not only the materiality of the balances or transactions affected by the policy but also other factors including the nature of the company's operations.

Example:

Taxable temporary differences arise on certain brands and licenses that were acquired in past business combinations. Management considers that these assets have an indefinite

life and are expected to be consumed by use in the business. For these assets deferred tax is recognised using the capital gains tax applicable on sale.

8. Disclosures of Key Estimates and Judgements

- Effective disclosures about the most important estimates and judgements enable investors to understand your financial statements.
- Focus on the most difficult, subjective and complex estimates.
- Include details of how the estimate was derived, key assumptions involved, the process for reviewing and an analysis of its sensitiveness.
- Provide sufficient background information on the judgement, explain how the judgement was made and the conclusion reached.

9. Integrated Approach

- Financial statements are just one part of your communication with the stakeholders. An annual report typically includes financial statements, a management commentary and information about governance, strategy and business developments, CSR Reporting, Business Responsibility Reporting etc. There is also a growing trend towards integrated reporting.
- To ensure overall effective communication consider the annual report as a whole and deliver a consistent and coherent message throughout.
- Ind AS 1 also acknowledges that one may present, outside the financial statements, a financial review that describes and explains the main features of the company's financial performance and financial position, and the principal uncertainties it faces.
- Many companies also present, outside the financial statements, reports and statements such as environmental reports and value added statements, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group.
- Even though the reports and statements presented outside financial statements are outside the scope of AS / Ind AS, they are not out of the scope of regulation.

Example :

CSR disclosures, as required by the Companies Act, 2013. in section 134 and Schedule VII.



5. CASE STUDIES BASED ON IND AS

Case Study 1

On 1 April 20X1, Star Limited has advanced a housing loan of ₹ 15 lakhs to one of its employees at an interest rate of 6% per annum which is repayable in 5 equal annual installments along with interest at each year end. Employee is not required to give any specific performance against this benefit. The market rate of similar loan for housing finance by banks is 10% per annum.

The accountant of the company has recognized the staff loan in the balance sheet equivalent to the amount of housing loan disbursed i.e. ₹ 15 lakhs. The interest income for the year is recognized at the contracted rate in the Statement of Profit and Loss by the company i.e. ₹ 90,000 (6% of ₹ 15 lakhs).

Analyze whether the above accounting treatment made by the accountant is in compliance with the relevant Ind AS. If not, advise the correct treatment of housing loan, interest and other expenses in the financial statements of Star Limited for the year 20X1-20X2 along with workings and applicable Ind AS.

You are required to explain how the housing loan should be reflected in the Ind AS compliant Balance Sheet of Star Limited on 31 March 20X2.

Solution

The accounting treatment made by the accountant is not in compliance with Ind AS 109 'Financial Instruments'. As per Ind AS 109, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value. The fair value of a financial instrument at initial recognition is normally the transaction price i.e. the fair value of the consideration given or received.

After initial recognition, an entity shall measure a financial asset either at amortised cost or at fair value through profit and loss or fair value through other comprehensive income.

Here, the loan given to employee is not at market rate. Hence, the fair value of the loan will not be equal to its initial loan proceeds. As per Ind AS 109, a financial instrument is initially measured and recorded in the books at its fair value. Further, interest income to be recognised in the Statement of Profit and Loss will be the finance income recognised at effective rate of interest i.e. @ 10% and not the rate of interest charged by the company i.e. @ 6%.

The correct accounting treatment as per Ind AS 109 will be as under:

For measuring the fair value or present value of the loan at initial recognition, market rate of interest of similar loan is considered (level 1 observable input) ie @ 10%, to discount the cash outflows.

The fair value of the loan shall be as follows:

Date	Outstanding loan	Principal	Interest income @ 6%	Total inflow	Discount factor @ 10%	PV
31 March 20X2	15,00,000	3,00,000	90,000	3,90,000	0.909	3,54,510
31 March 20X3	12,00,000	3,00,000	72,000	3,72,000	0.826	3,07,272
31 March 20X4	9,00,000	3,00,000	54,000	3,54,000	0.751	2,65,854
31 March 20X5	6,00,000	3,00,000	36,000	3,36,000	0.683	2,29,488
31 March 20X6	3,00,000	3,00,000	18,000	3,18,000	0.621	1,97,478
Fair value of the loan						13,54,602

As per Ind AS 19, employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for termination of employment. Difference of loan proceeds and present value of the loan (fair value) will be treated as prepaid employee cost irrespective of the fact that employee is not required to give any specific performance against this benefit. This is because employee is required to be in service of the company to continue availing the benefits of concessional rate of interest on housing loan. Practically, once the employee leaves the organisation, they have to repay the outstanding loan because the company provides the loan at concessional rate of interest only to its employees.

Hence, it is an employee benefit given by the company to its employees. This deemed employee cost of ₹ 1,45,398 (15,00,000 – 13,54,602) will be deferred and amortised over the period of loan on straight line basis.

Calculation of amortised cost of loan to employees

Financial year ending on 31 March	Amortised cost (opening balance)	Interest to be recognised @ 10%	Repayment (including interest)	Amortised cost (closing balance)
20X2	13,54,602	1,35,460	3,90,000	11,00,062
20X3	11,00,062	1,10,006	3,72,000	8,38,068
20X4	8,38,068	83,807	3,54,000	5,67,875
20X5	5,67,875	56,788	3,36,000	2,88,663
20X6	2,88,663	29,337*	3,18,000	-

* $2,88,663 \times 10\% = ₹ 28,866$. Difference of ₹ 471 (29,337 – 28,866) is due to approximation in computation.

Journal Entries to be recorded at every period end:

1. On 1 April 20X1

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan to employee A/c	Dr.	13,54,602	
Prepaid employee cost A/c	Dr.	1,45,398	
To Bank A/c			15,00,000
(Being loan asset recorded at initial fair value)			

2. On 31 March 20X2

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	3,90,000	
To Finance income A/c (profit and loss) @10%			1,35,460
To Loan to employee A/c			2,54,540
(Being first instalment of repayment of loan accounted for using the amortised cost and effective interest rate @ 10%)			
Employee benefit cost (profit and loss) A/c Dr.		29,080	
To Prepaid employee cost A/c (1,45,398/5)			29,080
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)			

The Following housing loan balances should appear in the financial statements:

Extracts of Balance sheet of Star Ltd. as at 31 March 20X2

Non-current asset	
Financial asset	
Loan to employee (11,00,062 – 3,72,000 + 1,10,006)	8,38,068
Other non-current asset	
Prepaid employee cost	87,238
Current asset	
Financial asset	
Loan to employee (3,72,000-1,10,006)	2,61,994
Other current asset	
Prepaid employee cost	29,080

Deferred tax on temporary differences arising on the above-mentioned account balances (appearing in the balance sheet) should be recognised. However, in the absence of any tax rate in the question no deferred tax has been recognised.

Case Study 2

Pluto Ltd. has purchased a manufacturing plant for ₹ 6 lakhs on 1st April, 20X1. The useful life of the plant is 10 years. On 30th September, 20X3, Pluto temporarily stops using the manufacturing plant because demand has declined. However, the plant is maintained in a workable condition and it will be used in future when demand picks up.

The accountant of Pluto Ltd. decided to treat the plant as held for sale until the demands picks up and accordingly measures the plant at lower of carrying amount and fair value less cost to sell.

Also, the accountant has also stopped charging the depreciation for the rest of period considering the plant as held for sale. The fair value less cost to sell on 30th September, 20X3 and 31st March, 20X4 was ₹ 4 lakhs and ₹ 3.5 lakhs respectively.

The accountant has performed the following working: ₹

Carrying amount on initial classification as held for sale		
Purchase Price of Plant	6,00,000	
Less: Accumulated dep (6,00,000/ 10 Years) x 2.5 years	<u>(1,50,000)</u>	4,50,000
Fair Value less cost to sell as on 30 th September, 20X3		4,00,000
The value will be lower of the above two		4,00,000

Balance Sheet extracts as on 31st March, 20X4

Assets	
Current Assets	
Other Current Assets	
Assets classified as held for sale	3,50,000

Analyse whether the above accounting treatment made by the accountant is in compliance with the Ind AS. If not, advise the correct treatment alongwith the necessary workings.

Solution:

The above treatment needs to be examined in the light of the provisions given in Ind AS 16 'Property, Plant and Equipment' and Ind AS 105 'Non-current Assets Held for Sale and Discontinued Operations'.

Para 6 of Ind AS 105 'Non-current Assets Held for Sale and Discontinued Operations' states that:

"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".

Paragraph 7 of Ind AS 105 states that:

"For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable. 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".

Further, paragraph 8 of Ind AS 105 states that:

"For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn."

Paragraph 13 of Ind AS 105 states that:

"An entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned. This is because its carrying amount will be recovered principally through continuing use."

Paragraph 14 of Ind AS 105 states that:

"An entity shall not account for a non-current asset that has been temporarily taken out of use as if it had been abandoned."

Paragraph 55 of Ind AS 16 states that:

"Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated."

Going by the guidance given above,

The Accountant of Pluto Ltd. has treated the plant as held for sale and measured it at the fair value less cost to sell. Also, the depreciation has not been charged thereon since the date of classification as held for sale which is not correct and not in accordance with Ind AS 105 and Ind AS 16.

Accordingly, the manufacturing plant should neither be treated as abandoned asset nor as held for sale because its carrying amount will be principally recovered through continuous use. Pluto Ltd. shall not stop charging depreciation or treat the plant as held for sale because its carrying amount will be recovered principally through continuing use to the end of their economic life.

The working of the same for presenting in the balance sheet is given as below:

Calculation of carrying amount as on 31 st March, 20X4	
Purchase Price of Plant	6,00,000
Less: Accumulated depreciation (6,00,000/ 10 Years) x 3 Years	<u>(1,80,000)</u>
	4,20,000
Less: Impairment loss	<u>(70,000)</u>
	<u>3,50,000</u>

Balance Sheet extracts as on 31st March, 20X4

Assets	
Non-Current Assets	
Property, Plant and Equipment	3,50,000

Working Note:

Fair value less cost to sell of the Plant = ₹ 3,50,000

Value in Use (not given) or = Nil (since plant has temporarily not been used for manufacturing due to decline in demand)

Recoverable amount = higher of above i.e. ₹ 3,50,000

Impairment loss = Carrying amount – Recoverable amount

Impairment loss = ₹ 4,20,000 - ₹ 3, 50,000 = ₹ 70,000.

Case Study 3

On 5th April, 20X2, fire damaged a consignment of inventory at one of the Jupiter's Ltd.'s warehouse. This inventory had been manufactured prior to 31st March, 20X2 costing ₹ 8 lakhs. The net realisable value of the inventory prior to the damage was estimated at ₹ 9.60 lakhs. Because of the damage caused to the consignment of inventory, the company was required to

spend an additional amount of ₹ 2 lakhs on repairing and re-packaging of the inventory. The inventory was sold on 15th May, 20X2 for proceeds of ₹ 9 lakhs.

The accountant of Jupiter Ltd treats this event as an adjusting event and adjusted this event of causing the damage to the inventory in its financial statement and accordingly re-measures the inventories as follows:

	₹ lakhs
Cost	8.00
Net realisable value (9.6 -2)	7.60
Inventories (lower of cost and net realisable value)	7.60

Analyse whether the above accounting treatment made by the accountant in regard to financial year ending on 31.0.20X2 is in compliance of the Ind AS. If not, advise the correct treatment alongwith working for the same.

Solution:

The above treatment needs to be examined in the light of the provisions given in Ind AS 10 'Events after the Reporting Period' and Ind AS 2 'Inventories'.

Para 3 of Ind AS 10 'Events after the Reporting Period' defines "Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue. Two types of events can be identified:

- those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and
- those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

Further, paragraph 10 of Ind AS 10 states that:

"An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period".

Further, paragraph 6 of Ind AS 2 defines:

"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".

Further, paragraph 9 of Ind AS 2 states that:

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

Accountant of Jupiter Ltd. has re-measured the inventories after adjusting the event in its financial statement which is not correct and nor in accordance with provision of Ind AS 2 and Ind AS 10.

Accordingly, the event causing the damage to the inventory occurred after the reporting date and as per the principles laid down under Ind AS 10 '*Events After the Reporting Date*' is a non-adjusting event as it does not affect conditions at the reporting date. Non-adjusting events are not recognised in the financial statements, but are disclosed where their effect is material.

Therefore, as per the provisions of Ind AS 2 and Ind AS 10, the consignment of inventories shall be recorded in the Balance Sheet at a value of ₹ 8 Lakhs calculated below: ₹ lakhs

Cost	8.00
Net realisable value	9.60
Inventories (lower of cost and net realisable value)	8.00

Case Study 4

On 1st April, 20X1, Sun Ltd. has acquired 100% shares of Earth Ltd. for ₹ 30 lakhs. Sun Ltd. has 3 cash-generating units A, B and C with fair value of ₹ 12 lakhs, ₹ 8 lakhs and ₹ 4 lakhs respectively. The company recognizes goodwill of Rs 6 lakhs that relates to CGU 'C' only.

During the financial year 20X2-20X3, the CFO of the company has a view that there is no requirement of any impairment testing for any CGU since their recoverable amount is comparatively higher than the carrying amount and believes there is no indicator of impairment.

Analyse whether the view adopted by the CFO of Sun Ltd is in compliance of the Ind AS. If not, advise the correct treatment in accordance with relevant Ind AS

Solution

The above treatment needs to be examined in the light of the provisions given in Ind AS 36: Impairment of Assets.

Para 9 of Ind AS 36 '*Impairment of Assets*' states that "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 shall estimate the recoverable amount of the asset."

Further, paragraph 10(b) of Ind AS 36 states that:

"Irrespective of whether there is any indication of impairment, an entity shall also test goodwill acquired in a business combination for impairment annually."

Sun Ltd has not tested any CGU on account of not having any indication of impairment is partially correct i.e. in respect of CGU A and B but not for CGU C. Hence, the treatment made by the Company is not in accordance with Ind AS 36.

Accordingly, impairment testing in respect of CGU A and B are not required since there are no indications of impairment. However, Sun Ltd shall test CGU C irrespective of any indication of impairment annually as the goodwill acquired on business combination is fully allocated to CGU 'C'.

Case Study 5

Deepak started a new company Softbharti Pvt. Ltd. with Iktara Ltd. wherein investment of 55% is done by Iktara Ltd. and rest by Deepak. Voting powers are to be given as per the proportionate share of capital contribution. The new company formed was the subsidiary of Iktara Ltd. with two directors, and Deepak eventually becomes one of the directors of company. A consultant was hired and he charged ₹ 30,000 for the incorporation of company and to do other necessary statutory registrations. ₹ 30,000 is to be charged as an expense in the books after incorporation of company. The company, Softbharti Pvt. Ltd. was incorporated on 1st April 20X1.

The financials of Iktara Ltd. are prepared as per Ind AS.

An accountant who was hired at the time of company's incorporation, has prepared the draft financials of Softbharti Pvt. Ltd. for the year ending 31st March, 20X2 as follows:

Statement of Profit and Loss

Particulars	Amount (₹)
Revenue from operations	10,00,000
Other Income	<u>1,00,000</u>
Total Revenue (a)	<u>11,00,000</u>
Expenses:	
Purchase of stock in trade	5,00,000
(Increase)/Decrease in stock in trade	(50,000)
Employee benefits expense	1,75,000
Depreciation	30,000
Other expenses	<u>90,000</u>
Total Expenses (b)	<u>7,45,000</u>
Profit before tax (c) = (a)-(b)	<u>3,55,000</u>
Current tax	1,06,500
Deferred tax	<u>6,000</u>
Total tax expense (d)	<u>1,12,500</u>
Profit for the year (e) = (c) – (d)	<u>2,42,500</u>

Balance Sheet

Particulars	Amount (₹)
EQUITY AND LIABILITIES	
(1) Shareholders' Funds	
(a) Share Capital	1,00,000
(b) Reserves & Surplus	2,27,500
(2) Non-Current Liabilities	
(a) Long Term Provisions	25,000
(b) Deferred tax liabilities	6,000
(3) Current Liabilities	
(a) Trade Payables	11,000
(b) Other Current Liabilities	45,000
(c) Short Term Provisions	<u>1,06,500</u>
TOTAL	<u>5,21,000</u>
ASSETS	
(1) Non Current Assets	
(a) Property, plant and equipment (net)	1,00,000
(b) Long-term Loans and Advances	40,000
(c) Other Non Current Assets	50,000
(2) Current Assets	
(a) Current Investment	30,000
(b) Inventories	80,000
(c) Trade Receivables	55,000
(d) Cash and Bank Balances	1,15,000
(e) Other Current Assets	<u>51,000</u>
TOTAL	<u>5,21,000</u>

Additional information of Softbharti Pvt Ltd.:

- i. Deferred tax liability of ₹ 6,000 is created due to following temporary difference:

Difference in depreciation amount as per Income tax and Accounting profit

- ii. There is only one property, plant and equipment in the company, whose closing balance as at 31st March, 20X2 is as follows:

Asset description	As per Books	As per Income tax
Property, plant and equipment	₹ 1,00,000	₹ 80,000

- iii. Pre incorporation expenses are deductible on straight line basis over the period of five years as per Income tax. However, the same are immediately expensed off in the books.
- iv. Current tax is calculated at 30% on PBT - ₹ 3,55,000 without doing any adjustments related to Income tax. The correct current tax after doing necessary adjustments of allowances / disallowances related to Income tax comes to ₹ 1,25,700.
- v. After the reporting period, the directors have recommended dividend of ₹ 15,000 for the year ending 31st March, 20X2 which has been deducted from reserves and surplus. Dividend payable of ₹ 15,000 has been grouped under 'other current liabilities' alongwith other financial liabilities.
- vi. There are 'Government statutory dues' amounting to ₹ 15,000 which are grouped under 'other current liabilities'.
- vii. The capital advances amounting to ₹ 50,000 are grouped under 'Other non-current assets'.
- viii. Other current assets of ₹ 51,000 comprise Interest receivable from trade receivables.
- ix. Current investment of ₹ 30,000 is in shares of a company which was done with the purpose of trading; current investment has been carried at cost in the financial statements. The fair value of current investment in this case is ₹ 50,000 as at 31st March, 20X2.
- x. Actuarial gain on employee benefit measurements of ₹ 1,000 has been omitted in the financials of Softbharti private limited for the year ending 31st March, 20X2.

The financial statements for financial year 20X1-20X2 have not been yet approved.

You are required to ascertain that whether the financial statements of Softbharti Pvt. Ltd. are correctly presented as per the applicable financial reporting framework. If not, prepare the revised financial statements of Softbharti Pvt. Ltd. after the careful analysis of mentioned facts and information.

Solution

If Ind AS is applicable to any company, then Ind AS shall automatically be made applicable to all the subsidiaries, holding companies, associated companies, and joint ventures of that company, irrespective of individual qualification of set of standards on such companies.

In the given case it has been mentioned that the financials of Iktara Ltd. are prepared as per Ind AS. Accordingly, the results of its subsidiary Softbharti Pvt. Ltd. should also have been prepared as per Ind AS. However, the financials of Softbharti Pvt. Ltd. have been presented as per accounting standards (AS).

Hence, it is necessary to revise the financial statements of Softbharti Pvt. Ltd. as per Ind AS after the incorporation of necessary adjustments mentioned in the question.

The revised financial statements of Softbharti Pvt. Ltd. as per Ind AS and Division II to Schedule III of the Companies Act, 2013 are as follows:

STATEMENT OF PROFIT AND LOSS
for the year ended 31st March, 20X2

Particulars	Amount (₹)
Revenue from operations	10,00,000
Other Income (1,00,000 + 20,000) (refer note -1)	1,20,000
Total Revenue	<u>11,20,000</u>
Expenses:	
Purchase of stock in trade	5,00,000
(Increase) / Decrease in stock in trade	(50,000)
Employee benefits expense	1,75,000
Depreciation	30,000
Other expenses	90,000
Total Expenses	<u>7,45,000</u>
Profit before tax	<u>3,75,000</u>
Current tax	1,25,700
Deferred tax (W.N.1)	4,800
Total tax expense	<u>1,30,500</u>
Profit for the year (A)	<u>2,44,500</u>
OTHER COMPREHENSIVE INCOME	
Items that will not be reclassified to Profit or Loss:	
Remeasurements of net defined benefit plans	1,000
Tax liabilities relating to items that will not be reclassified to Profit or Loss	
Remeasurements of net defined benefit plans (tax) [1000 x 30%]	<u>(300)</u>
Other Comprehensive Income for the period (B)	<u>700</u>
Total Comprehensive Income for the period (A+B)	<u>2,45,200</u>

BALANCE SHEET

as at 31st March, 20X2

Particulars	(₹)
ASSETS	
Non-current assets	
Property, plant and equipment	1,00,000
Financial assets	

Other financial assets (Long-term loans and advances)	40,000
Other non-current assets (capital advances) (refer note-2)	50,000
Current assets	
Inventories	80,000
Financial assets	
Investments (30,000 + 20,000) (refer note -1)	50,000
Trade receivables	55,000
Cash and cash equivalents/Bank	1,15,000
Other financial assets (Interest receivable from trade receivables)	51,000
TOTAL ASSETS	5,41,000
EQUITY AND LIABILITIES	
Equity	
Equity share capital	1,00,000
Other equity	2,45,200
Non-current liabilities	
Provision (25,000 – 1,000)	24,000
Deferred tax liabilities (4800 + 300)	5,100
Current liabilities	
Financial liabilities	
Trade payables	11,000
Other financial liabilities (Refer note 5)	15,000
Other current liabilities (Govt. statutory dues) (Refer note 3)	15,000
Current tax liabilities	1,25,700
TOTAL EQUITY AND LIABILITIES	5,41,000

STATEMENT OF CHANGES IN EQUITYFor the year ended 31st March, 20X2**A. EQUITY SHARE CAPITAL**

	Balance (₹)
As at 31 st March, 20X1	-
Changes in equity share capital during the year	<u>1,00,000</u>
As at 31 st March, 20X2	<u>1,00,000</u>

B. OTHER EQUITY

	Reserves & Surplus
	Retained Earnings (₹)
As at 31 st March, 20X1	-
Profit for the year	2,44,500
Other comprehensive income for the year	700
Total comprehensive income for the year	2,45,200
Less: Dividend on equity shares (refer note – 4)	-
As at 31 st March, 20X2	<u>2,45,200</u>

DISCLOSURE FORMING PART OF FINANCIAL STATEMENTS:

Proposed dividend on equity shares is subject to the approval of the shareholders of the company at the annual general meeting and not recognized as liability as at the Balance Sheet date. (refer note 4)

Notes:

1. Current investment are held for the purpose of trading. Hence, it is a financial asset classified as FVTPL. Any gain in its fair value will be recognised through profit or loss. Hence, ₹ 20,000 (₹ 50,000 – ₹ 30,000) increase in fair value of financial asset will be recognised in profit and loss. However, it will attract deferred tax liability on increased value (Refer W.N).
2. Assets for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
3. Liabilities for which there is no contractual obligation to deliver cash or other financial asset to another entity, are not financial liabilities.
4. As per Ind AS 10, 'Events after the Reporting Period', If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognized as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with Ind AS 1, Presentation of Financial Statements.
5. Other current financial liabilities:

	(₹)
Balance of other current liabilities as per financial statements	45,000
Less: Dividend declared for FY 20X1 – 20X2 (Note – 4)	(15,000)
Reclassification of government statutory dues payable to 'other current liabilities'	<u>(15,000)</u>
Closing balance	<u>15,000</u>

Working Note:

Calculation of deferred tax on temporary differences as per Ind AS 12 for financial year 20X1 – 20X2

Item	Carrying amount (₹)	Tax base (₹)	Difference (₹)	DTA / DTL @ 30% (₹)
Property, Plant and Equipment	1,00,000	80,000	20,000	6,000-DTL
Pre-incorporation expenses	Nil	24,000	24,000	7,200-DTA
Current Investment	50,000	30,000	20,000	<u>6,000-DTL</u>
			Net DTL	<u>4,800-DTL</u>

Case Study 6

Mumbai Challengers Ltd., a listed entity, is a sports organization owning several cricket and hockey teams. The issues below pertain to the reporting period ending 31 March 20X2.

- (a) Owing to the proposed schedules of Indian Hockey League as well as Cricket Premier Tournament, Mumbai Challengers Ltd. needs a new stadium to host the sporting events. This stadium will form a part of the Property, Plant and Equipment of the company. Mumbai Challengers Ltd. began the construction of the stadium on 1 December, 20X1. The construction of the stadium was completed in 20X2-20X3. Costs directly related to the construction amounted to ₹ 140 crores in December 20X1. Thereafter, ₹ 350 crores have been incurred per month until the end of the financial year. The company has not taken any specific borrowings to finance the construction of the stadium, although it has incurred finance costs on its regular overdraft during the period, which were avoidable had the stadium not been constructed. Mumbai Challengers Ltd. has calculated that the weighted average cost of the borrowings for the period 1 December 20X1 to 31 March 20X2 amounted to 15% per annum on an annualized basis.

The company seeks advice on the treatment of borrowing costs in its financial statements for the year ending 31 March 20X2.

- (b) Mumbai Challengers Ltd. acquires and sells players' registrations on a regular basis. For a player to play for its team, Mumbai Challengers Ltd. must purchase registrations for that player. These player registrations are contractual obligations between the player and the company. The costs of acquiring player registrations include transfer fees, league levy fees, and player agents' fees incurred by the club.

At the end of each season, which happens to also be the reporting period end for Mumbai Challengers Ltd., the club reviews its contracts with the players and makes decisions as to whether they wish to sell/transfer any players' registrations. The company actively markets

these registrations by circulating with other clubs a list of players' registrations and their estimated selling price. Players' registrations are also sold during the season, often with performance conditions attached. In some cases, it becomes clear that a player will not play for the club again because of, for example, a player sustaining a career threatening injury or being permanently removed from the playing squad for any other reason. The playing registrations of certain players were sold after the year end, for total proceeds, net of associated costs, of ₹ 175 crores. These registrations had a net book value of ₹ 49 crores.

