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Editorial

The new standard on leases, Indian Accounting Standard (Ind AS) 116, *Leases* has been made applicable to companies following Ind AS framework from 1 April 2019. Lease definition is the new on/off balance sheet test for lessees and a key area of judgement in applying the standard. It brings a paramount shift in accounting of leases by lessees. Lessees will recognise most leases on balance sheet. Unlike Ind AS 17, *Leases* (erstwhile standard on leases), Ind AS 116 provides detailed guidance on when a capacity portion of a larger asset can be classified as an identified asset and assessment of substantive substitution rights held by a lessor. The impact of the standard is not limited only to financial reporting. It may prompt changes to certain contract terms and business practices - e.g. changes in structuring or pricing of lease agreement, including the type of variability of lease payments and the inclusion of the options in the contract. Recently, the IFRS Interpretations Committee (IFRIC) has also issued clarifications through its agenda decisions with respect to determination of incremental borrowing rate and assessment of subsurface rights under the new standard. In this edition of Accounting and Auditing Update (AAU), we aim to discuss some of the key issues relating to the implementation of Ind AS 116 along with the clarifications provided by IFRIC.

The Ind AS Technical Facilitation Group (ITFG) of the Institute of Chartered Accountants of India (ICAI) through its bulletins (bulletin 22 and 23) provided clarifications relating to implementation of various Ind AS. The key clarifications relate to determination of lease term and qualification of a lease as a short-term lease in specific scenarios under Ind AS 116, assessment of distribution of gifts under Ind AS 115, *Revenue from Contracts with Customers* and restatement of comparative information in case of common control business combination under Ind AS 103, *Business Combinations*. It also covers impact of the Taxation Laws (Amendment) Ordinance, 2019 in the interim results/financial statements particularly with respect to determination of deferred taxes. Our article on the topic aims to provide an overview of