Mumbai Challengers Ltd. seeks your advice on the treatment of the acquisition, extension, review and sale of players' registrations in the circumstances outlined above.

- (c) Mumbai Challengers Ltd. measures its stadiums in accordance with the revaluation model. An airline company has approached the directors offering ₹ 700 crores for the property naming rights of all the stadiums for five years. Three directors are on the management boards of both Mumbai Challengers Ltd. and the airline. Additionally, statutory legislations regulate the financing of both the cricket and hockey clubs. These regulations prevent contributions to the capital from a related party which 'increases equity without repayment in return'. Failure to adhere to these legislations could lead to imposition of fines and withholding of prize money.

Mumbai Challengers Ltd. wants to know how to take account of the naming rights in the valuations of the stadium and the potential implications of the financial regulations imposed by the legislations.

Solution:

(a) Borrowing Costs

As per Ind AS 23 *Borrowing Costs*, an entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset (i.e. an asset that necessarily takes a substantial period of time to get ready for its intended use or sale) as part of the cost of that asset. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period.

The capitalization rate of the borrowings of Mumbai Challengers Ltd. during the period of construction is 15% per annum (as given in the question), and therefore, the total amount of borrowing costs to be capitalized is the expenditures incurred on the asset multiplied by the capitalization rate, which is as under:

Particulars	₹ in crores
Costs incurred in December 20X1: (₹ 140 crores x 15% x 4/12)	7.000
Costs incurred in January 20X2: (₹ 350 crores x 15% x 3/12)	13.125
Costs incurred in February 20X2: (₹ 350 crores x 15% x 2/12)	8.750
Costs incurred in March 20X2: (₹ 350 crores x 15% x 1/12)	4.375
Borrowing Costs to be capitalized in 20X1-X2	33.250

OR

Weighted average carrying amount of the stadium during 20X1-X2 is:

₹ (140 + 490 + 840 + 1,190) crores/4 = ₹ 665 crores

Applying the weighted average rate of borrowings of 15% per annum, the borrowing cost to be capitalized is computed as:

₹ 665 crores x (15% x 4/12) = ₹ 33.25 crores

(b) Players' Registrations

Acquisition

As per Ind AS 38 *Intangible Assets*, an entity should recognize an intangible asset where it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably. Accordingly, the **costs** associated with the acquisition of players' registrations would need to be **capitalized which would be the amount of cash or cash equivalent paid or the fair value of other consideration given to acquire such registrations**. In line with Ind AS 38 *Intangible Assets*, costs would include transfer fees, league levy fees, and player agents' fees incurred by the club, along with other directly attributable costs, if any. Amounts capitalized would be fully amortized over the period covered by the player's contract.

Sale of registrations

Player registrations would be classified as assets held for sale under Ind AS 105 *Non-Current Assets Held for Sale and Discontinued Operations* when their carrying amount is expected to be recovered principally through a sale transaction and a sale is considered to be highly probable. To consider a sale to be 'highly probable', the assets (in this case, player registrations) should be actively marketed for sale at a price that is reasonable in relation to its current fair value. In the given case, it would appear that the management is committed to a plan to sell the registration, that the asset is available for immediate sale and that an active plan to locate a buyer is already in place by circulating clubs. Ind AS 105 stipulates that it should be unlikely that the plan to sell the registrations would be significantly changed or withdrawn. To fulfil this requirement, it would be prudent if only

those registrations are classified as held for sale where unconditional offers have been received prior to the reporting date.

Once the conditions for classifying assets as held for sale in accordance with Ind AS 105 have been fulfilled, the player registrations would be stated at lower of carrying amount and fair value less costs to sell, with the carrying amount stated in accordance with Ind AS 38 prior to application of Ind AS 105, subjected to impairment, if any.

Profits and losses on sale of players' registrations would be computed by deducting the carrying amount of the players' registrations from the fair value of the consideration receivable, net of transactions costs. In case a portion of the consideration is receivable on the occurrence of a future performance condition (i.e. contingent consideration), this amount would be recognized in the Statement of Profit and Loss only when the conditions are met.

The players registrations disposed of, subsequent to the year end, for ₹ 175 crores, having a corresponding book value of ₹ 49 crores would be disclosed as a non-adjusting event in accordance with Ind AS 10 *Events after the Reporting Period*.

Impairment review

Ind AS 36 *Impairment of Assets* requires companies to **annually test their assets for impairment**. An asset is said to be impaired if the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is higher of the asset's fair value less costs to sell and its value in use (which is the present value of future cash flows expected to arise from the use of the asset). In the given scenario, it is not easy to determine the value in use of any player in isolation as that player cannot generate cash flows on his/her own unless via a sale transaction or an insurance recovery. Whilst any individual player cannot really be separated from the single cash-generating unit (CGU), being a cricket team or a hockey team in the instant case, there may be certain instances where a player is taken out of the CGU when it becomes clear that he/she will not play for the club again. If such circumstances arise, the **carrying amount of the player should be assessed against the best estimate of the player's fair value less any costs to sell and an impairment charge should be recognized in the profit or loss**, which reflects any loss arising.

(c) Valuation of stadiums

In terms of Ind AS 113 *Fair Value Measurement*, stadiums would be valued at the **price which would be received to sell the asset in an orderly transaction between market participants** at the measurement date (i.e. exit price). The price would be the one which **maximizes the value of the asset** or the group of assets using the principle of the highest and best use. The price would essentially use Level 2 inputs which are inputs other than quoted market prices included within Level 1 which are observable for the asset or liability, either directly or indirectly. Property naming rights present complications when valuing property. The status of the property indicates its suitability for inviting sponsorship attached

to its name. It has nothing to do with the property itself but this can be worth a significant amount. Therefore, Mumbai Challengers Ltd. could include the property naming rights in the valuation of the stadium and write it off over three years.

Ind AS 24 *Related Party Disclosures* lists the criteria for two entities to be treated as related parties. Such criteria include being members of the same group or where a person or a close member of that person's family is related to a reporting entity if that person has control or joint control over the reporting entity. Ind AS 24 deems that parties are not related simply because they have a director or a key manager in common. In this case, there are three directors in common and in the absence of any information to the contrary, it appears as though the entities are not related. However, the regulator will need to establish whether the sponsorship deal is a related party transaction for the purpose of the financial control provisions. There would need to be demonstrated that the airline may be expected to influence, or be influenced by, the club or a related party of the club. If the deal is deemed to be a related party transaction, the regulator will evaluate whether the sponsorship is at fair value or not.

Case Study 7

- (a) Neelanchal Gas Refinery Ltd. (hereinafter referred to as Neelanchal), a listed company, is involved in the production and trading of natural gas and oil. Neelanchal jointly owns an underground storage facility with another entity, Seemanchal Refineries Ltd. (hereinafter referred to as Seemanchal). Both the companies are engaged in extraction of gas from offshore gas fields, which they own and operate independently of each other. Neelanchal owns 60% of the underground facility and Seemanchal owns 40%. Both the companies have agreed to share services and costs accordingly, with decisions relating to the storage facility requiring unanimous agreement of the parties. The underground facility is pressurised so that the gas is pushed out when extracted. When the gas pressure is reduced to a certain level, the remaining gas is irrecoverable and remains in the underground storage facility until it is decommissioned. As per the laws in force, the storage facility should be decommissioned at the end of its useful life.

Neelanchal seeks your advice on the treatment of the agreement with Seemanchal as well as the accounting for the irrecoverable gas.

- (b) Neelanchal has entered into a ten-year contract with Uttaranchal Refineries Pvt. Ltd. (hereinafter referred to as Uttaranchal) for purchase of natural gas. Neelanchal has paid an advance to Uttaranchal equivalent to the total quantity of gas contracted for ten years based on the forecasted price of gas. This advanced amount carries interest at the rate of 12.5% per annum, which is settled by Uttaranchal way of supply of extra gas. The contract requires fixed quantities of gas to be supplied each month. Additionally, there is a price adjustment mechanism in the contract whereby the difference between the forecasted price of gas and the prevailing market price is settled in cash on a quarterly

basis. If Uttaranchal does not deliver the gas as agreed, Neelanchal has the right to claim compensation computed at the current market price of the gas.

Neelanchal wants to account for the contract with Uttaranchal in accordance with Ind AS 109 *Financial Instruments* and seeks your inputs in this regard.

Solution

(a) Joint Arrangement

As per Ind AS 111 *Joint Arrangements*, a joint arrangement is an arrangement of which two or more parties have joint control. Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. The structure and form of the arrangement determines the nature of the relationship. However, irrespective of the purpose, structure or form of the arrangement, the classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement. Accordingly, a joint arrangement could be classified as a joint operation or as a joint venture. A joint arrangement which is NOT structured through a separate vehicle is a joint operation. In such cases, the contractual arrangement establishes the parties' rights and obligations. A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant Ind AS. Based on the information provided, the arrangement with Seemanchal Refineries Ltd. is a joint operation as no separate vehicle is formed and the companies have agreed to share services and costs with decisions regarding the storage facility requiring unanimous agreement of the parties. Neelanchal Gas Refinery Ltd. should recognize its share of the asset as Property, Plant and Equipment.

As per Para 16 of Ind AS 16 *Property, Plant and Equipment*, the cost of an item of property, plant and equipment comprises the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets* provides guidance on measuring decommissioning, restoration and similar liabilities. Para 45 of Ind AS 37 provides that where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation. Thus, costs incurred by an entity in respect of obligations for dismantling, removing and restoring the site on which an item of property, plant and equipment is situated are recognized and measured in accordance with Ind AS 16 and Ind AS 37, with the journal entry being as under:

Property, Plant and Equipment	Dr.	xxx
To Provision for Dismantling, Removal and Restoration		xxx

Neelanchal Gas Refinery Ltd. should recognize 60% of the cost of decommissioning of the underground storage facility. However, in line Para 29 of Ind AS 37 where an entity is jointly

and severally liable for an obligation, **the part of the obligation that is expected to be met by other parties is treated as a contingent liability**. Accordingly, Neelanchal Gas Refinery Ltd. should also disclose 40% of the cost of decommissioning of the underground facility as a contingent liability, should there arise future events that prevent Seemanchal Refineries Ltd. from fulfilling its obligations under the arrangement.

As per Ind AS 16, 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.

Thus, Neelanchal Gas Refinery Ltd. should classify and account for its share of irrecoverable gas as property, plant and equipment, as the irrecoverable gas is necessary for the storage facility to perform its function. Therefore, the **irrecoverable gas, being a part of the storage facility, should be capitalized as a component of the storage facility asset**, and should be depreciated to its residual value over the life of the storage facility. However, if the gas is recoverable in full upon decommissioning of the storage facility, then depreciation against the irrecoverable gas component will be recorded only if the estimated residual value of the gas decreases below cost during the life of the facility. Upon decommissioning of the storage facility, when the cushion gas is extracted and sold, the sale of irrecoverable gas is accounted as a disposal of an item of property, plant and equipment in accordance with Ind AS 16 and the resulting gain or loss is recognized in the Statement of Profit and Loss. The natural gas in excess of the irrecoverable gas which is injected into the facility would be treated as inventory in accordance with Ind AS 2 *Inventories*.

(b) Contract with Uttaranchal Refineries Pvt. Ltd.

As per para 2.4 of Ind AS 109 *Financial Instruments*, this standard applies to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, **with the exception** of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (i.e. own use contracts). This contract will result in physical delivery of the commodity i.e. extra gas.

Para 2.5 of Ind AS 109 further provides that a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency

(sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard.

There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

- (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
- (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
- (c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
- (d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A written option to buy or sell a non-financial item, such as a commodity, that can be settled net in cash or another financial instrument, or by exchanging financial instruments, is within the scope of Ind AS 109. Such a contract is accounted as a derivative. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements. Judgment would be required in this area as net settlements caused by unique events beyond management's control may not necessarily prevent the entity from applying the 'own use' exemption to all similar contracts.

In the given case, the contract with Uttaranchal Refineries Pvt. Ltd. will result in physical delivery of extra gas (which is a commodity and not cash, or a financial instrument) for the use of Neelanchal Gas Refinery Ltd. Accordingly, it appears that this contract would be an own use contract falling outside the scope of Ind AS 109 and therefore, would be treated as an executory contract. However, arguments could be placed that the contract is net settled due to the penalty mechanism requiring Uttaranchal Refineries Pvt. Ltd. to compensate Neelanchal Gas Refinery Ltd. at the current prevailing market price. Further, if natural gas is readily convertible into cash at the location of delivery, the contract could be considered net settled. Additionally, if there is volume flexibility, the contract could be regarded as a written option which falls within the scope of Ind AS 109.

However, the contract will probably continue to be regarded as 'own use' as long as it has been entered into and continues to be held for expected counterparties' sale / usage requirements. Additionally, the entity has not irrevocably designated the contract as measured at fair value through profit or loss, thus emphasizing the 'own use' designation.

TEST YOUR KNOWLEDGE

Questions

- Venus Ltd. is a multinational entity that owns three properties. All three properties were purchased on 1st April, 20X1. The details of purchase price and market values of the properties are given as follows:

Particulars	Property 1	Property 2	Property 3
	Factory	Factory	Let-Out
Purchase price	15,000	10,000	12,000
Market value 31.03.20X2	16,000	11,000	13,500
Life	10 Years	10 Years	10 Years
Subsequent Measurement	Cost Model	Revaluation Model	Revaluation Model

Property 1 and 2 are used by Venus Ltd. as factory building whilst property 3 is let-out to a non-related party at a market rent. The management presents all three properties in balance sheet as 'property, plant and equipment'.

The Company does not depreciate any of the properties on the basis that the fair values are exceeding their carrying amount and recognise the difference between purchase price and fair value in Statement of Profit and Loss.

Required:

Analyse whether the accounting policies adopted by the Venus Ltd. in relation to these properties is in accordance with Ind AS. If not, advise the correct treatment alongwith working for the same.

- On 1st January, 20X2, Sun Ltd. was notified that a customer was taking legal action against the company in respect of a financial losses incurred by the customer. Customer alleged that the financial losses were caused due to supply of faulty products on 30th September, 20X1 by the Company. Sun Ltd. defended the case but considered, based on the progress of the case up to 31st March, 20X2, that there was a 75% probability they would have to pay damages of ₹ 10 lakhs to the customer.

However, the accountant of Sun Ltd. has not recorded this transaction in its financial statement as the case is not yet finally settled. The case was ultimately settled against the company resulting in to payment of damages of ₹ 12 lakhs to the customer on 15th May, 20X2. The financials have been authorized by the Board of Directors in its meeting held on 18th May, 20X2.

Analyse whether the above accounting treatment made by the accountant is in compliance of the Ind AS. If not, advise the correct treatment along with working for the same.

3. Mercury Ltd. is an entity engaged in plantation and farming on a large scale diversified across India. On 1st April, 20X1, the company has received a government grant for ₹ 10 lakhs subject to a condition that it will continue to engage in plantation of eucalyptus tree for a coming period of five years. Eucalyptus trees are not considered as bearer plant in this case.

The management has a reasonable assurance that the entity will comply with condition of engaging in the plantation of eucalyptus tree for specified period of five years and accordingly it recognises proportionate grant for ₹ 2 lakhs in Statement of Profit and Loss as income following the principles laid down under *Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance*.

Analyse whether the above accounting treatment made by the management is in compliance of the Ind AS. If not, advise the correct treatment alongwith working for the same.

4. Mercury Ltd. has sold goods to Mars Ltd. at a consideration of ₹ 10 lakhs, the receipt of which receivable in three equal installments of ₹ 3,33,333 over a two year period (receipts on 1st April, 20X1, 31st March, 20X2 and 31st March, 20X3).

The company is offering a discount of 5 % (i.e. ₹ 50,000) if payment is made in full at the time of sale. The sale agreement reflects an implicit interest rate of 5.36% p.a.

The total consideration to be received from such sale is at ₹ 10 Lakhs and hence, the management has recognised the revenue from sale of goods for ₹ 10 lakhs.

Analyse whether the above accounting treatment made by the accountant is in compliance of the Ind AS. If not, advise the correct treatment along with working for the same.

5. Master Creator Private Limited (a subsidiary of listed company) is an Indian company to whom Ind AS are applicable. Following draft balance sheet is prepared by the accountant for year ending 31st March 20X2.

Balance Sheet of Master Creator Private Limited as at 31st March, 20X2

Particulars	₹
ASSETS	
Non-current assets	
Property, plant and equipment	85,37,500
Financial assets	
Other financial assets (Security deposits)	4,62,500

Other non-current assets (capital advances)	17,33,480
Deferred tax assets	2,54,150
Current assets	
Trade receivables	7,25,000
Inventories	5,98,050
Financial assets	
Investments	55,000
Other financial assets	2,17,370
Cash and cash equivalents	1,16,950
TOTAL ASSETS	1,27,00,000
EQUITY AND LIABILITIES	
Equity share capital	10,00,000
Non-current liabilities	
Other Equity	25,00,150
Deferred tax liability	4,74,850
Borrowings	64,00,000
Long term provisions	5,24,436
Current liabilities	
Financial liabilities	
Other financial liabilities	2,00,564
Trade payables	6,69,180
Current tax liabilities	9,30,820
TOTAL EQUITY AND LIABILITIES	1,27,00,000

Additional Information:

- On 1st April 20X1, 8% convertible loan with a nominal value of ₹ 64,00,000 was issued by the entity. It is redeemable on 31st March 20X5 also at par. Alternatively, it may be converted into equity shares on the basis of 100 new shares for each ₹ 200 worth of loan.

An equivalent loan without the conversion option would have carried interest at 10%. Interest of ₹ 5,12,000 has already been paid and included as a finance cost.

Present Value (PV) rates are as follows:

Year End	@ 8%	@ 10%
1	0.93	0.91
2	0.86	0.83
3	0.79	0.75
4	0.73	0.68

- After the reporting period, the board of directors have recommended dividend of ₹ 50,000 for the year ending 31st March, 20X1. However, the same has not been yet accounted by the company in its financials.
- 'Other current financial liabilities' consists of the following:

Particulars	Amount (₹)
Wages payable	21,890
Salary payable	61,845
TDS payable	81,265
Interest accrued on trade payables	35,564

- Property, Plant and Equipment consists following items:

Particulars	Amount (₹)	Remarks
Building	37,50,250	It is held for administration purposes
Land	15,48,150	It is held for capital appreciation
Vehicles	12,37,500	These are used as the conveyance for employees
Factory premises	20,01,600	The construction was started on 31 st March 20X2 and consequently no depreciation has been charged on it. The construction activities will continue to happen, and it will take 2 years to complete and be available for use.

- The composition of 'other current financial assets' is as follows:

Particulars	Amount (Rs.)
Interest accrued on bank deposits	57,720
Prepaid expenses	90,000
Royalty receivable from dealers	69,650

- Current Investments consist of securities held for trading which are carried at fair value through profit & loss. Investments were purchased on 1st January, 20X2 at

₹ 55,000 and accordingly are shown at cost as at 31st March 20X2. The fair value of said investments as on 31st March 20X2 is ₹ 60,000.

7. Trade payables and Trade receivables are due within 12 months.
8. There has been no changes in equity share capital during the year.
9. Entity has the intention to set off a deferred tax asset against a deferred tax liability as they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off taxes.
10. Other Equity consists retained earnings only. The opening balance of retained earnings was ₹ 21,25,975 as at 1st April 20X1.
11. No dividend has been actually paid by company during the year.
12. Assume that the deferred tax impact, if any on account of above adjustments is correctly calculated in financials.

Being Finance & Accounts manager, you are required to identify the errors and misstatements if any in the balance sheet of Master Creator Private Limited and prepare corrected balance sheet with details on the face of the balance sheet i.e. no need to prepare notes to accounts, after considering the additional information. Provide necessary explanations/workings for the treated items, wherever necessary.

6. HIM Limited having net worth of ₹ 250 crores is required to adopt Ind AS from 1st April, 20X2 in accordance with the Companies (Indian Accounting Standard) Rules 2015.

Rahul, the senior manager, of HIM Ltd. has identified following issues which need specific attention of CFO so that opening Ind AS balance sheet as on the date of transition can be prepared:

Issue 1 : As part of Property, Plant and Equipment, Company has elected to measure land at its fair value and want to use this fair value as deemed cost on the date of transition. The carrying value of land as on the date of transition was ₹ 5,00,000. The land was acquired for a consideration of ₹ 5,00,000. However, the fair value of land as on the date of transition was ₹ 8,00,000.

Issue 2 : Under Ind AS, the Company has designated mutual funds as investments at fair value through profit or loss. The value of mutual funds as per previous GAAP was ₹ 4,00,000 (at cost). However, the fair value of mutual funds as on the date of transition was ₹ 5,00,000.

Issue 3 : Company had taken a loan from another entity. The loan carries an interest rate of 7% and it had incurred certain transaction costs while obtaining the same. It was carried at cost on its initial recognition. The principal amount is to be repaid in equal instalments over the period of loan. Interest is also payable at each year end. The fair value of loan as

on the date of transition is ₹ 1,80,000 as against the carrying amount of loan which at present equals ₹ 2,00,000.

Issue 4 : The company has declared dividend of ₹ 30,000 for last financial year. On the date of transition, the declared dividend has already been deducted by the accountant from the company's 'Reserves & Surplus' and the dividend payable has been grouped under 'Provisions'. The dividend was only declared by board of directors at that time and it was not approved in the annual general meeting of shareholders. However, subsequently when the meeting was held it was ratified by the shareholders.

Issue 5 : The company had acquired intangible assets as trademarks amounting to ₹ 2,50,000. The company assumes to have indefinite life of these assets. The fair value of the intangible assets as on the date of transition was ₹ 3,00,000. However, the company wants to carry the intangible assets at ₹ 2,50,000 only.

Issue 6 : After consideration of possible effects as per Ind AS, the deferred tax impact is computed as ₹ 25,000. This amount will further increase the portion of deferred tax liability. There is no requirement to carry out the separate calculation of deferred tax on account of Ind AS adjustments.

Management wants to know the impact of Ind AS in the financial statements of company for its general understanding.

Prepare Ind AS Impact Analysis Report (Extract) for HIM Limited for presentation to the management wherein you are required to discuss the corresponding differences between Earlier IGAAP (AS) and Ind AS against each identified issue for preparation of transition date balance sheet. Also pass journal entry for each issue.

Answers

1. The above issue needs to be examined in the umbrella of the provisions given in Ind AS 1 '*Presentation of Financial Statements*', Ind AS 16 '*Property, Plant and Equipment*' in relation to property '1' and '2' and Ind AS 40 '*Investment Property*' in relation to property '3'.

Property '1' and '2'

Para 6 of Ind AS 16 '*Property, Plant and Equipment*' defines:

"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."*

Paragraph 29 of Ind AS 16 states that:

“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”.

Further, paragraph 36 of Ind AS 16 states that:

“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”.

Further, paragraph 39 of Ind AS 16 states that:

“If an asset’s carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss”.

Further, paragraph 52 of Ind AS 16 states that:

“Depreciation is recognised 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”.

Property ‘3’

Para 6 of Ind AS 40 ‘Investment property’ defines:

“Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- (a) use in the production or supply of goods or services or for administrative purposes; or*
- (b) sale in the ordinary course of business”.*

Further, paragraph 30 of Ind AS 40 states that:

“An entity shall adopt as its accounting policy the cost model to all of its investment property”.

Further, paragraph 79 (e) of Ind AS 40 requires that:

“An entity shall disclose the fair value of investment property”.

Further, paragraph 54 (2) of Ind AS 1 ‘Presentation of Financial Statements’ requires that:

“As a minimum, the balance sheet shall include line items that present the following amounts:

- (a) property, plant and equipment;*
- (b) investment property;*

As per the facts given in the question, Venus Ltd. has

- (a) presented all three properties in balance sheet as 'property, plant and equipment';
- (b) applied different accounting policies to Property '1' and '2';
- (c) revaluation is charged in statement of profit and loss as profit; and
- (d) applied revaluation model to Property '3' being classified as Investment Property.

These accounting treatment is neither correct nor in accordance with provision of Ind AS 1, Ind AS 16 and Ind AS 40.

Accordingly, Venus Ltd. shall apply the same accounting policy (i.e. either revaluation or cost model) to entire class of property being property '1' and '2'. It also required to depreciate these properties irrespective of that, their fair value exceeds the carrying amount. The revaluation gain shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.

There is no alternative of revaluation model in respect to property '3' being classified as Investment Property and only cost model is permitted for subsequent measurement. However, Venus Ltd. is required to disclose the fair value of the property in the Notes to Accounts. Also the property '3' shall be presented as separate line item as Investment Property.

Therefore, as per the provisions of Ind AS 1, Ind AS 16 and Ind AS 40, the presentation of these three properties in the balance sheet is as follows:

Case 1: Venus Ltd. has applied the Cost Model to an entire class of property, plant and equipment.

Balance Sheet (extracts) as at 31st March, 20X2

₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	13,500	
Property '2'	<u>9,000</u>	22,500
Investment Properties		
Property '3'		10,800

Case 2: Venus Ltd. has applied the Revaluation Model to an entire class of property, plant and equipment.

Balance Sheet (extracts) as at 31st March, 20X2

₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	16,000	
Property '2'	<u>11,000</u>	27,000
Investment Properties		
Property '3'		10,800
Equity and Liabilities		
Other Equity		
Revaluation Reserve		
Property '1' [16,000 – (15,000 – 1,500)]	2,500	
Property '2' [11,000 – (10,000 – 1,000)]	<u>2,000</u>	4,500

The revaluation reserve should be routed through Other Comprehensive Income (subsequently not reclassified to Profit and Loss) in Statement of Profit and Loss and shown in a separate column under Statement of Changes in Equity.

- The above treatment needs to be examined in the light of the provisions given in Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets' and Ind AS 10 'Events After the Reporting Period'.

Para 10 of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets' defines:

"Provision is a liability of uncertain timing or amount.

Liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits".

Further, paragraph 14 of Ind AS 37, states:

"A provision shall be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event;*
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and*

(c) *a reliable estimate can be made of the amount of the obligation*".

Further, paragraph 36 of Ind AS 37, states:

"The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period".

Further, paragraph 3 of Ind AS 10 'Events after the Reporting Period' defines:

"Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue. Two types of events can be identified:

- (a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and*
- (b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).*

Further, paragraph 8 of Ind AS 10 states that:

"An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period."

The Accountant of Sun Ltd. has not recognised the provision and accordingly not adjusted the amounts recognised in its financial statements to reflect adjusting events after the reporting period is not correct and nor in accordance with provision of Ind AS 37 and Ind AS 10.

As per given facts, the potential payment of damages to the customer is an obligation arising out of a past event which can be reliably estimated. Therefore, following the provision of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets' – a provision is required. The provision should be for the best estimate of the expenditure required to settle the obligation at 31st March, 20X2 which comes to ₹ 7.5 lakhs (₹ 10 lakhs x 75%).

Further, following the principles of Ind AS 10 'Events After the Reporting Period' evidence of the settlement amount is an adjusting event. Therefore, the amount of provision created shall be increased to ₹ 12 lakhs and accordingly be recognised as a current liability.

3. As per given facts, the company is engaged in plantation and farming. Hence Ind AS 41 Agriculture shall be applicable to this company.

The above facts need to be examined in the light of the provisions given in Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance' and Ind AS 41 'Agriculture'.

Para 2(d) of Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance' states:

"This Standard does not deal with government grants covered by Ind AS 41, Agriculture".

Further, paragraph 1 (c) of Ind AS 41 'Agriculture', states:

"This Standard shall be applied to account for the government grants covered by paragraphs 34 and 35 when they relate to agricultural activity".

Further, paragraph 1 (c) of Ind AS 41 'Agriculture', states:

"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".

Understanding of the given facts, The Company has recognised the proportionate grant for ₹ 2 lakhs in Statement of Profit and Loss before the conditions attaching to government grant are met which is not correct and nor in accordance with provision of Ind AS 41 'Agriculture'.

Accordingly, the accounting treatment of government grant received by the Mercury Ltd. is governed by the provision of Ind AS 41 'Agriculture' rather Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance'.

Government grant for ₹ 10 lakhs shall be recognised in profit or loss when, and only when, the conditions attaching to the government grant are met i.e. after the expiry of specified period of five years of continuing engagement in the plantation of eucalyptus tree.

Balance Sheet extracts showing the presentation of Government Grant

as on 31st March, 20X2

₹

Liabilities	
Non-Current liabilities	
Other Non-Current Liabilities	
Government Grants	10,00,000

- The revenue from sale of goods shall be recognised at the fair value of the consideration received or receivable. The fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest where the receipt is deferred beyond normal

credit terms. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue.

The fair value of consideration (cash price equivalent) of the sale of goods is calculated as follows: ₹

Year	Consideration (Installment)	Present value factor	Present value of consideration
Time of sale	3,33,333	-	3,33,333
End of 1 st year	3,33,333	0.949	3,16,333
End of 2 nd year	<u>3,33,334</u>	0.901	<u>3,00,334</u>
	10,00,000		9,50,000

The Company that agrees for deferring the cash inflow from sale of goods will recognise the revenue from sale of goods and finance income as follows:

<i>Initial recognition of sale of goods</i>		₹	₹
Cash	Dr.	3,33,333	9,50,000
Trade Receivable	Dr.	6,16,667	
To Sale			
<i>Recognition of interest expense and receipt of second installment</i>			
Cash	Dr.	3,33,333	3,00,280
To Interest Income			
To Trade Receivable			
<i>Recognition of interest expense and payment of final installment</i>			
Cash	Dr.	3,33,334	3,16,387
To Interest Income (Balancing figure)			
To Trade Receivable			

Statement of Profit and Loss (extracts)
for the year ended 31st March, 20X2 and 31st March, 20X3

₹

	As at 31 st March, 20X2	As at 31 st March, 20X3
Income		
Sale of Goods	9,50,000	-
Other Income (Finance income)	33,053	16,947

Balance Sheet (extracts) as at 31st March, 20X2 and 31st March, 20X3

₹

	As at 31 st March, 20X2	As at 31 st March, 20X3
Assets		
Current Assets		
<u>Financial Assets</u>		
Trade Receivables	3,16,387	XXX

5. Balance Sheet of Master Creator Private Limited as at 31st March, 20X2

Particulars	Working/ Note reference	(₹)
ASSETS		
Non-current assets		
Property, plant and equipment	1	49,87,750
Capital work-in-progress	2	20,01,600
investment Property	3	15,48,150
Financial assets		
Other financial assets (Security deposits)		4,62,500
Other non-current assets (capital advances)	4	17,33,480
Current assets		
Inventories		5,98,050
Financial assets		
Investments (55,000 + 5,000)	5	60,000
Trade receivables	6	7,25,000
Cash and cash equivalents	7	1,16,950
Other financial assets	8	1,27,370
Other current assets (Prepaid expenses)	8	90,000
TOTAL ASSETS		1,24,50,850
EQUITY AND LIABILITIES		
Equity		
Equity share capital	A	10,00,000
Other equity	B	28,44,606
Non-current liabilities		
Financial liabilities		

8% Convertible loan	11	60,60,544
Long term provisions		5,24,436
Deferred tax liability	12	2,20,700
Current liabilities		
Financial liabilities		
Trade payables	13	6,69,180
Other financial liabilities	14	1,19,299
Other current liabilities (TDS payable)	15	81,265
Current tax liabilities		9,30,820
TOTAL EQUITY AND LIABILITIES		1,24,50,850

Statement of changes in equity
For the year ended 31st March, 20X2

A. Equity Share Capital

	Balance (₹)
As at 31 st March, 20X1	10,00,000
Changes in equity share capital during the year	-
As at 31 st March, 20X2	<u>10,00,000</u>

B. Other Equity

	Retained Earnings (₹)	Equity component of Compound Financial Instrument (₹)	Total (₹)
As at 31 st March, 20X1	21,25,975	-	21,25,975
Total comprehensive income for the year (25,00,150 + 5,000 - 85,504- 21,25,975)	2,93,671	-	2,93,671
Issue of compound financial instrument during the year	-	<u>4,24,960</u>	<u>4,24,960</u>
As at 31st March, 20X2	<u>24,19,646</u>	<u>4,24,960</u>	<u>28,44,606</u>

Disclosure forming part of Financial Statements:

Proposed dividend on equity shares is subject to the approval of the shareholders of the company at the annual general meeting and not recognized as liability as at the Balance Sheet date. (Note 9)

Notes/ Workings: (for adjustments/ explanations)

1. 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. Therefore, the items of PPE are Buildings (₹ 37,50,250) and Vehicles (₹ 12,37,500), since those assets are held for administrative purposes.
2. Property, plant and equipment which are not ready for intended use as on the date of Balance Sheet are disclosed as "Capital work-in-progress". It would be classified from PPE to Capital work-in-progress.
3. 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.

Therefore, Land held for capital appreciation should be classified as Investment property rather than PPE.

4. Assets for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
5. Current investments here are held for the purpose of trading. Hence, it is a financial asset classified as FVTPL. Any gain in its fair value will be recognised through profit or loss. Hence, ₹ 5,000 (60,000 – 55,000) increase in fair value of financial asset will be recognised in profit and loss.
6. A contractual right to receive cash or another financial asset from another entity is a financial asset. Trade receivables is a financial asset in this case and hence should be reclassified.
7. Cash is a financial asset. Hence it should be reclassified.
8. Other current financial assets:

Particulars	Amount (₹)
Interest accrued on bank deposits	57,720
Royalty receivable from dealers	69,650
Total	1,27,370

Prepaid expenses does not result into receipt of any cash or financial asset. However, it results into future goods or services. Hence, it is not a financial asset.

9. As per Ind AS 10, 'Events after the Reporting Period', If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognized as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with Ind AS 1, Presentation of Financial Statements.
10. 'Other Equity' cannot be shown under 'Non-current liabilities'. Accordingly, it is reclassified under 'Equity'.
11. There are both 'equity' and 'debt' features in the instrument. An obligation to pay cash i.e. interest at 8% per annum and a redemption amount will be treated as 'financial liability' while option to convert the loan into equity shares is the equity element in the instrument. Therefore, convertible loan is a compound financial instrument.

Calculation of debt and equity component and amount to be recognised in the books:

S. No	Year	Interest amount @ 8%	Discounting factor @ 10%	Amount
Year 1	20X2	5,12,000	0.91	4,65,920
Year 2	20X3	5,12,000	0.83	4,24,960
Year 3	20X4	5,12,000	0.75	3,84,000
Year 4	20X5	69,12,000	0.68	<u>47,00,160</u>
Amount to be recognised as a liability				59,75,040
Initial proceeds				<u>(64,00,000)</u>
Amount to be recognised as equity				<u>4,24,960</u>

* In year 4, the loan note will be redeemed; therefore, the cash outflow would be ₹ 69,12,000 (₹ 64,00,000 + ₹ 5,12,000).

Presentation in the Financial Statements:

In Statement of Profit and Loss for the year ended on 31 March 20X2

Finance cost to be recognised in the Statement of Profit and Loss (59,75,040 x 10%)	₹ 5,97,504
Less: Already charged to the Statement of Profit and Loss	<u>(₹ 5,12,000)</u>
Additional finance charge required to be recognised in the Statement of Profit and Loss	<u>₹ 85,504</u>

In Balance Sheet as at 31 March 20X2

Equity and Liabilities	
Equity	
Other Equity (8% convertible loan)	4,24,960
Non-current liability	
Financial liability [8% convertible loan – [(59,75,040+ 5,97,504– 5,12,000)]]	60,60,544

12. Since entity has the intention to set off deferred tax asset against deferred tax liability and the entity has a legally enforceable right to set off taxes, hence their balance on net basis should be shown as:

Particulars	Amount (₹)
Deferred tax liability	4,74,850
Deferred tax asset	<u>(2,54,150)</u>
Deferred tax liability (net)	<u>2,20,700</u>

13. A liability that is a contractual obligation to deliver cash or another financial asset to another entity is a financial liability. Trade payables is a financial liability in this case.
14. 'Other current financial liabilities':

Particulars	Amount (₹)
Wages payable	21,890
Salary payable	61,845
Interest accrued on trade payables	35,564
Total	<u>1,19,299</u>

15. Liabilities for which there is no contractual obligation to deliver cash or other financial asset to another entity, are not financial liabilities. Hence, TDS payable should be reclassified from 'Other current financial liabilities' to 'Other current liabilities' since it is not a contractual obligation.

6. Assessment of Preliminary Impact Assessment of Transition to Ind AS on Him Limited's Financial Statements

Issue 1: Fair value as deemed cost for property plant and equipment:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS 10, Property, Plant and Equipment is recognised at cost less depreciation.	Ind AS 101 allows entity to elect to measure Property, Plant and Equipment on the transition date at its fair value or previous GAAP carrying value (book value) as deemed cost.	The company has decided to adopt fair value as deemed cost in this case. Since fair value exceeds book value, so the book value should be brought up to fair value. The resulting impact of fair valuation of land ₹ 3,00,000 should be adjusted in other equity.

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Property Plant and Equipment Dr.	3,00,000	
To Revaluation Surplus (OCI- Other Equity)		3,00,000

Issue 2: Fair valuation of Financial Assets:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per Accounting Standard, investments are measured at lower of cost and fair value.	On transition, financial assets including investments are measured at fair values except for investments in subsidiaries, associates and JVs' which are recorded at cost.	All financial assets (other than Investment in subsidiaries, associates and JVs' which are recorded at cost) are initially recognized at fair value. The subsequent measurement of such assets are based on its categorization either Fair Value through Profit & Loss (FVTPL) or Fair Value through Other Comprehensive Income (FVTOCI) or at Amortised Cost based on business model assessment and contractual cash flow characteristics. Since investment in mutual fund are designated at FVTPL, increase of ₹ 1,00,000 in mutual funds fair value

		would increase the value of investments with corresponding increase to Retained Earnings.

Journal Entry on the date of transition

Particulars		Debit (₹)	Credit (₹)
Investment in mutual funds	Dr.	1,00,000	
To Retained earnings			1,00,000

Issue 3: Borrowings - Processing fees/transaction cost:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, such expenditure is charged to Profit and loss account or capitalised as the case may be	As per Ind AS, such expenditure is amortised over the period of the loan. Ind AS 101 states that if it is impracticable for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind AS shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability.	Fair value as on the date of transition is ₹ 1,80,000 as against its book value of ₹ 2,00,000. Accordingly, the difference of ₹ 20,000 is adjusted through retained earnings.

Journal Entry on the date of transition

Particulars		Debit (₹)	Credit (₹)
Borrowings / Loan payable	Dr.	20,000	
To Retained earnings			20,000

Issue 4: Proposed dividend:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, provision for proposed dividend is made in the year when it has been	As per Ind AS, liability for proposed dividend is recognised in the	Since dividend should be deducted from retained earnings during the year when it has been declared and approved. Therefore, the provision

declared and approved.	and	year in which it has been declared and approved.	declared for preceding year should be reversed (to rectify the wrong entry). Retained earnings would increase proportionately due to such adjustment

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Provisions Dr.	30,000	
To Retained earnings		30,000

Issue 5 : Intangible assets:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
The useful life of an intangible asset cannot be indefinite under IGAAP principles. The Company amortised brand/trademark on a straight line basis over maximum of 10 years as per AS 26.	The useful life of an intangible asset like brand/trademark can be indefinite. Not required to be amortised and only tested for impairment. Company can avail the exemption given in Ind AS 101 as on the date of transition to use the carrying value as per previous GAAP.	Consequently, there would be no impact as on the date of transition since company intends to use the carrying amount instead of book value at the date of transition.

Issue 6: Deferred tax

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, deferred taxes are accounted as per income statement approach.	As per Ind AS, deferred taxes are accounted as per balance sheet approach.	On date of transition to Ind AS, deferred tax liability would be increased by ₹ 25,000.

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Retained earnings Dr.	25,000	
To Deferred tax liability		25,000

[illegible]

PROFESSIONAL AND ETHICAL DUTY OF A CHARTERED ACCOUNTANT

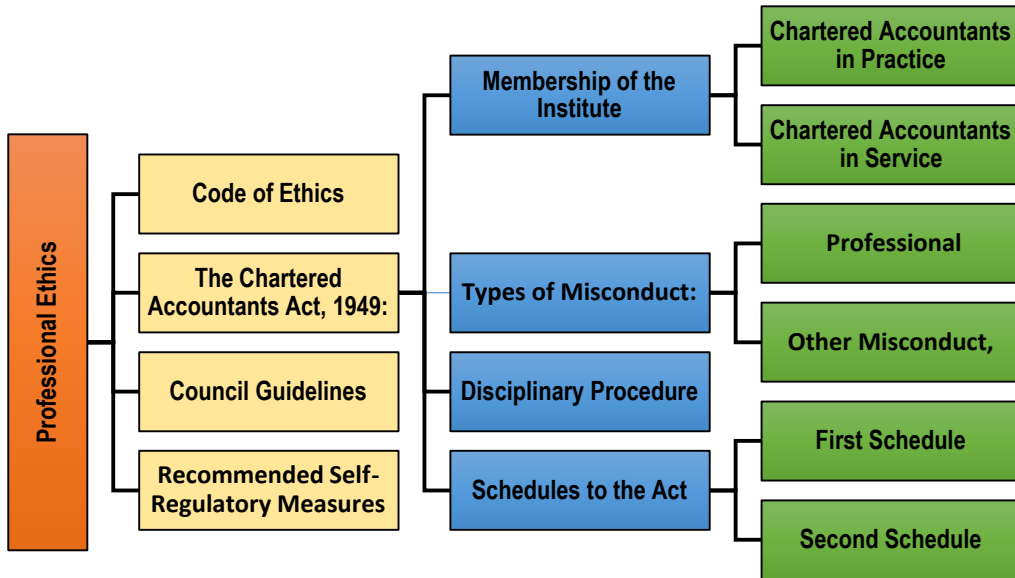


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Comply with the Code of Ethics, Fundamental Principles and Conceptual Framework (applicable to all Chartered Accountants); and
- ❑ Comply with the Code of Ethics relevant for the Chartered Accountants in Service and Practice.
- ❑ Realise the implications of various Schedules of Chartered Accountants Act relating to professional and other misconduct.

CHAPTER OVERVIEW





1. WHAT ARE ETHICS?

The Merriam-Webster dictionary defines ethic / ethics to be a set of moral principles: a theory or system of moral values, the principles of conduct governing an individual or the discipline dealing with what is good and bad and with moral duty and obligation.



2. ETHICAL PRINCIPLES IN FINANCIAL REPORTING

ICAI's Code of Ethics (2019), the "Code", which was developed on adopting the provisions of International Federation of Accountants (IFAC) Code of Ethics for the Chartered Accountants identifies the fundamental principles relevant to accountants. This Code of Ethics is applicable from 1st July, 2020.

This Code has been derived from the International Ethics Standards Board for Accountants (IESBA) Code of Ethics, 2018 issued by the International Federation of Accountants (IFAC).

- A. The Code of Ethics ("the Code") sets out fundamental principles of ethics for Chartered Accountants (hereinafter also called as "accountants"), reflecting the recognition and responsibility of the profession 'chartered accountant' in public interest. These principles establish the standard of behaviour expected of a Chartered Accountant.
- B. The Code provides a conceptual framework that Chartered Accountants are to apply in order to identify, evaluate and address threats to compliance with the fundamental principles. The Code sets out requirements and application material on various topics to help accountants apply the conceptual framework to those topics.

Note: The principles laid down in the Code of Ethics pertaining to the case of audits, reviews and other assurance engagements, including Independence Standards, established by the application of the conceptual framework to threats to independence in relation to these engagements are dealt with in detail in the 'Advanced Auditing, Assurance and Professional Ethics'.



3. THE CHARTERED ACCOUNTANTS ACT, 1949

A person qualifying as a Chartered Accountant becomes the member on registration with the Institute of the Chartered Accountants of India. Every member has to carry on their professional and other conduct as per the Chartered Accountants Act, 1949.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any Professional or Other Misconduct.



4. WHAT IS PROFESSIONAL OR OTHER MISCONDUCT FOR A CHARTERED ACCOUNTANT?

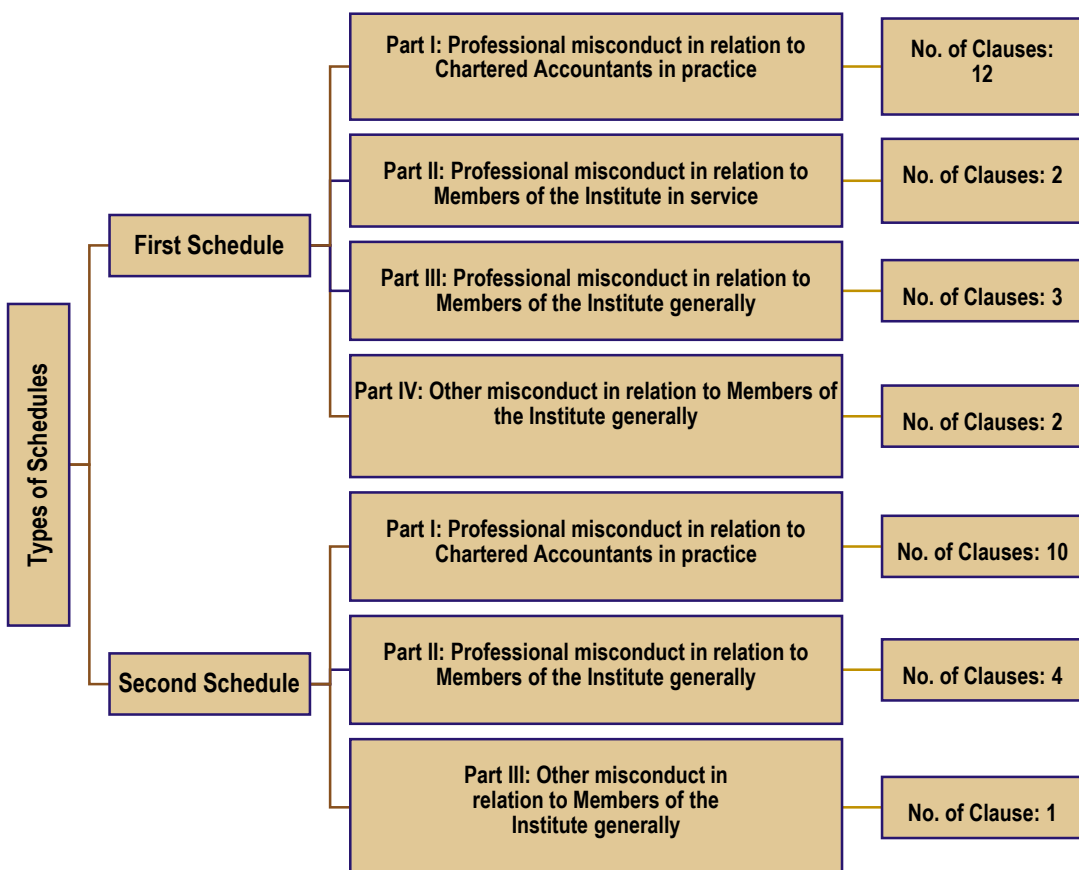
According to section 22 of the Act, the expression “professional or other misconduct” shall be deemed to include any act or omission provided in any of the Schedules (of the Act).

4.1 Professional Misconduct

Professional misconduct has been defined in Part I, II and III of the First Schedule; and Part I and II of the Second Schedule. A member who is engaged in the profession of accountancy whether in practice or in service should conduct/restrict his actions in accordance with the provisions contained in the respective parts of the schedules. If the member is found guilty of any of the acts or omissions stated in any of the respective parts of the Schedule, he/she shall be deemed to be guilty of professional misconduct.

4.2 Other Misconduct

Other misconduct has been defined in part IV of the First Schedule and part III of the Second Schedule. These provisions empower the Council to inquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action.



The clauses covered in Part I, II and III of Second Schedule have been shown in the form of flowchart below. However, for detail explanation, one must refer the Chapter on 'Professional Ethics' of Final Paper 3 'Advanced Auditing, Assurance and Professional Ethics'.

Second Schedule to The Chartered Accountants Act, 1949

Part I - Professional Misconduct in relation to Chartered Accountants in Practice: (10 clauses)

- **Clause 1** → Discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force.
- **Clause 2** → Certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice.
- **Clause 3** → Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.
- **Clause 4** → Expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.
- **Clause 5** → Fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.
- **Clause 6** → Fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity
- **Clause 7** → Does not exercise due diligence or is grossly negligent in the conduct of his professional duties.
- **Clause 8** → Fails to obtain sufficient information which is necessary for expression of an opinion, or its exceptions are sufficiently material to negate the expression of an opinion.
- **Clause 9** → Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.
- **Clause 10** → Fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

PART II - Professional misconduct in relation to members of the Institute generally (4 clauses)

- **Clause 1** → Contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council*.
- **Clause 2** → Being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer.
- **Clause 3** → Includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.
- **Clause 4** → Defalcates or embezzles money received in his professional capacity.

Part III - Other misconduct in relation to members of the Institute generally (1 clause)

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

***Note : Council Guidelines**

For conduct of a member being an employee, the Council Guidelines in its Appendix 34 of the Chartered Accountants Act, 1949, states that a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

The following part of the Code of Ethics shall be dealt with in Financial Reporting:

- Complying with the Code, Fundamental Principles and Conceptual Framework (applicable to all Chartered Accountants) (relevant part of this Section covered in detail in subsequent pages); and
- Chartered Accountants in Service (relevant part of this Section covered in detail in subsequent pages).

PART 1: COMPLYING WITH THE CODE, FUNDAMENTAL PRINCIPLES AND CONCEPTUAL FRAMEWORK

1. COMPLYING WITH THE CODE

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A Chartered Accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable Chartered Accountants to meet their responsibility to act in the public interest.

A Chartered Accountant shall comply with the Code. There might be circumstances where laws or regulations preclude an accountant from complying with certain parts of the Code. In such circumstances, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code.

The principle of professional behaviour requires a Chartered Accountant to comply with relevant laws and regulations. Accountants need to be aware of differences in local regulations from the provisions as set out in the Code and comply with the more stringent provisions unless prohibited by law or regulation.

2. THE FUNDAMENTAL PRINCIPLES

There are five fundamental principles of ethics for Chartered Accountants:

- (a) **Integrity** – to be straightforward and honest in all professional and business relationships.
- (b) **Objectivity** – not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.
- (c) **Professional Competence and Due Care** – to:
 - (i) attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and
 - (ii) act diligently and in accordance with applicable technical and professional standards.
- (d) **Confidentiality** – to respect the confidentiality of information acquired as a result of professional and business relationships.
- (e) **Professional Behaviour** – to comply with relevant laws and regulations and avoid any conduct that the Chartered Accountant knows or should know might discredit the profession.

A Chartered Accountant shall comply with each of the fundamental principles.

A Chartered Accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, with:

- Others within the firm or employing organization.
- Those charged with governance.
- Institute
- Legal counsel.

However, such consultation does not relieve the accountant from the responsibility to exercise professional judgment to resolve the conflict or, if necessary, and unless prohibited by law or regulation, disassociate from the matter creating the conflict.

3. INTEGRITY

A Chartered Accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships.

A Chartered Accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information:

- Contains a materially false or misleading statement;
- Contains statements or information provided negligently; or
- Omits or obscures required information where such omission or obscurity would be misleading.

4. OBJECTIVITY

A Chartered Accountant shall comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of others.

Illustration 1:

Infostar Ltd. is a listed company engaged in the provision of IT services in India. The directors are paid a bonus based on the profits achieved by the company during the year as per the bonus table given below:

<i>Range of Profit after tax</i>	<i>Bonus to Directors</i>
<i>Less than ₹ 1 crore</i>	<i>NIL</i>
<i>₹ 1 crore to < ₹ 5 crores</i>	<i>2% of Net Profit after tax</i>
<i>₹ 5 crores to < ₹ 10 crores</i>	<i>4% of Net Profit after tax</i>

₹ 10 crores to < ₹ 20 crores	6% of Net Profit after tax
₹ 20 crores to < ₹ 30 crores	8% of Net Profit after tax
₹ 30 crores and above	10% of Net Profit after tax

The draft Statement of Profit and Loss for the year ended 31 March 20X2 currently shows a profit of ₹ 2 crores.

Issue:

On 25 March 20X2, Infostar Ltd. sold land located adjacent to its head office to a third party Zest Ltd. for a consideration of ₹ 40 crores, with an option to purchase the land back on 25 May 20X2 for ₹ 40 crores plus a premium of 6%. The amount received from the transaction eliminated the bank overdraft of Infostar Ltd. as on 31 March 20X2. On instructions of the Chief Financial Officer of the company, who is a chartered accountant, the transaction was treated as a sale, including the profit arising on disposal in the Statement of Profit and Loss for the year ending 31 March 20X2.

Required:

Discuss the ethical and accounting implications of the above issues with respect to a chartered accountant in service, referring to the relevant Ind AS wherever appropriate.

Solution

Accounting Treatment

The sale of land meets the conditions specified in Ind AS 115, *Revenue from Contracts with Customers* for qualifying as a repurchase agreement as Infostar Ltd. has an option to buy back the land from Zest Ltd. and therefore, control is not transferred as Zest Ltd.'s ability to use and gain benefit from the land is limited. Infostar Ltd. must treat the transaction as a financing arrangement and record both the asset (land) and the financial liability (the amount received which is repayable to Zest Ltd.).

Infostar Ltd. should not have derecognized the land from the financial statements because the risks and rewards of ownership are not transferred. Thus, the substance of the transaction is a loan of ₹ 40 crores, with the 6% 'premium' on repurchase effectively reflecting interest payment.

Recording the aforesaid transaction as a sale is an attempt to manipulate the financial statements in order to show an improved profit figure and a more favourable cash position. The sale must be reversed and the land should be reinstated at its carrying amount prior to the transaction.

Ethical Issues

Chartered Accountants are required to comply with the fundamental principles laid down in the Code of Ethics. This includes acting with integrity. It appears that the integrity of CFO is compromised in this situation as he had accounted the transaction as sale and not as a loan or financial arrangement. The effect of accounting it as sale just before the year end is merely to improve profits and eliminate the bank overdraft, thereby making the cash position seem better than it is. This effectively amounts to 'window dressing', which is not honest as it does not present the actual performance and position of Infostar Ltd.

Accountants must also act with objectivity, which means they must not allow bias, conflict or undue influence of others to override professional or business judgments. Therefore, the management must put the interests of the company and the shareholders before their own interests. The pressure to show profits and achieve a bonus is in the self-interest of the directors and seems to have been partly driven the transaction and the subsequent accounting, which is clearly a conflict of interest.

It is further necessary for the accountants to comply with the principles of professional behaviour, which require compliance with relevant laws and regulations. In the instant case, the accounting treatment is not in conformity with Ind AS. The given facts do not make it clear whether CFO is aware of this or not. If he is aware but still applied the incorrect treatment, he has not complied with the principle of professional behaviour. It may be that he was under undue pressure from the directors to record the transaction in this manner. If, however, he is not aware that the treatment is incorrect, then he has not complied with the principle of professional competence as his knowledge and skills are not updated.

In such a case, he is subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

5. PROFESSIONAL COMPETENCE AND DUE CARE

Maintaining professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables a Chartered Accountant to develop and maintain the capabilities to perform competently within the professional environment.

Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

In complying with the principle of professional competence and due care, a Chartered Accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountant's authority have appropriate training and supervision.

Illustration 2:

Rustom Ltd., a company engaged in oil extraction, has a present obligation to dismantle the oil rig installed by it at the end of the useful life of 10 years. Rustom Ltd. cannot cancel this obligation or transfer it. Rustom Ltd. intends to carry out the dismantling work itself and estimates the cost of the work to be ₹ 100 crores at the end of 10 years.

The directors of Rustom Ltd. are aware of the requirements of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', read with Ind AS 16 'Property, Plant and Equipment'. However, they propose to expense the costs of dismantling the oil rig as and when incurred, with no entries or disclosures in the latest financial statements. They argue that application of Ind AS involves judgment, and although prudence is mentioned in the Conceptual Framework, it is only one among the many ways of achieving faithful representation.

Required:

Discuss whether the directors are acting unethically in the above instance what should be the practising Chartered Accountant's course of action in this regard.

Solution

The treatment proposed by the director is in contravention of Ind AS 37. As per Ind AS 16 and Ind AS 37, an entity, at the time of initial recognition of the asset, capitalises the present value of the cost of dismantling to be occurred at the end of the life of the asset, to the cost of the asset by simultaneously creating a provision for the same. In the given case, it appears to be a deliberate intention to contravene Ind AS 16 and Ind AS 37, and not an unintentional mistake.

Though the directors can exercise strong or undue influence over the chartered accountant, the chartered accountant is bound to act with integrity and remain unbiased, recommending to the directors that Ind AS 16 and Ind AS 37 must be complied with, and ensure appropriate entries are passed in the financial statements. The matter may be raised before the non-executive directors, explaining the issue to them and ensure the financial statements are true and fair and comply with the relevant Ind AS.

It is essential for the chartered accountant to inform those in governance (directors) about the necessary corrective measures in this case. By doing so, he uphold the fundamental principle of professional behaviour and demonstrate compliance with relevant laws and regulations. By

communicating the corrective measures to those responsible for governance, the chartered accountant can ensure that the contravention of Ind AS 16 and Ind AS 37 is addressed and rectified.

However, if he does not communicate the corrective measures to the directors, the fundamental principle of **professional behaviour** will be breached. Members should comply with relevant laws and regulations and avoid any action that discredits the profession. By knowingly allowing the directors not to apply the requirements of an Ind AS, the Chartered Accountant would not be acting diligently in accordance with applicable guidance and would not be demonstrating professional competence and due care. In such a situation, he will be subject to professional misconduct under Clauses 5, 6 and 7 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 5 states that a chartered accountant is guilty of professional misconduct when he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

Clause 6 states that a CA is guilty of professional misconduct when he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

Clause 7 states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

6. CONFIDENTIALITY

A Chartered Accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. An accountant shall:

- (a) Be alert to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member;
- (b) Maintain confidentiality of information within the firm or employing organization;
- (c) Maintain confidentiality of information disclosed by a prospective client or employing organization;
- (d) Not disclose confidential information acquired as a result of professional and employment relationships outside the firm or employing organization without proper and specific authority, unless there is a legal or professional duty or right to disclose;

- (e) Not use confidential information acquired as a result of professional and employment relationships for the personal advantage of the accountant or for the advantage of a third party;
- (f) Not use or disclose any confidential information, either acquired or received as a result of a professional or employment relationship, after that relationship has ended; and
- (g) Take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, respect the accountant's duty of confidentiality.

For instance, confidentiality is a paramount ethical principle that should not be breached when providing payroll services to clients, unless required by law or authorized by the client. Chartered Accountants have a duty to uphold the confidentiality of payroll-related information and ensure the security and protection of sensitive data of the organisation.

Confidentiality serves the public interest because it facilitates the free flow of information from the Chartered Accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where Chartered Accountants are or might be required to disclose confidential information or when such disclosure might be appropriate:

- (a) Disclosure is required by law, for example:
 - (i) Production of documents or other provision of evidence in the course of legal proceedings; or
 - (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light;
- (b) Disclosure is permitted by law and is authorized by the client or the employing organization; and
- (c) There is a professional duty or right to disclose, when not prohibited by law:
 - (i) To comply with the requirements of peer review or quality review of the Institute
 - (ii) To respond to an inquiry or investigation by a professional or regulatory body;
 - (iii) To protect the professional interests of a Chartered Accountant in legal proceedings; or
 - (iv) To comply with technical and professional standards, including ethics requirements.

Breaches of confidentiality may occur in the scenario like insider trading, where chartered accountants must avoid using or sharing material information of the entity for personal gain.

Similarly, hiding material facts which require disclosure like reporting fraud, illegal activities, or non-compliance with laws and regulations does not constitute confidentiality. Chartered accountants have an ethical duty to report fraudulent or manipulative activities that could impact the end users.

Nonetheless, confidentiality should be applied cautiously with justifiable legal or ethical grounds, and professional judgment and after due legal advice, wherever necessary.

A Chartered Accountant shall continue to comply with the principle of confidentiality even after the end of the relationship between the accountant and a client or employing organization. When changing employment or acquiring a new client, the accountant is entitled to use prior experience but shall not use or disclose any confidential information acquired or received as a result of a professional or employment relationship.

7. PROFESSIONAL BEHAVIOUR

When promoting himself and his work, a Chartered Accountant shall not bring the profession into disrepute. A Chartered Accountant is required to conduct his affairs in a manner that he remains outside the boundaries of professional and other misconduct. A Chartered Accountant shall be honest and truthful and shall not make:

- (a) Exaggerated claims for the services offered by, or the qualifications or experience of, the accountant; or
- (b) Disparaging references or unsubstantiated comparisons to the work of others.

Any direct or indirect measures to advertise any professional/other facts which are in violation of Advertisement Guidelines issued by the Council of the Institute from time to time.

THE CONCEPTUAL FRAMEWORK

The **Chartered Accountant shall apply the** conceptual framework to **identify, evaluate and address threats to compliance with the fundamental principles.**

- (a) Identify threats to compliance with the fundamental principles;
- (b) Evaluate the threats identified; and
- (c) Address the threats by eliminating or reducing them to an acceptable level.

When applying the conceptual framework, the Chartered Accountant shall:

- (a) Exercise professional judgment;
- (b) Remain alert for new information and to changes in facts and circumstances; and

Use the reasonable and informed third party test.

Exercise of Professional Judgment

Professional judgment involves the application of relevant training, professional knowledge, skill and experience commensurate with the facts and circumstances, including the nature and scope of the particular professional activities, and the interests and relationships involved. In relation to undertaking professional activities, the exercise of professional judgment is required when the

Chartered Accountant applies the conceptual framework in order to make informed decisions about the courses of actions available, and to determine whether such decisions are appropriate in the circumstances.

An understanding of known facts and circumstances is a prerequisite to the proper application of the conceptual framework. Determining the actions necessary to obtain this understanding and coming to a conclusion about whether the fundamental principles have been complied with also require the exercise of professional judgment.

In exercising professional judgment to obtain this understanding, the Chartered Accountant might consider, among other matters, whether:

- There is reason to be concerned that potentially relevant information might be missing from the facts and circumstances known to the accountant.
- There is an inconsistency between the known facts and circumstances and the accountant's expectations.
- The accountant's expertise and experience are sufficient to reach a conclusion.
- There is a need to consult with others with relevant expertise or experience.
- The information provides a reasonable basis on which to reach a conclusion.
- The accountant's own preconception or bias might be affecting the accountant's exercise of professional judgment.
- There might be other reasonable conclusions that could be reached from the available information.

Reasonable and Informed Third Party

The reasonable and informed third party test is a consideration by the Chartered Accountant about whether the same conclusions would likely be reached by another party. Such consideration is made from the perspective of a reasonable and informed third party, who weighs all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made. The reasonable and informed third party does not need to be an accountant but would possess the relevant knowledge and experience to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

PART 2: CHARTERED ACCOUNTANTS IN SERVICE

A. CONFLICTS OF INTEREST

A Chartered Accountant shall not allow a conflict of interest to compromise professional or business judgment.

Examples of circumstances that might create a conflict of interest include:

- (a) Serving in a management or governance position for two employing organizations and acquiring confidential information from one organization that might be used by the Chartered Accountant to the advantage or disadvantage of the other organization.
- (b) Undertaking a professional activity for each of two parties in a partnership, where both parties are employing the accountant to assist them to dissolve their partnership.
- (c) Preparing financial information for certain members of management of the accountant's employing organization who are seeking to undertake a management buy-out.
- (d) Being responsible for selecting a vendor for the employing organization when an immediate family member of the accountant might benefit financially from the transaction.
- (e) Serving in a governance capacity in an employing organization that is approving certain investments for the company where one of those investments will increase the value of the investment portfolio of the accountant or an immediate family member.

1. Conflict Identification

A Chartered Accountant shall take reasonable steps to identify circumstances that might create a conflict of interest, and therefore a threat to compliance with one or more of the fundamental principles. Such steps shall include identifying:

- (a) The nature of the relevant interests and relationships between the parties involved; and
- (b) The activity and its implication for relevant parties.

2. Threats created by Conflict of Interest

In general, the more direct the connection between the professional activity and the matter on which the parties' interests conflict, the more likely the level of the threat is not at an acceptable level.

An example of an action that might eliminate threats created by conflicts of interest is withdrawing from the decision-making process related to the matter giving rise to the conflict of interest.

Examples of actions that might be safeguards to address threats created by conflicts of interest include:

- (a) Restructuring or segregating certain responsibilities and duties.
- (b) Obtaining appropriate oversight, for example, acting under the supervision of an executive or non-executive director.

3. Disclosure and Consent

It is generally necessary to:

- (a) Disclose the nature of the conflict of interest and how any threats created were addressed to the relevant parties, including to the appropriate levels within the employing organization affected by a conflict; and
- (b) Obtain consent from the relevant parties for the Chartered Accountant to undertake the professional activity when safeguards are applied to address the threat.

When addressing a conflict of interest, the Chartered Accountant is encouraged to seek guidance from within the employing organization or from the Institute, legal counsel or another accountant. When making such disclosures or sharing information within the employing organization and seeking guidance of third parties, the principle of confidentiality applies.

Illustration 3:

Alaap Ltd.'s directors feel that the company needs a significant injection of capital in order to modernize plant and equipment as the company has been promised firm orders if it can produce goods of international standards. The current lending policies of the banks require prospective borrowers to demonstrate strong projected cash flows, coupled with a Debt Service Coverage Ratio exceeding 10. However, the current projected statement of cash flows does not satisfy the bank's criteria for lending. The directors have told the bank that the company is in an excellent financial position, the financial results and cash flow projections will meet the criteria and the chartered accountant will submit a report to this effect shortly. The chartered accountant has recently joined Alaap Ltd. and has openly stated that he cannot afford to lose his job because of financial commitments.

Required:

Discuss the potential ethical conflicts which may arise in the above scenario and the ethical principles which would guide how the chartered accountant should respond to the situation.

Solution

The given scenario presents a twofold conflict of interest:

- (i) *Pressure to obtain finance and chartered accountant's personal circumstances*

The chartered accountant is under pressure to provide the bank with a projected cash flow statement that will meet the bank's criteria when in fact the actual projections do not meet

the criteria. The chartered accountant's financial circumstances mean that he cannot lose his job, thus **the ethical and professional standards required of the accountant are at odds with the pressures of his personal circumstances.**

(ii) *Duty to shareholders, employees and bank*

The **directors have a duty to act in the best interests of the company's shareholders and employees, and a duty to present fairly any information the bank may rely on.** The injection of capital to modernise plant and equipment appears to be for capacity expansion which will lead to greater profits, thus being in the interests of the shareholders and the employees. However, if such finance is obtained based on misleading information, it could actually be detrimental to the going concern status of the company.

It could be argued that there is a **conflict between the short-term and medium-term interests of the company** (the need to modernise the company) **and its long-term interests** (the detriment to the company's reputation if its directors do not conform to ethics).

Ethical principles guiding the chartered accountant's response

The chartered accountant's financial circumstances coupled with the pressure from the directors could end up in him knowingly disclosing incorrect information to the bank, thereby compromising the fundamental principles of **objectivity, integrity and professional competence.**

By exhibiting **bias** due to the **risk of losing his job** through reporting favourable cash flows to the bank, **objectivity** is compromised. Further, **integrity** is also compromised as by not acting in a straightforward and honest manner, **incorrect information is knowingly disclosed.** Forecasts, unlike financial statements, do not specify that they have been prepared in accordance with Ind AS. However, the principle of **professional competence** requires the accountant to prepare the cash flow projections to the **best of his professional judgment** which would not be the case if the projections showed a more positive position than what is actually anticipated.

Appropriate action

The **chartered accountant faces an immediate ethical dilemma** and must apply his moral and ethical judgment. As a professional, he is responsible for presenting the truth, and not to indulge in 'creative accounting' owing to pressure.

Thus, **the chartered accountant should put the interests of the company and professional ethics first** and insist that the report to the bank be an honest reflection of the company's current financial position. Being an advisor to the directors, he must prevent deliberate misrepresentation to the bank, no matter what the consequences to him are personally. The accountant should not allow any undue influence from the directors to override his professional judgment or integrity. This is in the long-term interests of the company and its survival.

It is suggested that the chartered accountant should communicate to the directors to submit the projected statement of cash flows to the bank, which reflects the current position of the company.

Knowingly providing incorrect information is considered as professional misconduct. To prevent such misconduct, a chartered accountant should not provide incorrect projected cash flows to the bank and colour the financial position of the entity. By adhering to the ethical principles, the chartered accountant will maintain his professional integrity and contribute to the trust and reliability placed in the work expected from him.

However, if he submits the incorrect projected statement of cash flows, he would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

B. PREPARATION AND PRESENTATION OF INFORMATION

When preparing or presenting information, a Chartered Accountant shall:

- (a) Prepare or present the information in accordance with a relevant reporting framework, where applicable;
- (b) Prepare or present the information in a manner that is intended neither to mislead nor to influence contractual or regulatory outcomes inappropriately;
- (c) Exercise professional judgment to:
 - (i) Represent the facts accurately and completely in all material respects;
 - (ii) Describe clearly the true nature of business transactions or activities; and
 - (iii) Classify and record information in a timely and proper manner; and
- (d) Not omit anything with the intention of rendering the information misleading or of influencing contractual or regulatory outcomes inappropriately.

An example of influencing a contractual or regulatory outcome inappropriately is using an unrealistic estimate with the intention of avoiding violation of a contractual requirement such as a debt covenant or of a regulatory requirement such as a capital requirement for a financial institution.

1. Use of Discretion in Preparing or Presenting Information

Preparing or presenting information might require the exercise of discretion in making professional judgments. The Chartered Accountant shall not exercise such discretion with the intention of misleading others or influencing contractual or regulatory outcomes inappropriately.

Examples of ways in which discretion might be misused to achieve inappropriate outcomes include:

- Determining estimates, for example, determining fair value estimates in order to misrepresent profit or loss.
- Selecting or changing an accounting policy or method among two or more alternatives permitted under the applicable financial reporting framework, for example, selecting a policy for accounting for long-term contracts in order to misrepresent profit or loss.
- Determining the timing of transactions, for example, timing the sale of an asset near the end of the fiscal year in order to mislead.
- Determining the structuring of transactions, for example, structuring financing transactions in order to misrepresent assets and liabilities or classification of cash flows.
- Selecting disclosures, for example, omitting or obscuring information relating to financial or operating risk in order to mislead.

When performing professional activities, the Chartered Accountant shall exercise professional judgment to identify and consider:

- (a) The purpose for which the information is to be used;
- (b) The context within which the information is given; and
- (c) The audience to whom it is addressed.

For example, when preparing or presenting pro forma reports, budgets or forecasts, the inclusion of relevant estimates, approximations and assumptions, where appropriate, would enable those who might rely on such information to form their own judgments.

2. Relying on the Work of Others

A Chartered Accountant who intends to rely on the work of others, either internal or external to the employing organization, shall exercise professional judgment to determine what steps to take, if any, in order to fulfil the responsibilities.

Factors to consider in determining whether reliance on others is reasonable include:

- The reputation and expertise of, and resources available to, the other individual or organization.

- Whether the other individual is subject to applicable professional and ethics standards.

Such information might be gained from prior association with, or from consulting others about, the other individual or organization.

3. Addressing Information that Is or Might be Misleading

When the Chartered Accountant knows or has reason to believe that the information with which the accountant is associated is misleading, the accountant shall take appropriate actions to seek to resolve the matter.

- Actions that might be appropriate include:
- Discussing concerns that the information is misleading with the Chartered Accountant's superior and/or the appropriate level(s) of management within the accountant's employing organization or those charged with governance and requesting such individuals to take appropriate action to resolve the matter. Such action might include:
 - Having the information corrected.
 - If the information has already been disclosed to the intended users, informing them of the correct information.

Consulting the policies and procedures of the employing organization (for example, an ethics or whistle-blowing policy) regarding how to address such matters internally

The Chartered Accountant might determine that the employing organization has not taken appropriate action. If the accountant continues to have reason to believe that the information is misleading, the following further actions might be appropriate provided that the accountant remains alert to the principle of confidentiality:

- Consulting with:
 - The Institute
 - The internal or external auditor of the employing organization
 - Legal counsel.
- Determining whether any requirements exist to communicate to:
 - Third parties, including users of the information.
 - Regulatory and oversight authorities.

If after exhausting all feasible options, the Chartered Accountant determines that appropriate action has not been taken and there is reason to believe that the information is still misleading, the accountant shall refuse to be or to remain associated with the information.

In such circumstances, it might be appropriate for a Chartered Accountant to resign from the employing organization.

Illustration 4:

Sunshine Ltd., a listed company in the cosmetics industry, has debt covenants attached to some of its borrowings which are included in Financial Liabilities in the Balance Sheet. These covenants mandate the company to repay the debt in full if Sunshine Ltd. fails to maintain a liquidity ratio and operating margin above the specified limit.

The directors alongwith the CFO of the Company who is a chartered accountant are considering entering into a fresh five-year leasing arrangement but are concerned about the negative impact any potential lease obligations may have on the above-mentioned covenants. Accordingly, the directors and CFO propose that the lease agreement be drafted in such a way that it is a series of six ten-month leases rather than a single five-year lease in order to utilize the short-term lease exemption available under Ind AS 116, Leases. This would then enable accounting for the leases in their legal form. The directors believe that this treatment will meet the requirements of the debt covenant, though such treatment may be contrary to the accounting standards.

Required:

Discuss the ethical and accounting implications of the above issue from the perspective of CFO.

Solution**Lease agreement substance presentation**

Stakeholders make informed and accurate decisions based on the information presented in the financial statements and as such, ensuring the financial statements are reliable and of utmost importance. The directors of Sunshine Ltd. are ethically responsible to produce financial statements that comply with Ind AS and are transparent and free from material error. Lenders often attach covenants to the terms of the agreement in order to protect their interests in an entity. They would also be of crucial importance to potential debt and equity investors when assessing the risks and returns from any future investment in the entity.

The proposed action by Sunshine Ltd. appears to be a deliberate attempt to circumvent the terms of the covenants. The legal form would require treatment as a series of short-term leases which would be recorded in the profit or loss, without any right-of-use asset and lease liability being recognized as required by Ind AS 116, Leases. This would be a form of 'off-balance sheet finance' and would not report the true assets and obligations of Sunshine Ltd. As a result of this proposed action, the liquidity ratios would be adversely misrepresented. Further, the operating profit margins would also be adversely affected, as the expenses associated with the lease are likely to

be higher than the depreciation charge if a leased asset was recognized, hence the proposal may actually be detrimental to the operating profit covenant.

Sunshine Ltd. is aware that the proposed treatment may be contrary to Ind AS. Such manipulation would be a clear breach of the fundamental principles of objectivity and integrity as outlined in the Code of Ethics. It is important for a chartered accountants to exercise professional behaviour and due care all the time. The proposals by Sunshine Ltd. are likely to mislead the stakeholders in the entity. This could discredit the profession by creating a lack of confidence within the profession. The directors of Sunshine Ltd. must be reminded of their ethical responsibilities and persuaded that the accounting treatment must fully comply with the Ind AS and principles outlined within the framework should they proceed with the financing agreement.

However, if the CFO fails to comply with his professional duties, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

C. ACTING WITH SUFFICIENT EXPERTISE

A Chartered Accountant shall not intentionally mislead an employing organization as to the level of expertise or experience possessed.

A self-interest threat to compliance with the principle of professional competence and due care might be created if a Chartered Accountant has:

- Insufficient time for performing or completing the relevant duties.
- Incomplete, restricted or otherwise inadequate information for performing the duties.
- Insufficient experience, training and/or education.
- Inadequate resources for the performance of the duties.

Examples of actions that might be safeguards to address such a self-interest threat include:

- Obtaining assistance or training from someone with the necessary expertise.
- Ensuring that there is adequate time available for performing the relevant duties.

If a threat to compliance with the principle of professional competence and due care cannot be addressed, a Chartered Accountant shall determine whether to decline to perform the duties in

question. If the accountant determines that declining is appropriate, the accountant shall communicate the reasons.

Illustration 5:

Agastya Ltd. is a listed company engaged in the manufacturing of automotive spare parts. The company is preparing the financial statements for the year ended 31 March 20X3. The directors of Agastya Ltd. are entitled to an incentive based on the operating profit margin of the company. You have been appointed as a consultant to advise on the preparation of the financial statements, and you notice the following issue:

Issue:

On 1 April 20X2, Agastya Ltd.'s defined benefit pension scheme was amended to increase the pension entitlement from 12% of final salary to 18.5% of final salary. This amendment was made due to the salary cuts made on account of the pandemic. The chartered accountant has shown such increase in the pension entitlement (amounting to ₹ 85 crores) under the head 'Employee Benefits' forming part of the operating profit. The directors are unhappy with this presentation. They believe that the pension scheme is not integral to the operations of the company since it is paid post-retirement of the employees, and thus insist that such presentation would be misleading in computing the operating profit or loss. Accordingly, the directors propose a change in accounting policy so that all such gains or losses on pension scheme would be recognized under Other Comprehensive Income. The directors believe that this policy choice will make the financial statements more consistent, understandable thereby justifying the same on grounds of fair presentation as defined in the Framework. The pension scheme of Agastya Ltd. is currently in deficit.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate from the perspective of the consultant.

Solution**Ethical Implications of change in accounting policy**

Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors only permits a change in accounting policy if the change is: (i) required by an Ind AS or (ii) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. A retrospective adjustment is required unless the change arises from a new accounting policy with transitional arrangements to account for the change. It is permissible to depart from the requirements of Ind AS but only in extremely rare circumstances where compliance would be so

misleading that it would conflict with overall objectives of the financial statements. Practically, this override is rarely, if ever, invoked.

Ind AS 19, Employee Benefits requires all gains and losses on a defined benefit pension scheme to be recognised in profit or loss except for the remeasurement component relating to plan assets and defined benefit obligations, which must be recognized in Other Comprehensive Income. Accordingly, current service cost, past service cost and net interest cost on the net defined benefit obligation must all be recognized in profit or loss. Ind AS 19 does not offer any alternative treatment as an accounting policy choice in terms of Ind AS 8, and therefore the directors' proposals cannot be justified on the grounds of fair presentation. The directors are ethically bound to prepare financial statements which reflect a true and fair view of the entity's performance and financial position and comply with all Ind AS.

It is the self-interest in the pension scheme that is making the directors consider a change in accounting policy in order to maximize profits for maximizing their bonus potential. The amendment to the pension scheme is a past service cost in terms of Ind AS 19 which should be expensed to the profit or loss during the period such plan amendment has occurred, i.e., immediately. This would impact the operating profits of Agastya Ltd. thereby reducing the potential bonus.

Additionally, it appears that the directors wish to manipulate aspects of the pension scheme such as current service cost and, since the pension scheme is given to be in deficit, the net finance cost. The directors are purposely manipulating the presentation of these items by recording them in equity instead of Profit or Loss. The financial statements would not be compliant with Ind AS and would not give a reliable picture of the true costs to the company of operating the pension scheme and this treatment would make the financial statements less comparable with other entities correctly applying Ind AS 19. Further, the explicit statement given in the financial statements stating that all compliance with Ind AS is achieved would be an incorrect statement to make in the event of the above non-compliance. Further, such treatment would be against the fundamental principles of objectivity, integrity and professional behaviour as stated in the Code of Ethics. The directors need to understand their ethical responsibilities and avoid implementing the proposed change in policy.

As a meaningful addition, the directors could use other tools/indicators within the financial statements to explain the company's results such as drawing attention of the users to the cash generated from operations which would exclude the non-cash pension expense. Alternative measures such as EBITDA could be disclosed where non-cash items are consistently eliminated for comparison purposes.

When a Chartered Accountant discovers that a company's financial position has been compromised through misstatement, they have two options. They can either report the non-

compliance to the authorities or consider withdrawing from the engagement. Both the actions ensure integrity, transparency, and the interests of stakeholders at large.

In case the consultant-chartered accountant is influenced by the director's suggestions and report accordingly, he will be subject to professional misconduct under Clauses 5,7 and 8 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 5 states that a Chartered Accountant is guilty of professional misconduct when he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

Clause 7 states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

Clause 8 of Part I of the Second Schedule of the Chartered Accountants Act 1949 states that a CA is guilty of professional misconduct when he fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

D. FINANCIAL INTERESTS, COMPENSATION AND INCENTIVES LINKED TO FINANCIAL REPORTING AND DECISION MAKING

A Chartered Accountant shall not manipulate information or use confidential information for personal gain or for the financial gain of others.

Chartered Accountants might have financial interests or might know of financial interests of immediate or close family members that, in certain circumstances, might create threats to compliance with the fundamental principles. Financial interests include those arising from compensation or incentive arrangements linked to financial reporting and decision making.

Examples of circumstances that might create a self-interest threat include situations in which the Chartered Accountant or an immediate or close family member:

- Has a motive and opportunity to manipulate price- sensitive information in order to gain financially.
- Holds a direct or indirect financial interest in the employing organization and the value of that financial interest might be directly affected by decisions made by the accountant.
- Is eligible for a profit-related bonus and the value of that bonus might be directly affected by decisions made by the accountant.
- Holds, directly or indirectly, deferred bonus share rights or share options in the employing organization, the value of which might be affected by decisions made by the accountant.

- Participates in compensation arrangements which provide incentives to achieve targets or to support efforts to maximize the value of the employing organization's shares. An example of such an arrangement might be through participation in incentive plans which are linked to certain performance conditions being met.

Illustration 6:

The directors of Spinz Ltd. are eligible for an incentive computed as a percentage of 'Cash Generated from Operations' as defined in Ind AS 7, Statement of Cash Flows in accordance with the terms of their appointment. Due to the onset of the pandemic, the company has not performed well, and it has, in fact, lost Cash from Operations. In order to meet the cash requirements, the directors of Spinz Ltd. are planning to dispose off under-utilized equipment and investments (not subsidiaries or associates). The directors opine that since the cash generated from sale of such equipment and investments would be used for operations, the inflows on such sale would be presented in the Statement of Cash Flows under 'Cash from Operations'. The directors are concerned about meeting the targets in order to ensure security of their jobs and feel that this treatment would enhance the 'cash flow picture' of the business. The inflows on sale of such equipment and investments have the potential to make the 'Cash from Operations' figure positive.

Required:

Discuss the ethical responsibility of Spinz Ltd.'s Chartered Accountant who is an employee to ensure that the manipulation of the Statement of Cash Flows, as suggested by the directors, does not occur.

Solution

In order to meet targets, it is quite possible that management may want to **present a company's results in a favourable manner**. Such an objective could be achieved by employing creative accounting techniques such as window dressing, or as can be seen in the case, **inaccurate classification**.

As per para 16 of Ind AS 7, separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Example of cash flows arising from investing activities are cash receipts from sales of property, plant and equipment, intangibles and other long-term assets.

Presenting proceeds of sale of investments and under-utilized equipment as part of 'Cash from Operations' gives a **misleading picture** of the financial statements. Operating cash flows are crucial for the long-term survival of the company, and a negative cash from operations figure could be a possible indicator of cash shortage in the short-term, and possibly question the going concern

assumption of the entity in the long-run. Further, operating cash flows are recurring, whereas investing and financing cash flows tend to be one-off.

In the given case, it may appear that to meet cash requirements for its operations, the company is selling its investments and equipment. Selling of equipment and investments is not usually a part of trading operations. Such sales generate short-term cash flow and cannot be repeated on a regular basis. The proposed misclassification could be regarded as a deliberate attempt to mislead stakeholders about the performance of Spinz Ltd. and its future performance, which is unethical.

Chartered Accountants have a duty, not only to the **company** they work for, but also to their **professional body (i.e., ICAI)**, and to the **stakeholders** of the company. Proceeds received from sale of equipment and investment should be presented under '**Cash Flows from Investing Activities**' (instead of 'Operating Activities') in accordance with Ind AS 7, Statement of Cash Flows. As per the Code of Ethics, a Chartered Accountant should follow the fundamental principle of **professional competence and due care** which includes preparing financial statements in compliance with Ind AS. In case the accountant permits the treatment of the matter as proposed by the management, it would result in a breach of the principle of professional competence and due care. This treatment may be permitted by the accountant under pressure from the management.

The chartered accountant should **prevent the management not to proceed with the aforesaid accounting treatment** which violates Ind AS 7. In case the management insists on continuing with their suggested treatment, then the chartered accountant must **bring this to the attention of the auditors**. Otherwise, the chartered accountant would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

Illustration 7:

Infostar Ltd. is a listed company engaged in the provision of IT services in India. The directors are paid a bonus based on the profits achieved by the company during the year as per the bonus table given below:

Profit Range	Bonus to Directors
NIL < Profit < ₹ 1 crore	NIL
₹ 1 crore < Profit < ₹ 5 crores	2% of Net Profit
₹ 5 crores < Profit < ₹ 10 crores	4% of Net Profit
₹ 10 crores < Profit < ₹ 20 crores	6% of Net Profit
₹ 20 crores < Profit < ₹ 30 crores	8% of Net Profit
Profit > ₹ 30 crores	10% of Net Profit

The draft Statement of Profit and Loss for the year ended 31 March 20X2 currently shows a profit of ₹ 2 crores.

Issue:

The employees of Infostar Ltd. have historically been paid an individual-performance-based discretionary incentive for the last 15 years. Based on the past trends and performance, the bonus amount for the year 20X1-20X2 would be ₹ 3 crores. In view of the possibility of the directors not receiving the bonus on account of the company's poor performance, Infostar Ltd.'s Chief Financial Officer (CFO), who is a chartered accountant, has suggested that the discretionary incentive usually payable to the employees could be avoided in the current year, which would result in the company reporting profits. As a part of its annual report, Infostar Ltd. reports employee satisfaction scores, staff attrition rates, gender equality and employee absenteeism rates as non-financial performance measures. The CFO has also told the directors over mail that no stakeholder reads the non-financial information anyway, and thus his aforesaid suggestion of not paying the discretionary incentive would not impact the company greatly.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate from perspective of CA. Sushil Bhupathy.

Solution

Ethical Considerations

Long-term success of any organization strongly depends on the fair treatment of employees, which in turn is based on the ethical behaviour of the management as well as how the same is perceived by the stakeholders. In the given case, the CFO has suggested not paying the discretionary bonus, which the directors are considering as it will enable the company to record profits of ₹ 2 crores, thereby ensuring a bonus pay out to the directors. This suggestion is not illegal at all as the bonus is discretionary rather than statutory/contractual. In other words, the company has no

legal obligation to pay the bonus to the employees. However, the reason behind non-payment of the bonus is what gives rise to ethical considerations. The suggestion by the CFO will have the aforesaid impact of reducing expenses and improving profits.

On a moral ground, the suggestion is likely to have negative consequences for the company. The employees would be dissatisfied that the bonus has been withdrawn, and further, when they would see the directors withdrawing bonuses out of the profits arising on a saving in bonus costs, it would have a negative impact on employee morale, which would result in low employee satisfaction scores and poor retention rates, which are reported as non-financial information in the financial statements. Companies are also under increasing pressure to reduce the wage gap between the management and its employees. By not paying a bonus, this metric will be adversely affected.

The CFO's statement that the above action will not negatively impact the company as the non-financial reporting indicators are not widely read by the users is misleading. The non-financial information is becoming increasingly important to the users of financial statements as they care about companies' treatment of their employees and view it as being important in the long-term success of the company.

A chartered accountant has a responsibility to exercise due diligence and clearly consider both financial and non-financial information while discharging his professional duty. It would be unethical for a chartered accountant to guide the management on matters which may result into any kind of disadvantage (it includes even non-financial matters) to the stakeholders.

Further, a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A chartered accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable chartered accountants to meet their responsibility to act in the public interest. (*Refer Section 100.1 A1, Code of Ethics issued by ICAI*)

Hence, it is essential for a chartered accountant to uphold the professional standards and act in accordance with the ethical principles by ensuring transparency and accuracy in financial reporting.

E. INDUCEMENTS, INCLUDING GIFTS AND HOSPITALITY

An inducement is an object, situation, or action that is used as a means to influence another individual's behaviour, but not necessarily with the intent to improperly influence that individual's behaviour. Inducements can range from minor acts of hospitality between business colleagues to

acts that result in non-compliance with laws and regulations. An inducement can take many different forms, for example:

- Gifts.
- Hospitality.
- Entertainment.
- Political or charitable donations.
- Appeals to friendship and loyalty.
- Employment or other commercial opportunities.
- Preferential treatment, rights or privileges

1. Immediate or Close Family Members

A Chartered Accountant shall remain alert to potential threats to the accountant's compliance with the fundamental principles created by the offering of an inducement:

- (a) By an immediate or close family member of the accountant to a counterparty with whom the accountant has a professional relationship; or
- (b) To an immediate or close family member of the accountant by a counterparty with whom the accountant has a professional relationship.

Where the Chartered Accountant becomes aware of an inducement being offered to or made by an immediate or close family member and concludes there is intent to improperly influence the behaviour of the accountant or of the counterparty or considers a reasonable and informed third party would be likely to conclude such intent exists, the accountant shall advise the immediate or close family member not to offer or accept the inducement.

One of the factors that is relevant in determining whether there is actual or perceived intent to improperly influence the behaviour of the Chartered Accountant or of the counterparty is the nature or closeness of the relationship, between:

- (a) The accountant and the immediate or close family member;
- (b) The immediate or close family member and the counterparty; and
- (c) The accountant and the counterparty.

For example, the offer of employment, outside of the normal recruitment process, to the spouse of the accountant by a counterparty with whom the accountant is negotiating a significant contract might indicate such intent.

F. RESPONDING TO NON-COMPLIANCE WITH LAWS AND REGULATIONS IN CASE OF EMPLOYMENT WITH LISTED ENTITIES

A Chartered Accountant might encounter or be made aware of non-compliance or suspected non-compliance in the course of carrying out professional activities. This section guides the accountant in assessing the implications of the matter and the possible courses of action when responding to non-compliance or suspected non-compliance with:

- (a) Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the employing organization's financial statements; and
- (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the employing organization's financial statements, but compliance with which might be fundamental to the operating aspects of the employing organization's business, to its ability to continue its business, or to avoid material penalties.

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. When responding to non-compliance or suspected non-compliance, the objectives of the Chartered Accountant are:

- (a) To comply with the principles of integrity and professional behaviour;
- (b) By alerting management or, where appropriate, those charged with governance of the employing organization, to seek to:
 - (i) Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or
 - (ii) Deter the non-compliance where it has not yet occurred; and
 - (iii) To take such further action as appropriate in the public interest.

Non-compliance with laws and regulations ("non-compliance") comprises acts of omission or commission, intentional or unintentional, which are contrary to the prevailing laws or regulations committed by the following parties:

- (a) The Chartered Accountant's employing organization;
- (b) Those charged with governance of the employing organization;
- (c) Management of the employing organization; or
- (d) Other individuals working for or under the direction of the employing organization.

Examples of laws and regulations which this section addresses include those that deal with:

- Fraud, corruption and bribery.
- Money laundering, terrorist financing and proceeds of crime.
- Securities markets and trading.

- Banking and other financial products and services.
- Data protection.
- Tax and pension liabilities and payments.
- Environmental protection.
- Public health and safety.

1. Responsibilities of All Chartered Accountants

If protocols and procedures exist within the Chartered Accountant's employing organization to address non-compliance or suspected non-compliance, the accountant shall consider them in determining how to respond to such non-compliance.

2. Responsibilities of Senior Chartered Accountants in Service

Senior Chartered Accountants in service ("senior Chartered Accountants") are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources. There is a greater expectation for such individuals to take whatever action is appropriate in the public interest to respond to non-compliance or suspected noncompliance than other Chartered Accountants within the employing organization. This is because of senior Chartered Accountants' roles, positions and spheres of influence within the employing organization.

1. Addressing the Matter

If the senior Chartered Accountant identifies or suspects that non-compliance has occurred or might occur, the accountant shall, subject to the considerations mentioned above under the responsibilities for all Chartered Accountants, discuss the matter with the accountant's immediate superior, if any. If the accountant's immediate superior appears to be involved in the matter, the accountant shall discuss the matter with the next higher level of authority within the employing organization.

The senior Chartered Accountant shall also take appropriate steps to:

- (a) Have the matter communicated to those charged with governance;
- (b) Comply with applicable laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority;
- (c) Have the consequences of the non-compliance or suspected non-compliance rectified, remediated or mitigated;
- (d) Reduce the risk of re-occurrence; and

(e) Seek to deter the commission of the non-compliance if it has not yet occurred.

In addition to responding to the matter in accordance with the provisions of this section, the senior Chartered Accountant shall determine whether disclosure of the matter to the employing organization's external auditor, if any, is needed.

Such disclosure would be pursuant to the senior Chartered Accountant's duty or legal obligation to provide all information necessary to enable the auditor to perform the audit.

2. Determining Whether Further Action Is Needed

The senior Chartered Accountant shall assess the appropriateness of the response of the accountant's superiors, if any, and those charged with governance.

Examples of circumstances that might cause the senior Chartered Accountant no longer to have confidence in the integrity of the accountant's superiors and those charged with governance include situations where:

- The accountant suspects or has evidence of their involvement or intended involvement in any non-compliance.
- Contrary to legal or regulatory requirements, they have not reported, or authorized the reporting of, the matter to an appropriate authority within a reasonable period.

Further action that the senior Chartered Accountant might take includes:

- Informing the management of the parent entity of the matter if the employing organization is a member of a group.
- Disclosing the matter to an appropriate authority as specified under respective law.
- Resigning from the employing organization.

Resigning from the employing organization is not a substitute for taking other actions that might be needed to achieve the senior Chartered Accountant's objectives under this section. However, there might be limitations as to the further actions available to the accountant. In such circumstances, resignation might be the only available course of action.

3. Seeking Advice

As assessment of the matter might involve complex analysis and judgments, the senior Chartered Accountant might consider:

- Consulting internally.
- Obtaining legal advice to understand the accountant's options and the professional or legal implications of taking any particular course of action.
- Consulting on a confidential basis with the Institute.

4. Determining Whether to Disclose the Matter to an Appropriate Authority

Disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation. Otherwise, the purpose of making disclosure is to enable an appropriate authority to cause the matter to be investigated and action to be taken in the public interest.

5. Responsibilities of Chartered Accountants Other than Senior Chartered Accountants

If, in the course of carrying out professional activities, a Chartered Accountant becomes aware of information concerning non-compliance or suspected non-compliance, the accountant shall seek to obtain an understanding of the matter. This understanding shall include the nature of the non-compliance or suspected non-compliance and the circumstances in which it has occurred or might occur.

If the Chartered Accountant identifies or suspects that noncompliance has occurred or might occur, the accountant shall, subject to the considerations mentioned above under the responsibilities for all Chartered Accountants, inform an immediate superior to enable the superior to take appropriate action. If the accountant's immediate superior appears to be involved in the matter, the accountant shall inform the next higher level of authority within the employing organization.

In exceptional circumstances, the Chartered Accountant may determine that disclosure of the matter to an appropriate authority is an appropriate course of action. If the accountant does so, that disclosure is permitted. When making such disclosure, the accountant shall act in good faith and exercise caution when making statements and assertions.

Illustration 8:

Agastya Ltd. is a listed company engaged in the manufacturing of automotive spare parts. The company is preparing the financial statements for the year ended 31 March 20X3. The directors of Agastya Ltd. are entitled to an incentive based on the operating profit margin of the company. You have been appointed as a consultant to advise on the preparation of the financial statements, and you notice the following issue:

Issue:

The draft financial statements include an amount of ₹ 75 lakhs given as loan to a director. The loan has no specific repayment terms; the same is repayable on demand. The directors have included such loan under the heading 'Cash and Cash Equivalents'. They have reasoned that since such loan, which is advanced to one of the directors, is repayable on demand, it is readily convertible to cash. Further the directors opine that such presentation should not be a problem even under the Ind AS Framework as financial statements are essentially prepared in accordance

with accounting policies which is the choice of the company, and in this case, Agastya Ltd. has made a policy choice to show such loan as a cash equivalent.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate.

Solution

The directors have included a loan made to a director as a part of Cash and Cash Equivalents. It appears that the directors have misunderstood the definition of Cash and Cash Equivalents, believing the loan to be a cash equivalent. As per Ind AS 7, *Statement of Cash Flows*, cash equivalents are short-term, highly liquid investments readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value. However, the loan given to the directors is not in place to enable Agastya Ltd. to manage its short-term cash commitments, it has no fixed repayment date and the likelihood of the director defaulting is also not known. Thus, the classification as a cash equivalent is inappropriate.

Instead, the loan should be regarded as a financial asset under Ind AS 109, *Financial Instruments*. Further information would be required, for example is ₹ 75 lakhs fair value? It could be said that the loan will never be repaid, and accordingly could be regarded as a component of directors' remuneration, and if so, the same should be expensed and disclosed accordingly. Further, since the director is likely to fall into the category of key management personnel, related party disclosures under Ind AS 24, *Related Party Disclosures* are likely to be necessary.

The treatment of loan as a cash equivalent breached two fundamental qualitative characteristics prescribed in the Conceptual Framework for Financial Reporting, namely:

- (i) **Relevance:** The information should be disclosed separately as it is relevant to users.
- (ii) **Faithful representation:** Information must be complete, neutral and free from error. Clearly, this will not be the case if loan to a director is shown as Cash Equivalents.

The said treatment is also violative of the Conceptual Framework's key enhancing qualitative characteristics:

- (i) **Understandability:** if the loan is shown as Cash Equivalents, it masks the true nature of company's practices, thereby reducing the understandability of the financial statements to the users.
- (ii) **Verifiability:** Verifiability ensures that different knowledgeable and independent observers can reach consensus that a particular depiction of a transaction / account balance is a faithful representation. Verifiability gives assurance to the users that the information faithfully

represents the economic phenomena it intends to represent. The treatment given by the directors of Agastya Ltd. does not meet this benchmark as it reflects the subjective bias of the directors.

- (iii) **Comparability:** For financial statements to be comparable year-on-year and with other companies, transactions must be correctly classified and presented, which is not happening here. If the cash balance of one year includes a loan to a director and the next year it does not, then you are not comparing like with like.

There is a potential **conflict of interest** between that of the director and that of the company, which mandates a separate disclosure as a minimum. Further, issues with compliance of section 185 of the Companies Act, 2013 would arise, which is why probably the directors want to hide such loan balance under cash equivalents. Directors are responsible for the financial statements required by statute, and thus it is their responsibility to put right any errors that result in the financial statements not complying with Ind AS. The directors are also legally bound to maintain proper accounting records and recording a loan as cash equivalent clashes with this requirement.

By masking the nature of the transaction, it is possible that the directors are **motivated by personal interest** and are thus failing in their duty to act honestly and ethically. If one transaction is misleading, it casts doubt on the credibility of the financial statements as a whole.

As a consultant, it becomes his responsibility to get the financial statements rectified and guide the directors about the principles enunciated in Ind AS and the correct treatment in accordance with the standards. Otherwise, he will be subject to professional misconduct under Clause 6 and 7 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 6 of Part I of the Second Schedule of the Chartered Accountants Act 1949 states that a CA is guilty of professional misconduct when he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

The Clause 7, states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

G. PRESSURE TO BREACH THE FUNDAMENTAL PRINCIPLES

A Chartered Accountant shall not:

- (a) Allow pressure from others to result in a breach of compliance with the fundamental principles; or
- (b) Place pressure on others that the accountant knows, or has reason to believe, would result in the other individuals breaching the fundamental principles.

A Chartered Accountant might face pressure that creates threats to compliance with the fundamental principles, for example an intimidation threat, when undertaking a professional activity. Pressure might be explicit or implicit and might come from:

- Within the employing organization, for example, from a colleague or superior.
- An external individual or organization such as a vendor, customer or lender.
- Internal or external targets and expectations.

Examples of pressure that might result in threats to compliance with the fundamental principles include:

- Pressure related to conflicts of interest:
 - Pressure from a family member bidding to act as a vendor to the Chartered Accountant's employing organization to select the family member over another prospective vendor.

Discussing the circumstances creating the pressure and consulting with others about those circumstances might assist the Chartered Accountant to evaluate the level of the threat. Such discussion and consultation, which requires being alert to the principle of confidentiality, might include:

- Discussing the matter with the individual who is exerting the pressure to seek to resolve it.
- Discussing the matter with the accountant's superior, if the superior is not the individual exerting the pressure.
- Escalating the matter within the employing organization, including when appropriate, explaining any consequential risks to the organization, for example with:
 - Higher levels of management.
 - Internal or external auditors.
 - Those charged with governance.
- Disclosing the matter in line with the employing organization's policies, including ethics and whistleblowing policies, using any established mechanism, such as a confidential ethics hotline.
- Consulting with:
 - A colleague, superior, human resources personnel, or another Chartered Accountant;
 - Institute or industry associations; or
 - Legal counsel.

An example of an action that might eliminate threats created by pressure is the Chartered Accountant's request for a restructure of, or segregation of, certain responsibilities and duties so that the accountant is no longer involved with the individual or entity exerting the pressure.

Illustration 9:

As at 31 March 20X4, Mitra Ltd. had a plan to dispose off its 75% subsidiary Dosti Ltd. This plan had been approved by the board and was reported in the media as well as to the Stock Exchange where Mitra Ltd. was listed. It is expected that Jaya Ltd., the non-controlling shareholder in Dosti Ltd. holding 25% stake, will acquire the 75% equity interest as well. The sale is expected to be completed by October 20X4. Dosti Ltd. is expected to have substantial trading losses in the period up to the sale. Mr. X, a chartered accountant, who is an employee in the finance department of Mitra Ltd., wishes to show Dosti Ltd. as held for sale in the financial statements and to create a restructuring provision to include the expected costs of disposal and future trading losses. However, the Chief Operating Officer (COO) does not wish Dosti Ltd. to be categorized as held for sale nor to provide for the expected losses. The COO is concerned as to how this may affect the sales and would surely result in bonus targets not being met. He has argued that as the management, it is his duty to secure a high sales price to maximize the return for shareholders of Mitra Ltd. He has also hinted that Mr. X's job could be at stake if such a provision were to be made in the financial statements. The expected costs from the sale are as follows:

Future Trading Losses:	₹ 20 crores
Various legal costs of sale	₹ 1.5 crores
Redundancy costs for Dosti Ltd.'s employees	₹ 4 crores
Impairment losses on Property, Plant and Equipment	₹ 7 crores

Required:

- Discuss the accounting treatment which Mitra Ltd. should adopt to address the issue above for the financial statements.
- Discuss the ethical issues which may arise in the above scenario, including any actions which Mitra Ltd. and Mr. X should take.

Solution

- In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, 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.

For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be *highly probable*.

For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the **sale should be expected to qualify for recognition as a completed sale within one year from the date of classification**, except in specific cases as permitted by the Standard, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The probability of required approvals (as per the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

An entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out above are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

Based on the provisions highlighted above, the disposal of Dosti Ltd. appears to meet the criteria of **held for sale**. Jaya Ltd. is the probable acquirer, and the sale is highly probable, expected to be completed seven months after the year end, well within the 12-months criteria highlighted above. Accordingly, Dosti Ltd. should be treated as a disposal group, since a single equity transaction is the most likely form of disposal. In case Dosti Ltd. is deemed to be a separate major component of business or geographical area of the group, the losses of the group should be presented separately as a discontinued operation within the Financial Statements of Mitra Ltd.

In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, 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 carrying amount of Dosti Ltd. (i.e., the subsidiary of Mitra Ltd.) comprises of the net assets and goodwill less the non-controlling interest. The impairment loss recognised to reduce Dosti Ltd. to fair value less costs to sell should be allocated first to goodwill and then on a pro-rata basis across the other non-current assets of the Company.

The Chief Operating Officer (COO) is incorrect to exclude any form of restructuring provision in the Financial Statements. Since the disposal is communicated to the media as well as the Stock Exchange, a constructive obligation exists. However, ongoing costs of business should not be provided for, only **directly attributable costs of restructuring** should be provided. Future operating losses should be excluded as no obligating event has arisen, and no provision is required for impairment losses of Property, Plant and Equipment as it is already

considered in the remeasurement to fair value less costs to sell. Thus, a provision is required for ₹ 5.5 crores (₹ 1.5 crores + ₹ 4 crores).

(b) **Ethics**

Accountants have a duty to ensure that the financial statements are **fair, transparent and comply with the accounting standards**. Mr. X have committed several mistakes. In particular, he was unaware of which costs should be included within a restructuring provision and has failed to recognise that there is no obligating event in relation to future operating losses. A chartered accountant is expected to carry his work with **due care and attention** for lending credibility to the financial statements. Accordingly, he must update his knowledge and ensure that work is carried out in accordance with relevant ethical and professional standards. Failure to do so would be a breach of **professional competence**. Accordingly, Mr. X must ensure that this issue is addressed, for example by attending regular training and professional development courses.

It appears that the chief operating officer is looking for means to **manipulate** the financial statements for meeting the bonus targets. Neither is he is willing to reduce the profits of the group by applying held for sale criteria in respect of Dosti Ltd. nor is he willing to create appropriate restructuring provisions. Both the adjustment which comply with the requirements of Ind AS will result in reduction of profits. His argument that the management has a duty to maximize the returns for the shareholders is true, but such maximization must not be achieved at the cost of **objective and faithful representation** of the performance of the Company. In the given case, it appears that the chief operating officer is motivated by bonus targets under the garb of maximizing returns for the shareholders, thereby resulting in misrepresentation of the results of the group.

Further, by threatening to dismiss Mr. X, the COO has acted unethically. **Threatening and intimidating behaviour** is unacceptable and against all ethical principles. This has given rise to an **ethical dilemma** for Mr. X. He has a duty to produce financial statements but doing so in a fair manner could result in a loss of job for him. The chartered accountant should approach the chief operating officer and remind him the basic ethical principles and communicate him to do the necessary adjustments in the accounts so that they are fair and objective.

In case Mr. X, falls under undue influence of COO and applies the incorrect accounting treatment, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, for contravening the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

TEST YOUR KNOWLEDGE**Question**

1. Shastra Ltd. desires to upgrade its production process since the directors believe that technology-led production is the only way the company can remain competitive. On 1 April 20X5, the company entered into a property lease arrangement in order to obtain tax benefits. However, the draft financial statements do not show a lease asset or a lease liability as on date.

A new financial controller, CA. Sunil Raghavan, joined Shastra Ltd. before the financial year ending 31 March 20X6 and was engaged in the review of financial statements to prepare for the upcoming audit and to begin making a loan application to finance the new technology. CA. Sunil Raghavan believes that the lease arrangement should be recognized in the Balance Sheet. However, the Managing Director, Ms. Anusha Shrivastava, an MBA (Finance), strongly disagrees. She wishes to charge the lease rentals to the Statement of Profit or Loss. Her opinion is based on the understanding that the lease arrangement is merely a monthly rental payment, without any corresponding asset or obligation, since there is no 'invoice' for transfer of asset to Shastra Ltd. Her disagreement also stems from the fact that showing a lease obligation in the Financial Statements would impact the gearing ratio of the company, which could have an adverse impact on the upcoming loan application. Ms. Anusha has made it clear to CA. Sunil Raghavan that at stake is not only the loan application but also his future prospects at Shastra Ltd.

Required:

Discuss the potential ethical conflicts which may arise in the above scenario and the ethical principles which would guide how the financial controller should respond to the situation.

Answer

1. As per Ind AS 116, Leases, at the inception of a contract, an entity shall assess whether the 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.

In accordance with the above definition, Shastra Ltd. must recognise a right-of-use asset representing the property and a corresponding lease liability for the obligation to make lease payments. At the commencement date, the right-of-use asset so recognised would include:

- The amount of the initial measurement of lease liability;

- Any initial direct costs;
- Any costs to be incurred for dismantling or removing the underlying asset or restoring the site at the end of the lease term.

The liability for the lease obligation would be measured as the present value of future lease payments including payments that would be made towards any residual value guarantee, discounted using the rate implicit in the lease or the incremental rate of borrowing of the lessor, whichever is available.

The fact that there is no 'invoice' evidencing transfer of the asset cannot be a reason to avoid recognition of the right-of-use asset. In fact, what is being recognised is not an asset, since ownership rights are not transferred. What is sought to be recognised under Ind AS 116 is the right to use the asset in the manner required by the lessee Shastra Ltd. Further, since the lease represents an obligation to pay lease rentals in the future, a corresponding lease liability should be recognised. Not recognising the right-of-use asset or lease liability would not only be a violation of Ind AS 116, Leases, but would also be an incorrect presentation of the financial position, which is critical given that Shastra Ltd. is interested in taking a loan for its operations.

Ethical issues:

The managing director's threat to the financial controller results in an ethical dilemma for the financial controller. This pressure is greater because the financial controller is new.

Threats to fundamental principles

The fact that the position of the financial controller has been threatened if the treatment suggested by the managing director is not followed indicates that there is an **intimidation threat** to the fundamental principles of **objectivity** and **integrity**.

Further, as the managing director has flagged the risk that the company may not obtain loan financing if the lease obligation is recorded in the balance sheet, there is an **advocacy threat** because the financial controller may be compelled to follow an incorrect treatment to maximise the chances of obtaining the loan. This pressure again is greater because the financial controller is new.

Professional competence

When preparing the financial statements, the financial controller should ensure that the fundamental principle of **professional competence** should be followed, which requires that accounts should be prepared in **compliance with Ind AS**.

Thus, since the arrangement meets the Ind AS 116 criteria for a lease, the right-of-use asset and a corresponding lease liability should be recognised, as otherwise the liabilities of

Shastra Ltd. would be understated. The ICAI Code of Ethics and Conduct sets boundaries beyond which accountants should not act. If the managing director refuses application of Ind AS 116, Leases, the financial controller should **disclose this to the appropriate internal governance authority**, and thus feel confident that his actions were ethical.

If the financial controller were to bend under pressure and **accept the managing director's proposed treatment**, this would contravene Ind AS 116 and **breach the fundamental principle of professional competence**. In such a case, he would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949, which states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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ACCOUNTING AND TECHNOLOGY

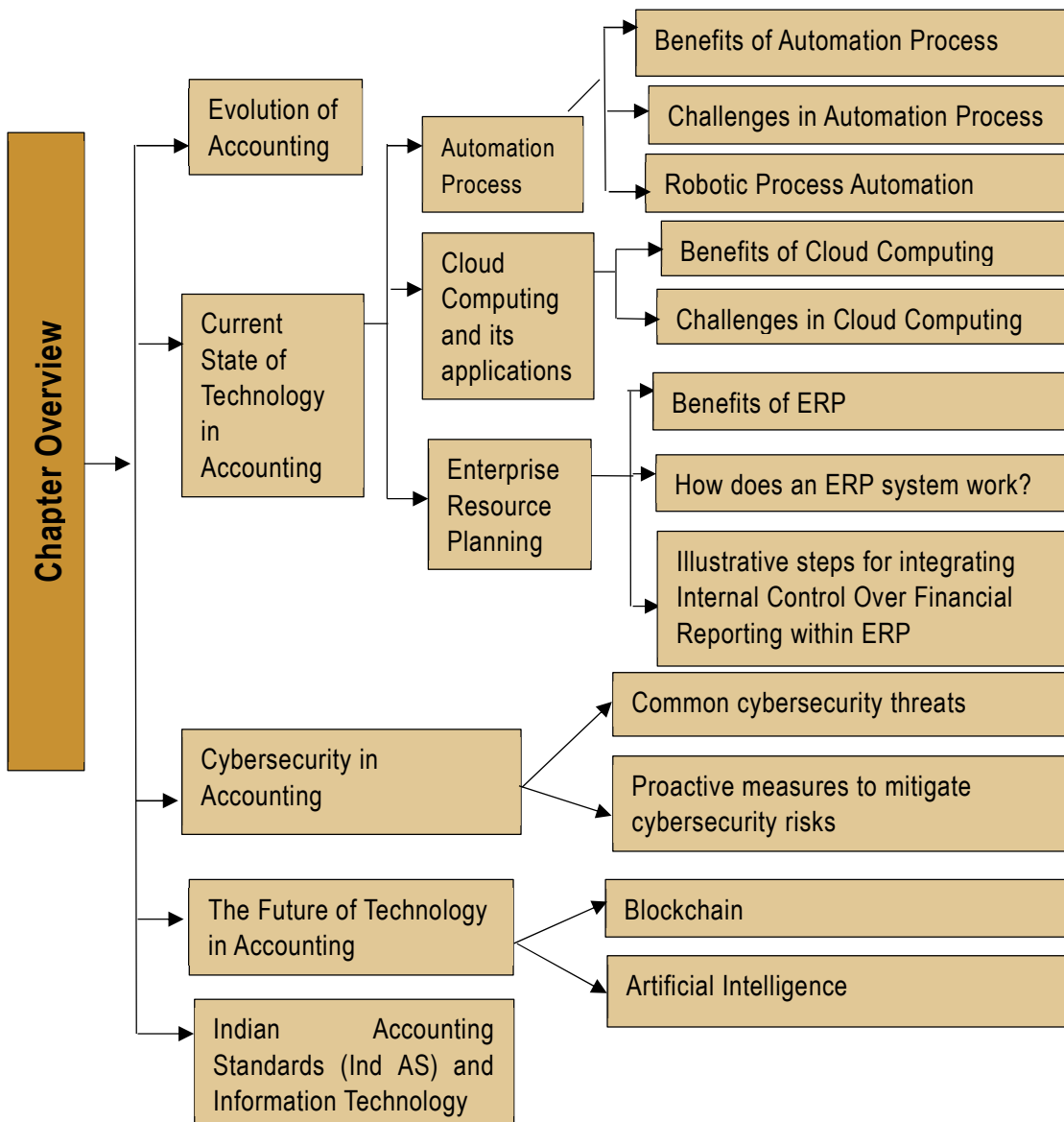


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Delve into various technologies that have had a significant impact on the accounting profession like Cloud Computing, Artificial Intelligence and Cybersecurity etc.
- ❑ Recognise the benefits of each technology and how they have changed the way accountants perform their tasks.
- ❑ Examine the challenges that accounting professionals face in adapting to new technologies.
- ❑ Appreciate the importance of accounting professionals staying up-to-date with the latest technologies.
- ❑ Automate the accounting process with various technologies for various Ind AS based situations.

CHAPTER OVERVIEW





1. INTRODUCTION

Accounting is a critical function for all businesses, as it enables them to track and manage their financial transactions, budgets, and investments. The field of accounting has undergone significant changes in recent years, primarily due to advancements in technology. As businesses have embraced digital transformation, the accounting profession has evolved, becoming more efficient and accurate with the help of new technologies.

It is not the intent of the chapter to discuss a particular accounting software in detail, hence this chapter will not contain for instance, commands to pass vouchers in software like Tally or SAP. This chapter intends to provide an overview of the impact of technology on the accounting profession. It highlights the trends that are transforming the industry and the challenges that accounting professionals face in adapting to new technologies.

The chapter commences with a discussion on the history of accounting and its evolution over time. Accounting practices were once manual and paper-based, but advancements in technology have enabled automation, making accounting processes faster and more efficient.

The chapter then delves into the various technologies that have had a significant impact on the accounting profession. These technologies include cloud computing, artificial intelligence, and cybersecurity etc. The chapter discusses the benefits of each technology and how they have changed the way accountants perform their tasks. For example, cloud computing has made it possible for accountants to access financial data from anywhere in the world.

The chapter also examines the challenges that accounting professionals face in adapting to new technologies. For example, the implementation of new technologies can be costly, and many businesses may not have the resources to invest in them. Additionally, some accounting professionals may be resistant to change, preferring to stick with the traditional methods they are comfortable with.

The chapter concludes by highlighting the importance of accounting professionals staying up-to-date with the latest technologies. As businesses continue to embrace digital transformation, accountants must be able to adapt to new technologies to remain competitive in the industry. The chapter emphasizes the need for ongoing education and training to ensure that accounting professionals have the skills they need to succeed in an increasingly digital world.



2. EVOLUTION OF ACCOUNTING

This section provides a detailed history of accounting from its earliest origins to modern-day practices. Understanding the history of accounting is essential to comprehending the current state of the profession and the role technology has played in its evolution.

The origins of accounting can be traced back to ancient civilizations such as the Egyptians, Greeks, and Romans. In these early civilizations, accounting primarily involved record-keeping for tax purposes and for the management of government resources. These early accounting systems were manual and paper-based, and the process was labour intensive. By the time of the Roman Empire, the government had access to detailed financial information.

In India, Chanakya authored a manuscript similar to a financial management book during the period of the Mauryan Empire. His book 'Arthashastra' contains few detailed aspects of maintaining books of accounts for a sovereign state.

The Italian Luca Pacioli, recognized as The Father of accounting and bookkeeping was the first person to publish a work on double-entry bookkeeping, thereby introducing the field in Italy. Subsequently, accounting practices evolved to include double-entry bookkeeping. This system enabled businesses to create a balance sheet, which showed the financial position of the company at a given time. The introduction of double-entry bookkeeping was a significant milestone in the history of accounting and laid the foundation for modern-day accounting practices.

With the industrial revolution, significant changes came to the accounting profession. Due to the advent of machines and mass production, accounting became more complex, requiring more detailed records of financial transactions. This period also saw the rise of the accounting profession, with the establishment of the first professional accounting organizations. The Institute of Chartered Accountants of Scotland is the world's oldest and first professional chartered accountants' body, being established by the Royal Charter in 1854. Subsequently, organizations such as the Institute of Chartered Accountants in England and Wales, Certified Practising Accountant Australia, American Institute of Certified Public Accountants and Chartered Accountants Ireland were established in the 19th Century. With the advent of the 20th Century, the Association of Chartered Certified Accountants was established, followed by organizations such as the Institute of Chartered Accountants of India and the Institute of Singapore Chartered Accountants.

In the post-industrial period, technological advancements such as the computer, transformed the accounting profession. The introduction of computers enabled accountants to automate many of the manual processes associated with accounting, making the process faster and more accurate. To elucidate further, interest calculation in banks, which is currently system driven was once computed manually by the bank staff. Given the huge volume of transactions, interest computation usually took over a month for each branch, and the chances of errors were very high since the same was manual.

Currently, there is an upsurge of technology in the accounting field on account of cloud computing and artificial intelligence, all of which are transforming the accounting profession, making it more efficient and accurate. However, these new technologies also present challenges for accounting professionals, who must adapt to new systems and processes to remain competitive.



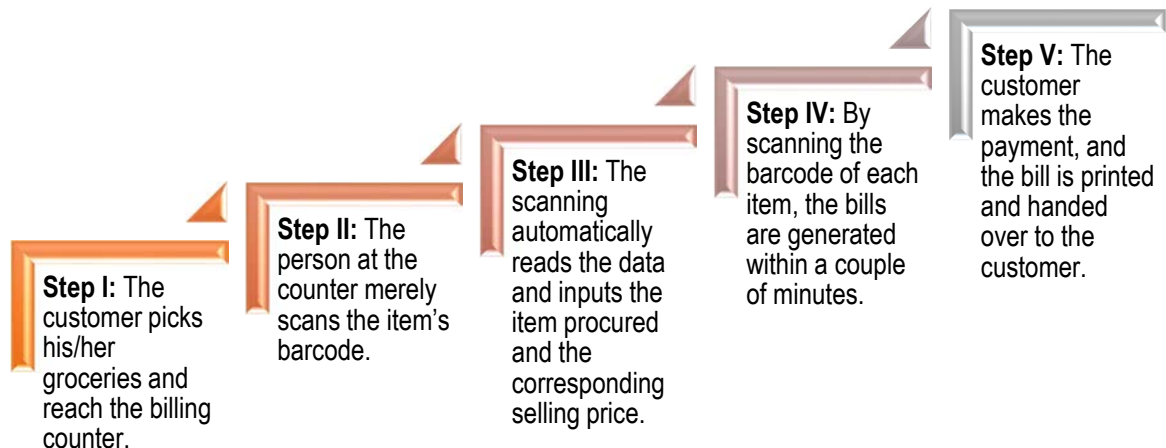
3. THE CURRENT STATE OF TECHNOLOGY IN ACCOUNTING

This section provides an in-depth overview of the current state of technology in the accounting profession. It discusses the various technologies used in accounting and their impact on the profession, including automation, cloud computing, and artificial intelligence

3.1 Automation Process

The major change visible is the automation of the accounting process. Automation is the use of software and other tools to automate manual processes, making them faster and more accurate. We can understand this with the help of the below example:

For instance, let us consider the activities involved in the process of procuring groceries from a departmental store such as Walmart or Reliance Smart Bazaar **at the Front-End**.



The entire process happens in a fraction of a second, saving valuable time and mitigating all errors.

However, **at the backend, the below activities take place:**

As and when the barcode of an item is scanned at the billing counter, the inventory of the said item at the departmental store is simultaneously updated recording the issue/sale of the same. This ensures accuracy in maintenance of inventory data.

A periodical physical check of inventory will give conclusive evidence of the correctness of data generated by the system, thereby giving comfort on the management assertions of accuracy, valuation and existence of the inventory.

In certain cases, the software is so programmed that the indirect taxes (GST) levied on the sale value as per the invoice is updated simultaneously, which can get uploaded on the GST portal at the end of the day by the accounting team in the backend.

This ensures accuracy in returns uploaded, thereby minimizing the need for manual reconciliation and data maintenance.

Software are also programmed to ensure that the bill amount is automatically displayed on the Point of Sale Machine, through which the customer makes the payment either through debit/credit card or through UPI. In case the customer opts to make payment in cash, entering the amount on the Screen will open the cash drawer in which the cash paid is deposited.

Since the cash drawer is opened through the system only after logging in by the concerned person, in case of mismatch in cash balances, the concerned person can be identified, thereby reducing the chances of misappropriation of cash.

3.1.1 Benefits of Automation Process

1. **Streamlining Data Entry:** Automation tools, such as optical character recognition (OCR) or barcode recognition technology, can help to automate the entry of data from source documents such as receipts and invoices. This can reduce the amount of time and effort required for manual data entry, as well as minimizing the potential for human error.
2. **Accelerating Data Processing:** Automation can help to process large amounts of data / large volumes of transactions more quickly and accurately than manual methods. For example, software can automatically categorize transactions into the appropriate accounts, calculate tax amounts, and generate financial statements, among other tasks.
3. **Enhancing Accuracy:** Automation can help to reduce errors and discrepancies in accounting processes. By automating tasks such as data entry and calculations, businesses can minimize the risk of errors caused by human error, improving the accuracy and reliability of their financial data.

4. **Improving Decision-Making:** Automation can provide real-time insights into financial data, enabling businesses to make informed decisions more quickly. With automated reporting, the time spent on routine tasks is greatly minimized, enabling businesses to gain deeper insights into their financial performance, identify trends and patterns, and adjust their strategies accordingly.
5. **Saving Time and Money:** Automation reduces the amount of time and resources required to perform manual tasks such as data entry and reconciliations. This results in businesses saving on staffing costs and increases productivity and enabling accountants to focus on higher-level tasks such as analysis and planning.
6. **Facilitating Compliance:** Automation helps business to stay compliant with regulations and standards by ensuring accounting practices meet the necessary requirements. As seen above, automation ensures accurate data for the purposes of return filing. Further, in case the systems are so programmed, reporting tools can generate financial statements that meet the criteria of Ind AS or Indian GAAP as the case may be. This would ensure minimizing the risk of non-compliance and potential penalties.

3.1.2 Challenges in Automation Process

Automation also comes with its own set of potential drawbacks and challenges, some of them are mentioned below:

- It arises the need for ongoing training and education to keep up with the latest technology.
- Automation also presents a risk of data breaches and cyber-attacks, which can compromise the security and confidentiality of financial data.
- Due to automation, there exists potential loss of jobs. However, this can be mitigated by ensuring appropriate training to the workforce to remain updated with the technology.

To summarize, automation helps businesses achieve efficiency, accuracy and decision-making in accounting while saving time and money and facilitating compliance with regulations and standards.

3.1.3 Robotic Process Automation

Robotic Process Automation (RPA) is an emerging technology that revolutionizes financial reporting processes. RPA utilizes software robots or "bots" to automate manual and repetitive tasks in financial data processing, analysis, and reporting. By mimicking human interactions with digital systems, RPA bots can extract and consolidate data, perform calculations, generate reports, and ensure compliance with accounting standards. The adoption of RPA in financial reporting improves accuracy, enhances efficiency, and frees up valuable time for finance professionals to focus on more strategic activities. Moreover, RPA enables organizations to

achieve timely reporting, cost savings, and increased data integrity, ultimately leading to more reliable and insightful financial information.

Example 1: Using RPA in Financial Reporting

Let us consider XYZ Company, a group of companies that prepares consolidated financial statements in accordance with Ind AS 110. To streamline their financial reporting processes, XYZ Company decides to leverage Robotic Process Automation (RPA). In that case, the steps involved would be:

- As XYZ Company has multiple subsidiaries, each maintaining their own financial data, RPA bots are implemented to automate the process of extracting financial data from the subsidiary systems and consolidating it into the parent company's financial system.
- The bots retrieve the relevant financial information, perform necessary currency conversions, and reconcile intercompany transactions, ensuring accurate and timely consolidation.
- As per Ind AS 110, intercompany transactions need to be eliminated to avoid double counting and provide a true representation of the group's financial position. RPA bots are programmed to identify intercompany transactions within the consolidated financial data.
- The bots automatically eliminate these transactions by adjusting the corresponding accounts and generating elimination entries, simplifying the process and reducing the potential for errors.
- The bots retrieve the consolidated financial data from the parent company's financial system and apply the necessary consolidation adjustments.
- They perform calculations for non-controlling interests, equity, and comprehensive income attributable to the parent and non-controlling interests.
- The bots generate the consolidated balance sheet, income statement, statement of changes in equity, and cash flow statement, ensuring accuracy and consistency in the financial reporting process.

3.2 Cloud Computing

Cloud computing refers to the delivery of computing services over the internet. It allows accountants to access their data and software from any device with an internet connection.

The entire world was hit in 2020 with probably the biggest black swan event of the past couple of decades– the COVID-19 pandemic. The continuous lockdowns severely impacted businesses, and operations came to a standstill. This in turn led to viewing cloud computing as a serious alternative compared to traditional client-server architecture in physical locations controlled by the entities themselves.

With the advent of cloud computing, persons could access the systems from their respective locations, work remotely during the lockdown and ensure that the accounting process and reporting requirements did not suffer adversely.

3.2.1 Common Applications / Cases of Cloud Computing

1. **Cloud Storage:** Services like Dropbox, Google Drive, and Microsoft OneDrive offer cloud storage solutions that allow users to store and access their files and data from anywhere with an internet connection. Users can save documents, photos, videos, and other files in the cloud and synchronize them across multiple devices.
2. **Software as a Service (SaaS):** SaaS platforms provide cloud-based software applications that users can access and utilize via the internet. Examples include Salesforce for customer relationship management (CRM), Slack for team collaboration, and QuickBooks Online for accounting and financial management.
3. **Infrastructure as a Service (IaaS):** IaaS providers offer virtualized computing resources, including servers, storage, and networking infrastructure, on a pay-as-you-go basis. Examples include Amazon Web Services (AWS), Microsoft Azure, and Google Cloud Platform. These platforms allow businesses to scale their IT infrastructure based on demand without the need for physical hardware.
4. **Platform as a Service (PaaS):** PaaS providers offer cloud-based platforms that enable developers to build, deploy, and manage applications without the complexity of infrastructure management. Examples include Microsoft Azure App Service, and Google App Engine.
5. **Cloud-based Communication and Collaboration:** Applications like Microsoft Teams, Google Workspace (formerly G Suite), and Zoom provide cloud-based communication and collaboration tools that facilitate real-time messaging, video conferencing, file sharing, and project management.
6. **Cloud-based E-commerce:** Few platforms enable businesses to set up and manage online stores using cloud infrastructure. These platforms provide features like product catalogues, payment processing, inventory management, and customer analytics.
7. **Big Data Analytics:** Cloud computing enables organizations to process and analyze large volumes of data efficiently. Services like Amazon Redshift, Google BigQuery, and Microsoft Azure Data Lake Analytics provide scalable infrastructure for big data processing and analytics, empowering businesses to derive valuable insights from their data.

3.2.2 Benefits of Cloud Computing

Following are some of the ways in which Cloud Computing has positively impacted accounting:

1. **Improved accessibility:** Cloud-based accounting software allows users to access their financial data from any location with an internet connection. This has increased accessibility and flexibility for accountants and business owners, allowing them to work remotely and collaborate in real-time.
2. **Enhanced security:** Cloud-based accounting software providers typically offer advanced security features such as encryption, firewalls, and multi-factor authentication helping in the protection of sensitive financial data from cyber threats and data breaches.
3. **Increased scalability:** Cloud-based accounting software allows businesses to easily scale up or down based on their changing needs. As a business grows, it can easily add new users and features without having to invest in additional hardware or software.
4. **Reduced costs:** Cloud-based accounting software typically requires less upfront investment in hardware and software, as well as ongoing maintenance costs. This can help businesses save money on IT expenses and redirect those funds to other areas of the business. For example, the costs of installing Microsoft Office Suite on a laptop or desktop is far more expensive than subscribing to the Office 365 Suite, which is a web-based download. Further, the web-based download also provides the options of continuous free updates unlike its Office Suite offline counterpart.
5. **Streamlined collaboration:** Cloud-based accounting software allows multiple users to collaborate in real-time, reducing the need for manual data entry and communication. This can help to streamline workflows and reduce errors caused by miscommunication.
6. **Improved reporting and analytics:** Cloud-based accounting software often includes powerful reporting and analytics tools that allow businesses to gain deeper insights into their financial performance. This can help businesses make more informed decisions and identify areas for improvement.

3.2.3 Challenges in Cloud Computing

Following are the potential challenges which may emerge in cloud computing:

- Since cloud-based software are completely online, they could be prone to hackers who could 'steal' data or passwords or compromise the integrity of the processed data, thereby causing disruptions to the businesses.
- Strong net connectivity is a must for cloud-computing to be a success. Though there has been a huge surge in network and mobile connectivity in the past decade, connectivity in

non-metros, tier-2 or tier-3 cities is not well-developed, which could create accessibility issues to the users of the cloud-based accounting software.

Example 2: Using Cloud Computing

The finance team at XYZ Company, consisting of chartered accountants and financial analysts, collaborates on the preparation of the Income Statement. They utilize cloud-based collaboration tools, such as Microsoft Teams or Google Workspace, to enhance their efficiency and ensure accuracy in the reporting process.

- Using cloud-based spreadsheets or shared documents, the finance professionals from various locations input the relevant financial data into the Income Statement template. They update revenue figures, operating expenses, cost of goods sold, and other relevant information, ensuring accurate and comprehensive data collection.
- Through cloud collaboration platforms, team members can work on the Income Statement simultaneously, regardless of their physical locations. They can review, edit, and make real-time updates to the document. For example, the finance team in Mumbai can update the revenue figures based on the sales data received, while the team in Bengaluru can revise the operating expenses based on the cost information provided.
- Cloud-based collaboration tools offer version control features, allowing the team to track changes made to the Income Statement over time. This ensures that the latest version is always accessible and helps in maintaining an audit trail for any revisions or modifications made during the reporting process.
- Once the Income Statement is prepared, the finance team can use cloud-based communication channels, such as instant messaging or video conferencing, to discuss the document and address any queries or concerns. The team lead or finance manager can review the Income Statement, provide feedback, and approve the final version before submission.
- Cloud-based collaboration ensures that all team members have secure access to the Income Statement from their respective locations. User access controls and permissions can be managed to restrict access to authorized personnel only, maintaining data confidentiality and security.

3.3 Enterprise Resource Planning (ERP)

Enterprise resource planning (ERP) is a type of software that organizations use for managing day-to-day business activities like procurement, project management, accounting, risk management, compliance, and supply chain operations.

ERP systems connects and correlates a multitude of business processes and enable the flow of data between them. It collects an organization's shared transactional data from multiple sources and thus eliminate data duplication and provide data integrity with a single source of authentication.

Nowadays, ERP systems are used by many organisations as it is critical for managing thousands of businesses of varied sizes covering all industries. Cloud-based ERP applications are embedded with next-generation technologies, such as AI, machine learning (ML), and digital assistants.

ERP systems are designed around a single, defined data structure (schema) that typically has a common database. This helps to ensure that the information used across the enterprise is normalized and based on common definitions and user experiences. These core constructs are then interconnected with business processes driven by workflows across business departments (e.g. finance, human resources, engineering, marketing, and operations), connecting systems and the people who use them.

Since data is the lifeblood of every modern company, ERP makes it easier to collect, organize, analyze, and distribute this information to every individual and system that needs it to best fulfill their role and responsibility. ERP also ensures that these data fields and attributes roll up to the correct account in the company's general ledger so that all costs are properly tracked and represented.

A key ERP principle is the central collection of data for wide distribution. With a secure and centralized data repository, everyone in the organization can be confident that data is correct, up-to-date, and complete. Data integrity is assured for every task performed throughout the organization, from a quarterly financial statement to a single outstanding receivables report.

3.3.1 Benefits of ERP

It's impossible to ignore the impact of ERP in today's business world. As enterprise data and processes are caged into ERP systems, businesses can align separate departments and improve workflows, resulting in significant bottom-line savings. Examples of specific business benefits include:

1. Improved business insight from real-time information generated by reports
2. Less operational costs through streamlined business processes and best practices
3. Enhanced collaboration of users sharing data in contracts, requisitions, and purchase orders
4. Better efficiency through a common user experience across many business functions and well-defined business processes
5. Consistent infrastructure from the back office to the front office

6. Increased user-adoption rates from a common user experience and design
7. Reduction in risk through improved data integrity and financial controls
8. Less management and operational costs through uniform and integrated systems

3.3.2 How does an ERP system work?

ERP systems work by using a defined, standard data structure. Information entered by one department is immediately available to authorized users across the business. This uniform structure helps keep everyone on the same page.

Real-time data is then woven into business processes and workflows across departments. Managers check if one location is doing significantly better than another site and can figure out why. Finance department can use ERP for comparison of sales, profits and other financial data to help executives in understanding the performance of the organisation and also for setting new targets.

ERP systems deliver the most value when a company has modules for each major business function and ensures timely and accurate data entry. When a company uses business systems from multiple vendors, integrations are generally possible to make data automatically flow into the ERP. This real-time data can then be used throughout the ERP instance to benefit any process or workflow.

3.3.3 Illustrative steps for integrating Internal Control Over Financial Reporting with an ERP

Integrating Internal Control over Financial Reporting (ICOFR) with an Enterprise Resource Planning (ERP) system offers the key advantage of streamlining financial processes, ensuring data integrity, and promoting effective internal controls. By automating and standardizing procedures, the ERP system reduces manual effort and minimizes the risk of errors. It enables segregation of duties, real-time visibility into financial data, comprehensive audit trails, enhanced reporting capabilities, and proactive risk mitigation. This integration strengthens financial control, accuracy, and compliance, ultimately enabling better decision-making and reducing the likelihood of fraud or errors.

The following are illustrative steps for integrating ICOFR within ERP:

1. Verify that the process includes identification and updating of internal and external financial reporting requirements and deadlines.

The finance team regularly reviews the regulatory guidelines and reporting requirements set by the regulators and ensures that the ERP system's financial closing process is aligned with these requirements. Examples are listed companies to declare quarterly results as per LODR, filing of periodical returns under GST, Income Tax, Labour laws, etc.,

2. Review the documented process to ensure it aligns with the organization's financial reporting policies and regulatory guidelines.

The finance team reviews the documented process in the ERP system and cross-checks it with the organization's financial reporting policies and regulatory guidelines to ensure consistency. Examples are accounting policies relating to Property plant and equipment, depreciation, Inventory etc.,

3. Use the ERP system's change management functionality to track and validate changes made to the financial closing and reporting process.

When changes are made to the financial closing and reporting process, the finance team uses the ERP system's change management functionality to track and record these changes. They review system logs and audit trail for changes made to the financial closing and reporting process are as per defined roles and responsibilities for change control, including change initiators, approvers, and change management teams.

4. Verify that changes to the process are authorized by designated individuals with appropriate authority using system logs.

The finance team reviews the system logs, audit trail and confirms that any changes to the financial closing and reporting process were authorized by designated individuals with the appropriate authority, such as the CFO or finance manager.

5. Review the change requests, approvals, and documentation within the ERP system to ensure proper authorization and validation of process changes.
6. Validate that roles and responsibilities in the financial closing and reporting process are clearly defined within the ERP system by reviewing users access matrix configurations and system logs.

Review system logs and audit trail with Responsibility assignment matrix (RAM). RAM is a tool used in project management and enterprise resource planning (ERP) implementations to define and communicate the roles and responsibilities of individuals or teams involved in a project or process. The matrix clarifies who is responsible, accountable, consulted, and informed for each task or deliverable within the ERP implementation.

7. Assess the qualifications and training records of individuals assigned to financial reporting roles within the ERP system.
8. Validate that individuals responsible for financial reporting have the necessary understanding of the organization's operations and appropriate accounting knowledge.

The finance team validates that individuals responsible for financial reporting within the ERP system have a comprehensive understanding of the organization's operations and possess

appropriate accounting knowledge. For example, verify HR records of those involved in accounting have appropriate knowledge.

9. Validate that decisions on alternative accounting treatments for significant events or transactions are documented and approved by management.

Reviewing the Journal vouchers listing by identifying non routine transactions. Review the system of Standardizing voucher types. This involves defining a set of predefined templates or formats for different types of journal entries to ensure consistency and accuracy in recording financial data.

10. Review the ERP system for documentation of accounting treatment decisions, including approvals and communication to the audit committee.

Documentation of accounting treatment decisions refers to the process of recording and maintaining comprehensive documentation regarding the rationale, analysis, and conclusions related to accounting treatments chosen for specific transactions or events like recognising long term construction projects.

11. Review the ERP system's user administration functionality to ensure appropriate individuals have access to the financial reporting process.

Review system logs and audit trail with Responsibility assignment matrix (RAM).

12. Review whether proper KYC validation controls are in place for creating account masters and review the process for identifying related party transactions.

Separate ledger coding for related parties for auto tabulating transactions to present as per Schedule III of Companies Act, 2013.

13. Validate that the ERP system captures and documents the appropriate accounting treatment for each non-routine event, transaction, and account balance by reviewing Journal Vouchers listing.

14. Use the ERP system's audit trail and reporting capabilities to validate that all postings have occurred in the correct accounting period reviewing accounting period configuration controls.

In an ERP system, the accounting date and transaction date are captured and stored as part of the transactional data. They are used in various processes, such as journal entry creation, financial statement generation, period-end closing activities, and audit trails. Understanding the distinction between these dates is important for accurate financial reporting, compliance, and analysis of business transactions within the ERP system.

15. Review the system's controls for preventing backdating or unauthorized adjustments to postings by reviewing the posting date and transactions date of entries.



4. CYBERSECURITY IN ACCOUNTING

This section seeks to provide an overview of cybersecurity threats and risks and explores the impact of cybersecurity breaches on accounting firms and their clients which may range from accessing the financial data of the firm or client, to an extent of modifying the financial statements without the knowledge of the management. This section also discusses best practices for mitigating cybersecurity risks. This section seeks to provide an overview of cybersecurity threats and risks and explores the impact of cybersecurity breaches on accounting firms and their clients which may range from accessing the financial data of the firm or client, to an extent of modifying the financial statements without the knowledge of the management. Protecting financial information is crucial to prevent unauthorized access and data breaches. Legal and regulatory frameworks, like the Information Technology Act, 2000 (Amended in 2008), govern the collection, storage, and transmission of financial data. Non-compliance with data protection laws can lead to financial penalties and reputational damage. This section also discusses best practices for mitigating cybersecurity risks.

Organizations have legal and ethical obligations to disclose cybersecurity incidents with financial implications. Cybersecurity incidents can affect financial reporting through financial losses, reputational damage, and legal consequences. Reporting guidelines of various regulators such as SEBI, RBI etc., address the disclosure of cybersecurity incidents in financial statements.

Cybersecurity is a critical concern for accounting professionals, as sensitive financial data is often stored and transmitted digitally. With the increasing reliance on technology in accounting, the risk of cybersecurity threats and breaches has also increased. A cybersecurity breach can have significant consequences, including financial losses, reputational damage, and loss of sensitive client data. Some of the common cybersecurity threats are highlighted below. In all the cases, the aim of the attack would be either stealing sensitive financial data or disrupting operations or demand ransom money.

4.1 Common cybersecurity threats

- (a) **Phishing attacks:** Phishing attacks are a common cybersecurity threat that involves tricking users into clicking on malicious links or providing sensitive information.
- (b) **Malware attacks:** Malware attacks involve infecting computers or networks with malicious software that can steal data or disrupt operations.
- (c) **Ransomware attacks:** Ransomware attacks involve encrypting files or locking users out of systems and demanding a ransom payment in exchange for restoring access.
- (d) **Insider threats:** Insider threats involve malicious actions by employees or other insiders who have access to sensitive data.

- (e) **Denial of Service (DoS) attacks:** DoS attacks involve overwhelming a system or network with traffic to disrupt operations.
- (f) **Supply chain attacks:** Supply chain attacks involve compromising third-party software or hardware to gain access to a system or network.

4.2 Proactive measures to mitigate cybersecurity risks

In view of the cybersecurity attacks and threats discussed above, it is important to taking proactive measures to mitigate cybersecurity risks as listed below:

- (a) **Password management:** Strong passwords are critical for protecting sensitive financial data. Accounting professionals should ensure that all passwords are complex and changed regularly.
- (b) **Encryption:** Encryption can be used to protect sensitive data during transmission and storage. The IT Team of an organization should ensure that all sensitive data is encrypted using appropriate methods.
- (c) **Access control:** Access control is critical for preventing unauthorized access to financial data. Accounting professionals should ensure that access to sensitive data is limited to authorized personnel and that appropriate access controls are in place. The access controls should be continuously reviewed and updated based on any changes in the management or employee structure.
- (d) **Network security:** Network security is critical for protecting financial data from cyberattacks. It should be ensured that firewalls and other security measures are in place to prevent unauthorized access to the network.
- (e) **Employee training:** Employee training is critical for ensuring that all staff members are aware of the importance of cybersecurity and understand how to protect sensitive financial data.
- (f) **Data backup:** Regular data backups are critical for ensuring that financial data is not lost in the event of a cyberattack. Accounting professionals should ensure that data backups are performed regularly and that backups are stored securely.
- (g) **Incident response planning:** Accounting professionals should have a clear incident response plan in place in the event of a cyberattack. This plan should include procedures for detecting, containing, and mitigating the impact of a cyberattack.

Overall, cybersecurity is a critical concern for accounting professionals, and it is essential to take appropriate measures to protect sensitive financial data



5. THE FUTURE OF TECHNOLOGY IN ACCOUNTING

5.1 Blockchain

Blockchain technology is revolutionizing the financial landscape, and its impact on financial statement preparation is undeniable. As a Chartered Accountant involved in financial reporting, understanding blockchain is crucial for staying ahead in this rapidly evolving digital era. At its core, blockchain is a decentralized and transparent ledger that enables secure and immutable transactions. Unlike traditional centralized systems, blockchain offers a distributed network where information is shared and verified by multiple participants, eliminating the need for intermediaries and enhancing data integrity. From a financial statement preparation perspective, blockchain holds immense potential to streamline processes, enhance transparency, and improve the accuracy and reliability of financial reporting. By leveraging blockchain, financial professionals can ensure trustworthy and real-time financial information, revolutionizing how financial statements are prepared, audited, and shared with stakeholders. In this dynamic landscape, embracing blockchain technology is essential for Chartered Accountants to navigate the future of financial reporting effectively.

5.1.1 Key impacts of blockchain on financial reporting

1. **Enhanced Transparency:** Blockchain technology provides a decentralized and immutable ledger, where transactions are recorded and stored in a transparent and tamper-proof manner. This increased transparency ensures that financial data is accurately captured and can be easily audited, promoting trust and reliability in financial reporting.
2. **Improved Data Integrity:** Blockchain's distributed ledger ensures that each transaction is verified and encrypted, preventing unauthorized modifications or tampering. This feature enhances data integrity, reducing the risk of fraudulent activities and errors in financial reporting.
3. **Streamlined Audit Processes:** Blockchain technology enables real-time access to financial data, eliminating the need for time-consuming and manual data reconciliation processes. Auditors can directly access the blockchain ledger to verify transactions, reducing audit time and enhancing efficiency in financial reporting.
4. **Enhanced Security:** Blockchain incorporates advanced cryptographic algorithms, making it highly secure against unauthorized access or data breaches. Financial data stored on the blockchain is encrypted and protected, minimizing the risk of data manipulation or unauthorized disclosure, thus strengthening the security of financial reporting.

5. **Simplified Reconciliation:** Blockchain's decentralized ledger eliminates the need for reconciling multiple versions of data across different systems. With a single shared source of truth, financial reporting processes become more streamlined, reducing reconciliation efforts and potential errors.
6. **Cost Reduction:** By eliminating intermediaries and central authorities, blockchain reduces the costs associated with traditional financial reporting processes. It eliminates the need for third-party verification and reconciliation, leading to cost savings for organizations.
7. **Enhanced Audit Trail:** Blockchain maintains a comprehensive and immutable audit trail of all transactions, providing a transparent and traceable record of financial activities. This audit trail simplifies the identification and investigation of any irregularities or discrepancies, improving the accuracy and reliability of financial reporting.
8. **Real-time Financial Reporting:** With blockchain's real-time data availability and consensus mechanism, financial reporting can be performed more frequently and with greater accuracy. Organizations can generate up-to-date financial statements, enabling stakeholders to make informed decisions based on the most current financial information.

Examples 3 – 5 : Using Blockchain

3. Imagine a finance professional working for a multinational corporation that engages in complex supply chain operations. With blockchain technology, the company can create a decentralized ledger that records every step of the supply chain process, from raw material sourcing to final product delivery. Each transaction is securely recorded on the blockchain, providing real-time visibility and transparency to all stakeholders involved. The finance professional can easily access the blockchain to verify the authenticity and accuracy of transactions, ensuring compliance with regulatory requirements and building trust with customers, investors, and auditors.
4. Consider a finance professional responsible for conducting an audit of a large e-commerce platform. Traditionally, audits involve manually reviewing numerous financial transactions and reconciling data from different sources, which can be time-consuming and prone to errors. However, with blockchain technology, the e-commerce platform can implement a blockchain-based payment system that automatically records and timestamps every transaction. During the audit process, the finance professional can access the blockchain ledger to instantly verify transaction details, reconcile data, and ensure compliance with accounting standards and regulatory guidelines. This streamlined approach improves audit efficiency, reduces the risk of human error, and enhances the accuracy of financial reporting.

5. Imagine a finance professional working for a financial institution that handles sensitive customer data, such as personal information and transaction records. By utilizing blockchain technology, the institution can implement a secure and encrypted blockchain network to store and share customer data. The finance professional can ensure the integrity and security of the data by leveraging blockchain's cryptographic algorithms and consensus mechanisms. This eliminates the risk of unauthorized access, data tampering, or data loss. With blockchain, the finance professional can confidently handle customer data, knowing that it is protected by a robust and transparent system, enhancing data privacy, and maintaining the trust of customers and regulatory bodies.

5.2 Artificial Intelligence (AI)

AI refers to the simulation of human intelligence in machines, enabling them to perform tasks that would typically require human intervention. Apart from the aspects of automation, accuracy, fraud detection and cost savings, the most important feature is enabling predictive analytics. AI can be used to analyze large amounts of data and make predictions about future trends, which can be useful for forecasting financial performance and identifying potential risks. Thus, AI has the potential to transform the accounting profession by enabling accountants to provide more accurate and timely financial information to their clients.

While technology has transformed the accounting profession, it has also presented challenges such as the need for ongoing training and education, the risk of data breaches, and the potential loss of jobs due to automation. However, technology also presents opportunities for accountants to expand their skill sets, offer new services to clients, and automate routine activities thereby freeing up human resources for tasks requiring greater application of knowledge and skill sets.

This section seeks to provide an understanding of how AI and machine learning are transforming/disrupting the accounting profession. The chapter provides an introduction to AI and machine learning, explores their applications in accounting, and discusses the benefits and challenges associated with their adoption.

Artificial Intelligence (AI) and Machine Learning (ML) are technologies that enable computers to learn and perform tasks without being explicitly programmed to do so. AI and ML are having a significant impact on the accounting profession, enabling accounting professionals to automate routine tasks, improve decision-making processes, and reduce errors.

5.2.1 Benefits of AI and ML when used in accounting

1. **Automated Data Entry:** AI and ML algorithms can process and extract data from invoices, receipts, and other documents, reducing the need for manual data entry. If programmed, AI and ML algorithms can also review bank statements and pass entries in the system, followed

by a bank reconciliation, thereby automating the entire process, saving time and improving efficiency.

2. **Fraud Detection:** AI can help detect fraud by analysing large amounts of data and identifying patterns that may indicate fraudulent activity.
3. **Financial Forecasting:** ML can be used to develop predictive models that can forecast financial performance based on historical data, market trends, and other factors. The predictive models can be of particular advantage where estimates are required to be made in financial reporting. For instance, where a store sells goods and offers a voucher giving the customer a discount on subsequent purchases, Ind AS 115 requires a degree of estimation of the likelihood of availing such discount to record Revenue. Predictive models can track customers' preferences and likelihood of availing the voucher, in which case the estimation of revenue as required under Ind AS 115 becomes more realistic.
4. **Accounting Automation:** AI can analyse financial statements and other data to identify errors or inconsistencies, making accounting more efficient and accurate.
5. **Tax Compliance:** AI can help automate tax compliance by analysing financial data and identifying tax obligations, ensuring that businesses remain compliant with tax regulations.

5.2.2 Challenges with Artificial Intelligence

Along with the advantages of AI and ML, there are following potential challenges and risks associated with the adoption of AI and machine learning like:

1. data privacy
2. security concerns
3. technical complexity
4. need to train employees in an organization to extract capabilities of AI from the system

AI and ML technology is expected to continue transforming the accounting landscape, with the development of more advanced applications such as natural language processing and cognitive computing. However, the adoption of AI and ML in accounting will require careful consideration of its benefits and risks, as well as ongoing education and training for accounting professionals.

Emerging technologies are changing the accounting landscape and holds a future for accounting professionals.

Emerging technologies, such as artificial intelligence (AI), machine learning (ML), and Robotic Process Automation (RPA), have had a revolutionary impact on the accounting profession. These technologies have the potential to revolutionize the way accounting is done, by automating routine tasks, reducing errors, and providing real-time insights into business performance. For example,

AI and machine learning can be used to automate tasks such as data entry, account reconciliation, and financial analysis.

The potential benefits of these technologies for accounting professionals could include increased efficiency, accuracy, and cost savings. However, technology also comes with its own potential challenges and risks, such as the need for specialized skills and expertise, the risk of job displacement, and the need to maintain security and privacy.

Accounting professionals must be willing to adapt to these changes and develop new skills and competencies to stay relevant in the industry. The preceding sections emphasize the need for ongoing education and training to ensure that accounting professionals have the skills and knowledge required to leverage these emerging technologies.

The emergence of these technologies is likely to lead to significant changes in the industry, such as the need for new business models and the rise of new types of accounting services. As accounting professionals, it becomes imperative to understand new business models based on which accounting can be done to give a true and fair view of the affairs of the business. Accounting professionals who are willing to adapt to these changes and develop new skills and competencies will be better positioned to provide value-added services to their clients or organizations and maintain a competitive edge in the industry.

Illustrative examples on the use of Artificial Intelligence in Financial Reporting:

Examples: 6 – 9 : Using Artificial Intelligence in Financial Reporting

6. XYZ Company, a large multinational corporation, needs to prepare its financial statements according to Ind AS. The company has a vast amount of financial data stored in various formats, including spreadsheets, PDFs, and scanned documents. Manually extracting and analysing this data is time consuming and error prone. By implementing AI-driven optical character recognition (OCR) technology, the company automates the data extraction process from diverse sources and converts it into structured formats. This enables seamless analysis and financial reporting, reducing human effort and minimizing the risk of errors.
7. PQR Company, a financial institution, needs to comply with Ind AS requirements while monitoring and mitigating fraud risks. AI-powered algorithms can analyse large volumes of financial transactions, identify patterns, and detect potential anomalies indicative of fraudulent activities. By implementing machine learning techniques, the company can create predictive models that learn from historical data, enabling early detection of suspicious transactions and reducing the risk of financial fraud.
8. ABC Company, a manufacturing entity, wants to forecast its financial performance based on various scenarios to comply with Ind AS guidelines. AI can assist in generating accurate financial forecasts by analysing historical data, market trends, and relevant external factors.

By leveraging machine learning algorithms, the company can simulate different scenarios, such as changes in market demand, input costs, or regulatory requirements. This helps management make informed decisions, assess potential risks, and develop robust financial strategies in accordance with Ind AS principles.

9. A to Z Company Ltd., a publicly listed entity, faces the challenge of timely financial reporting and compliance with Ind AS regulations. AI-powered tools can integrate with the company's financial systems and automatically extract relevant data in real-time. These tools apply data validation rules, perform calculations, and generate accurate financial reports. By leveraging natural language processing (NLP), AI systems can also assist in reviewing financial statements, identifying potential errors, and ensuring compliance with Ind AS requirements. This improves the accuracy, efficiency, and speed of financial reporting processes.



6. INDIAN ACCOUNTING STANDARDS (IND AS) AND INFORMATION TECHNOLOGY

Ind AS is predominantly a principle-based framework. Ind AS consists of specific principles for various accounting topics, such as revenue recognition, leasing, financial instruments, employee benefits, consolidation, and many more. These principles provide detailed guidance on how to account for transactions in accordance with the principles of measurement and recognition.

For implementation of Ind AS, the technology will play key role in automating the process of validating while generating the reports. However, the role of technology for such processing is directly related to the configuration at the Account level with rule-based validations. Configuration implements pre-defined validation rules within the system to identify discrepancies or non-compliance with Ind AS.

If the account level configuration is not done properly, then the next phase of using technology will be after generating the reports. In such scenario, the use of technology is about applications such as Microsoft Excel or Google Sheets which can be used to perform such validations from the Ind AS point of view and then generate the report. This is purely dependent on human intelligence rather than on technology, except for the cases where Artificial Intelligence is involved with proper training using machine learning.

Illustration 1

A listed company's financial transactions are carried out in ERP. Following financial reporting weaknesses were observed during internal control over financial reporting:

1. *There is no appropriate documented process with respect to financial closing and reporting, including the identification and updating of internal and external financial reporting requirements and deadlines.*
2. *Changes made to the financial closing and reporting process are not valid and properly authorised.*
3. *Roles and responsibilities in the financial closing and reporting process are not clearly defined, documented, updated, and not communicated to appropriate departments and individuals on a timely basis.*
4. *Individuals in financial reporting roles do not have the necessary understanding of the organisation's operations and appropriate accounting knowledge to properly perform their assigned responsibilities.*
5. *When alternative accounting treatments are available for a significant event or transaction, the decisions on which treatments to select are not documented, approved by management, and are not communicated to the audit committee.*
6. *General policies are not established and documented regarding permissible overrides of existing policies and procedures for the financial closing and reporting process.*
7. *User profiles (on General Ledger (G/L) system) are not monitored / maintained to ensure that appropriate individuals have access to financial reporting process.*
8. *The appropriate accounting treatment is not specified for each non-routine event, transaction, and account balance, including those requiring the use of accounting estimates and judgment in the selection and application of accounting principles.*
9. *Relevant, sufficient, and reliable data necessary to record, process, and report each non-routine event or transaction is not captured.*
10. *There are no procedures to ensure all postings have occurred in the correct period.*
11. *The application of the entity's accounting policies to each non-routine event or transaction is not performed on a timely basis and appropriately documented by knowledgeable and qualified personnel using approved methods and formats.*
12. *All non-routine events and transactions are not accurately processed in the appropriate accounting period.*
13. *There is no independent review of application of the entity's accounting policies to each non-routine event or transaction for appropriateness and absence of bias by an individual with the appropriate level of authority and experience.*

14. *There is no basis for significant estimates and judgments associated with each non-routine event or transaction.*
15. *No analysis is prepared accurately and consistently in accordance with the entity's defined financial closing process and in the appropriate accounting period.*
16. *All sources of information for routine and non-routine events and transactions are not identified and analysed.*
17. *There are no reconciliations for all significant accounts and no independent review of such reconciliation.*
18. *All intercompany transactions and balances are not identified, reconciled, and appropriately eliminated in consolidation in the appropriate accounting period.*
19. *All suspense accounts are not identified and monitored.*
20. *The trial balance(s) used to prepare the financial statements are not generated from the final general ledger(s).*
21. *All trial-balance accounts are not appropriately and consistently grouped for presentation in the financial statements for accounting periods presented.*
22. *There are no restrictions to access and to run transactions in the automated consolidation software which may compromise the integrity of financial data*
23. *All related-party events and transactions are not identified and authorised, appropriately accounted for, and disclosed in the appropriate accounting period.*
24. *There are no procedures to ensure all postings have occurred in the correct period.*
25. *Entries recorded directly to the financial statements are not valid.*

Provide illustrative steps for Financial Closing and Reporting.

Solution

Following are the illustrative steps for Financial Closing and Reporting:

1. Verify that the process includes identification and updating of internal and external financial reporting requirements and deadlines.
2. Review the documented process to ensure it aligns with the organization's financial reporting policies and regulatory guidelines.
3. Use the ERP system's change management functionality to track and validate changes made to the financial closing and reporting process using system logs and audit trail.

4. Verify that changes to the process are authorized by designated individuals with appropriate authority using system logs.
5. Review the change requests, approvals, and documentation within the ERP system to ensure proper authorization and validation of process changes.
6. Validate that roles and responsibilities in the financial closing and reporting process are clearly defined within the ERP system by reviewing users access matrix configurations and system logs
7. Assess the qualifications and training records of individuals assigned to financial reporting roles within the ERP system.
8. Validate that individuals responsible for financial reporting have the necessary understanding of the organization's operations and appropriate accounting knowledge.
9. Validate that decisions on alternative accounting treatments for significant events or transactions are documented and approved by management by reviewing the Journal vouchers listing.
10. Review the ERP system for documentation of accounting treatment decisions, including approvals and communication to the audit committee.
11. Review the ERP system's user administration functionality to ensure appropriate individuals have access to the financial reporting process.
12. Review whether proper KYC validation controls in place for creating account masters and review the process for identifying related party transactions.
13. Validate that the ERP system captures and documents the appropriate accounting treatment for each non-routine event, transaction, and account balance by reviewing Journal Vouchers listing.
14. Use the ERP system's audit trail and reporting capabilities to validate that all postings have occurred in the correct accounting period reviewing accounting period configuration controls.
15. Review the system's controls for preventing backdating or unauthorized adjustments to postings by reviewing the posting date and transactions date of entries.

Illustration 2

Company XYZ is a manufacturing company that implements Ind AS 2 and wants your advice on utility of an ERP system for inventory management. They also aim to integrate ICOFR controls into their ERP system to ensure accurate inventory valuation, minimize the risk of inventory fraud,

and enhance process efficiency and accordingly they need your guidance in integrating ICOFR in ERP system.

Also, advice the steps to be followed if the company cannot afford a ERP system but still want to ensure proper implementation of Ind AS 2 to the extent possible.

Solution

A. ERP System for inventory management

ERP system integrates all relevant modules, such as inventory management, production, purchasing, and cost accounting. This ensures data consistency and reduces manual errors in recording and processing transactions. Following illustrative steps may be followed to configure and enable ERP with following modules:

- Maintain an updated and accurate Bill of Materials (BOM) Management within the ERP system, specifying the components required for each control unit. This allows the system to calculate the total cost of materials accurately by considering the quantities and costs of each component.
- Implement Purchase order controls within the ERP system to manage the procurement process effectively. This includes verifying purchase requisitions, obtaining appropriate approvals, and ensuring that the correct quantities and costs of materials are recorded.
- Define appropriate costing methods within the ERP system to allocate costs to inventory accurately. The ERP system should be configured to apply the chosen costing method consistently across all inventory transactions.
- Track labour costs within the ERP system by integrating with timekeeping or attendance systems. This ensures accurate recording of the number of hours worked by production workers and enables the calculation of labour costs based on the defined hourly rate.
- Define an overhead absorption rate within the ERP system to allocate production overheads to inventory. This rate should be based on the normal level of production per month. The ERP system should apply the overhead rate consistently to all units produced during the period.
- Integrate the ERP system with the general ledger and expense allocation modules to accurately allocate non-production expenses such as factory rent, energy costs, and selling and administrative costs. This ensures that these expenses are appropriately recorded and reflected in the cost of inventory.
- Perform periodic reconciliations between the inventory records within the ERP system and physical inventory counts. This helps identify any discrepancies and ensures the accuracy of inventory valuation.

- Utilise the reporting and analytics capabilities of the ERP system to generate accurate and timely reports on inventory costs. These reports should provide detailed breakdowns of material costs, labour costs, overheads, and any other relevant cost components.

Integration of ICOFR in ERP system:

The management of company XYZ may integrate ICOFR controls in ERP system by using following points:

1. The integration of ICOFR into ERP system is configured to enforce segregation of duties within the inventory management process. For example, the system restricts the ability to initiate purchase orders, receive goods, and update inventory records to separate individuals. This segregation ensures that no single employee has the ability to manipulate inventory quantities or values without appropriate checks and balances.
2. ICOFR is incorporated by implementing access controls in the ERP system. Users are granted access to inventory-related functions based on their roles and responsibilities. For instance, only authorized personnel can modify inventory master data, update cost information, or perform inventory counts. This prevents unauthorized access and reduces the risk of data manipulation or theft.
3. To ensure proper authorization, the ERP system includes workflow approval processes for inventory transactions. For example, when a purchase requisition is raised, the system automatically routes it through predefined approval hierarchies based on transaction value or other criteria. This ensures that inventory purchases are authorized by the appropriate individuals before they are processed.
4. The company utilizes barcode or radio-frequency identification (RFID) technology to enhance inventory control and accuracy. The ERP system is integrated with barcode scanners or RFID readers, allowing real-time tracking of inventory movements. This reduces manual data entry errors and provides accurate and up-to-date inventory information within the system.
5. ICOFR requires periodic physical inventory counts to verify the accuracy of recorded inventory quantities. The ERP system supports this process by generating inventory count sheets or reports based on predefined criteria such as product categories or locations. The system can also reconcile the physical count results with the recorded quantities, highlighting any discrepancies for further investigation and adjustment.
6. Technology-driven data analytics tools can be integrated into the ERP system to identify inventory-related exceptions or anomalies. For example, the system can analyse inventory turnover ratios, slow-moving or obsolete items, or abnormal inventory cost fluctuations. These analytics help in detecting potential control weaknesses or irregularities, enabling timely action by management.

7. The ERP system can provide management dashboards or customized reports that display key inventory control indicators. These dashboards summarize information such as inventory turnover, stock levels, and valuation accuracy. They facilitate monitoring and decision-making, enabling management to assess the effectiveness of ICQFR controls and take corrective actions if needed.

B. Inventory management in the absence of efficient ERP system

In the absence of ERP system or in the absence of properly configured ERP system, the alternative procedure available is by exporting the data to a spreadsheet and perform the following steps:

1. Export the relevant data from the accounting package, including information such as quantities, costs, labour hours, and overhead expenses into a spreadsheet. Ensure that the exported data contains all the necessary details to calculate the inventory costs accurately.
2. Organize the exported data in appropriate columns. Label each column with the corresponding data, such as item codes, quantities, costs, labour hours, and overhead expenses.
3. Use the formulas to calculate the material costs for each item. Multiply the quantities of each component by their respective costs. If there are multiple components, sum up the costs of all components to get the total material cost for each item.
4. Use the formulas to calculate the labour costs for each item. Multiply the labour hours for each item by the defined hourly rate to obtain the labour cost.
5. Determine the overhead absorption rate based on the normal level of production per month. Multiply the rate by the total labour hours to calculate the total overhead cost. Divide the overhead cost by the total quantity of items produced to get the overhead cost per item.
6. If there are non-production expenses such as rent, energy costs, or administrative costs, allocate them to each item using an appropriate method. This can be based on quantities, labour hours, or other relevant factors. Apply formulas to distribute the expenses accordingly.
7. Sum up the material costs, labour costs, overhead costs, and allocated non-production expenses for each item to obtain the total inventory cost.
8. If you have physical inventory counts, compare the calculated inventory costs in spreadsheet with the physical counts. Identify any discrepancies and investigate the causes. Adjust the inventory costs as necessary to reconcile them with the physical counts.
9. Create reports in spreadsheet that provide a breakdown of the inventory costs for each item. Include material costs, labour costs, overhead costs, and allocated non-production expenses. Use formatting and charts to present the information clearly.

Illustration 3

Company Z is engaged in the business of importing oil seeds for further processing as well as trading purposes. It enters into the following types of contracts as on 1st October 20X1:

Particulars	Contract 1	Contract 2	Contract 3
Nature of Contract	Import of oil seeds from a foreign supplier	Purchase of oil seeds from a domestic producer / supplier	Contract to sell oil seeds on the commodity exchange
Quantity and rate	100 MT at USD 400 per MT to be delivered as on 31 st March 20X2	50 MT at ` 30,000 per MT to be delivered as on 31 st January 20X2	50 MT at USD 450 per MT, maturing as on 15 th January 20X2
Net settlement clause included in the contract	Yes	Yes	Yes
Net settlement in practice for similar contracts	There have also been several instances of the oil seeds being sold prior to or shortly after taking delivery. These instances of net settlement constitute approximately 30 per cent of the value of total import contracts.	Yes – company Z has net settled some of the domestic purchase contracts. However, these instances constitute only 1 per cent of the total domestic purchase contracts in value. The remaining contracts are settled by taking delivery of oil seeds which are used for further processing.	Yes – these contracts are required to be net settled with the exchange on the maturity date. Company Z enters into these types of derivative contracts to hedge the risks on its domestic oil seeds purchase contracts

Company Z wants to determine if the contracts entered into for purchase and sale of oil seeds are derivatives within the scope of Ind AS 109 or are executory contracts outside the scope of Ind AS 109. Though the Company Z is using an ERP accounting package it is not properly configured to provide the required reports for above said decision making. Therefore, Company Z requires your

advice on whether such process of determining the nature of contracts is possible through use of external sources of technology.

Solution

Yes, it is possible by extracting the data from the accounting package or by connecting to the database of the accounting package.

For example, the same can be done by connecting the spreadsheet with database through ODBC connectivity or by extracting the data from accounting package into a spreadsheet. In case the data is being extracted from accounting package, the following steps may be followed:

1. Identify the relevant data fields in the accounting package that contain the contract information, such as contract particulars, quantities, rates, and settlement details.
2. Export the required data from the accounting package in a compatible format (e.g., CSV, Excel, or other supported formats).
3. Open the exported data in Microsoft Excel.
4. Clean the data by removing any unnecessary or irrelevant columns and rows.
5. Ensure that the data is properly formatted and aligned for further analysis.
6. Define the rules or criteria for categorizing the contracts as derivative or executory based on the requirements of Ind AS 109.
7. Establish conditions using Excel formulas or logical functions to evaluate the contract data.
8. Apply the defined rules or criteria to the contract data using Excel formulas or logical functions.
9. Use functions such as IF, AND, OR, or VLOOKUP to evaluate the conditions and determine the nature of each contract.
10. Create additional columns in Excel to categorize the contracts based on the analysis results.
11. Assign appropriate labels or values to indicate whether a contract is a derivative or an executory contract.

Illustration 4

An entity provides broadband services to its customers along with voice call service. Customer buys modem from the entity. However, customer can also get the connection from the entity and modem from any other vendor. The installation activity requires limited effort and the cost involved

is almost insignificant. It has various plans where it provides either broadband services or voice call services or both.

Comment on how to identify whether the performance obligations under the contract is distinct by using an automated process?

Solution

To identify the performance obligations under the contract and determine if they are distinct, an automated process can be implemented using technology. The following steps can be taken:

- a. Analyze the clauses in the contract related to the services provided (broadband services, voice call services, modem sales).
- b. Each clause should be codified using appropriate parameters or tags to capture the relevant information.
- c. Assign Boolean values (0 or 1) to each parameter or tag in the codified clauses.
- d. Use "0" to represent "No" and "1" to represent "Yes" for each parameter.
- e. Define the criteria for evaluating the performance obligations based on the parameters and their Boolean values.
- f. Consider factors such as the type of service involved, benefits derived by the customer, and promises made in the contract regarding the transfer of goods or services.
- g. Develop an automated algorithm or script that evaluates the Boolean values of the parameters according to the defined criteria.
- h. Calculate scores or weights for each parameter based on their significance in determining performance obligations.
- i. Utilize the scores or weights assigned to the parameters to determine if the performance obligations are distinct.
- j. If the total score exceeds a certain threshold, consider it a separate performance obligation.

The automated process should flag and identify these distinct performance obligations based on the evaluation results.

TEST YOUR KNOWLEDGE

Questions

1. T Ltd is engaged in transport sector, running a fleet of buses at different routes. T Ltd has identified 3 operating segments:

- Segment 1: Local Route
- Segment 2: Inter-city Route
- Segment 3: Contract Hiring

The characteristics of each segment are as under:

Segment 1: The local transport authority awards the contract to ply the buses at different routes for passengers. These contracts are awarded following a competitive tender process; the ticket price paid by passengers are controlled by the local transport authority. T Ltd would charge the local transport authority on a per kilometer basis.

Segment 2: T Ltd operates buses from one city to another, prices are set by T Ltd on the basis of services provided (Deluxe, Luxury or Superior).

Segment 3: T Ltd also leases buses to schools under a long-term arrangement.

While Segment 1 has been showing significant decline in profitability, Segment 2 is performing well in respect of higher revenues and improved margins. The management of the company is not sure why is the segment information relevant for users when they should only be concerned about the returns from overall business. They would like to aggregate the Segment 1 and Segment 2 for reporting under 'Operating Segment'.

Required

What are the steps involved to automate the process to determine whether it is appropriate to aggregate Segments 1 and 2 with reference to Ind AS 108 'Operating Segments'?

2. New Way Ltd. decides to enter a new market that is currently experiencing economic difficulty and expects that in future the economy will improve. New Way Ltd. enters into an arrangement with a customer in the new region for networking products for promised consideration of ₹ 12,50,000.

At contract inception, New Way Ltd. wants to

- (i) Define criteria for identifying contracts with customers, such as enforceable rights and obligations, agreement terms, and consideration.

- (ii) Establish rules to link relevant transactions to specific contracts and assign unique identifiers to each contract

Required

Advise the steps to automate the process to perform the above tasks on behalf of New Way Ltd.

Answers

1. Following steps should be followed to automate the process to determine whether it is appropriate to aggregate Segments 1 and 2 with reference to Ind AS 108 'Operating Segments':
 1. Extract the relevant financial data related to Segments 1 and 2 from your accounting system.
 2. Ensure that the data includes segment-specific information such as revenue, expenses, assets, liabilities, and any other relevant metrics.
 3. Define the criteria for evaluating whether the segments should be aggregated.
 4. Consider factors such as the nature of the business activities, economic characteristics, customer base, pricing policies, and risks and returns associated with each segment.
 5. Utilize automated analysis tools or software capable of processing large volumes of financial data.
 6. Apply predefined algorithms or rules to evaluate the financial performance and characteristics of Segments 1 and 2 based on the defined criteria.
 7. Conduct a comparative analysis of the financial metrics and performance indicators between Segments 1 and 2.
 8. Based on the analysis and findings, evaluate whether it is appropriate to aggregate Segments 1 and 2.
 9. Document the rationale behind the decision, including the analysis results and supporting evidence.
 10. Use tools such as business intelligence software, data visualization platforms, or custom-built reporting modules to present the aggregated and segmented data in a meaningful way.
2. A contract management system may be implemented which allows to store and organize contract documents electronically. This system can help you define and capture key contract details, such as enforceable rights and obligations, agreement terms, and consideration.

Accordingly, the said contract management system shall be enabled to configure a mechanism to assign unique identifiers to each contract.

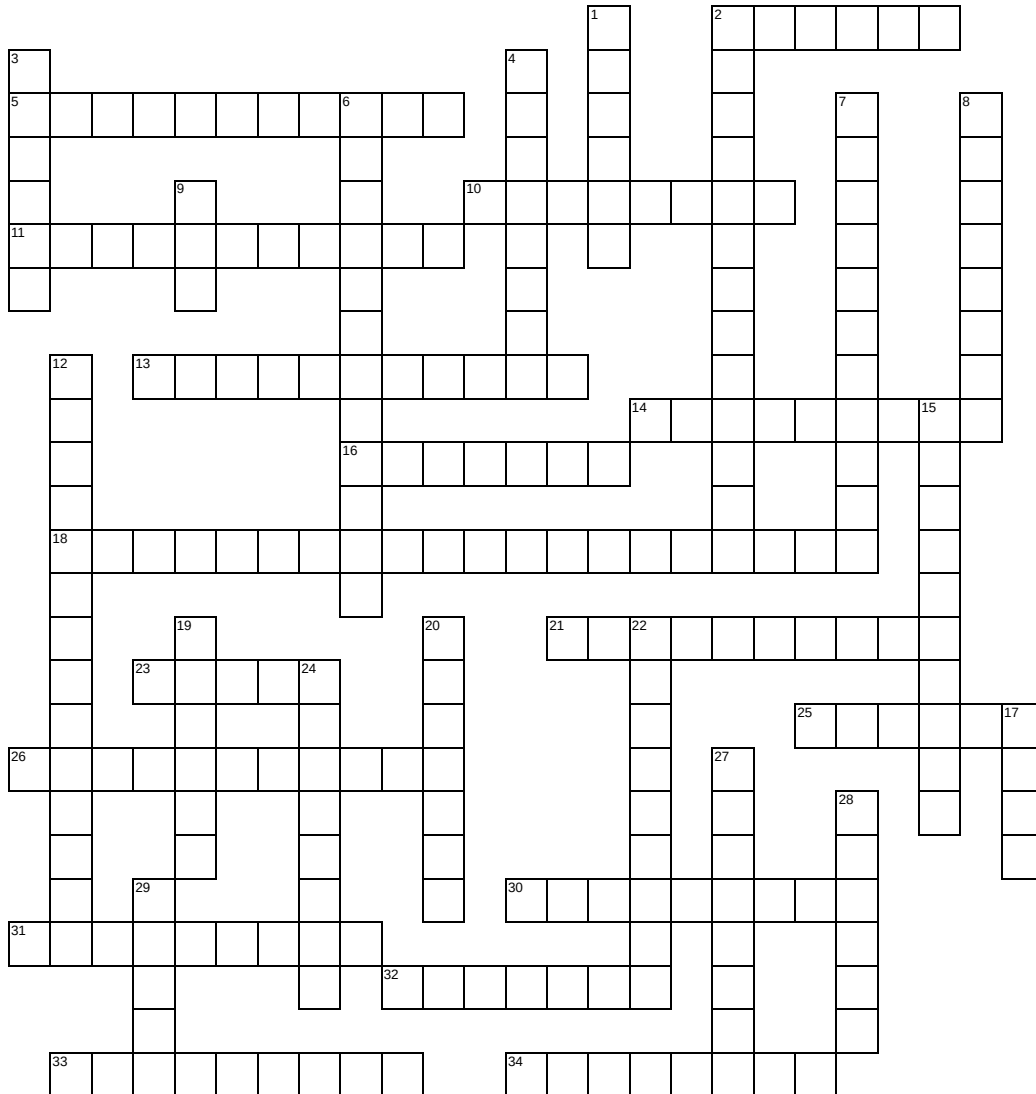
- Integrate the contract management system or accounting software with other operational systems, such as sales, CRM, or project management systems. This integration allows for the automatic capture and synchronization of contract-related data, ensuring that transactions associated with specific contracts are accurately linked.
- Assign specific tags or attributes to contracts based on the defined criteria, such as contract type, customer name, contract start and end dates, or specific service offerings, to enable efficient searching, filtering, and grouping of contracts based on various criteria.
- Use custom queries or predefined templates to extract information on the number of contracts identified, their characteristics, and the associated transactions. This provides visibility into the implementation of Ind AS 115 and helps to monitor compliance.

In addition to the above, the following may be adopted:

- Consider utilizing OCR technology to extract relevant information automatically. OCR can convert printed or handwritten text into machine-readable format, enabling efficient extraction of contract details for further processing and analysis.
- Apply machine learning and Neuro-Linguistic Programming (NLP) techniques to analyze and extract contract data automatically. These technologies can help identify specific contract terms, clauses, or obligations, aiding in the accurate identification and classification of contracts based on predefined criteria.
- Utilize workflow automation tools to streamline the contract identification process. Establish predefined rules or triggers within your system that automatically identify new contracts based on specific criteria and assign unique identifiers. This automation reduces manual effort and ensures consistency in contract identification.

[illegible]

IND AS PUZZLERS: TEST YOUR ACCOUNTING ACUMEN*



ACROSS:

2. Distributions received from an investee _____ the carrying amount of the investment of the investor. (6)

*Related to Chapters of Module 4 only

5. An entity shall account for each business combination by applying the _____ method. (11)
10. Separate financial statements are presented in _____ to consolidated financial statements. (8)
11. Ind AS 111 shall be applied by all entities that are a party to a joint _____. (11)
13. Ind AS 28 not only requires recording the income received from the associate or joint venture but it also requires an investor to record its share in the profit / loss of the associate or joint venture, which may not be yet _____ by the associate. (11)
14. For assessing control, an investor considers _____ voting rights (substantive) held by it as well as the other parties, to determine whether it has power. (9)
16. The acquirer shall, in general, account for acquisition-related cost as _____ in the period in which the cost is incurred and the service is received. (7)
18. Direct or indirect holding of 20 percent or more of the voting power of the investee, is generally presumed as _____, by the investor entity, unless it is clearly demonstrated otherwise. (11,9)
21. The beginning of the earliest period for which an entity presents full comparative information under Ind AS in first Ind AS Financial statements is said to be the date of **transition** to Ind AS. (10)
23. There is no significant influence over an investee when the entity _____ the power to participate in the financial and operating policy decisions of that investee. (5)
25. The _____ in a subsidiary not attributable, directly or indirectly, to a parent is known as non-controlling interest. (6)
26. Significant influence is the power to _____ in the financial and operating policy decisions of the investee but is not control or joint control of those policies. (11)
30. The fundamental ethical principle of professional _____ requires a chartered accountant to comply with relevant laws and regulations. (9)
31. _____ means to be straightforward and honest in all professional and business relationships. (9)
32. A joint _____ is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. (7)

33. A joint arrangement that is not structured through a separate vehicle is a joint _____. (9)
34. If the assets acquired are not a _____, the reporting entity shall account for the transaction or other event as an asset acquisition. (8)

DOWN:

1. Code of Ethics contains requirements and application material to enable chartered accountants to meet their responsibility to act in the _____ interest. (6)
2. Ind AS 101 prohibits _____ application of Ind AS in some areas (called exceptions). (13)
3. Automation is the use of software and other tools to automate _____ processes, making them faster and more accurate. (6)
4. Ind AS 103 says that the _____ in Ind AS 110 shall be used to identify the acquirer-the entity that obtains control of the acquiree. (8)
6. Artificial Intelligence refers to the simulation of human _____ in machines, enabling them to perform tasks that would typically require human intervention. (12)
7. An investor, in assessing whether it has power, considers only _____ rights relating to an investee (held by the investor and others). (11)
8. _____ 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. (8)
9. Cloud Computing allows accountants to access their data and software from _____ device with an internet connection. (3)
12. The _____ of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement. (14)
15. After the measurement period ends, the acquirer shall revise the _____ for a business combination only to correct an error. (10)
17. The measurement period, as per Ind AS 103, shall not exceed one _____ from the acquisition date. (4)

19. An investor does not have power over an investee, even though the investor holds the majority of the voting rights in the investee, when those _____ rights are not substantive. (6)
20. The chartered accountant shall apply the conceptual framework to identify, evaluate and address _____ to compliance with the fundamental ethical principles. (7)
22. An _____ is an entity over which the investor has significant influence. (9)
24. Ind AS 27 shall be applied in accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by law, to present _____ financial statements. (8)
27. An investor controls an investee when it is exposed, or has rights, to _____ returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. (8)
28. The _____ and content of the financial statements for companies is required to be in accordance with Schedule III to the Companies Act, 2013. (6)
29. Consolidation of an investee shall begin from the date the investor obtains control of the investee and _____ when the investor loses control of the investee. (5)

To know the answer of the above Ind AS Puzzle, scan the QR Code

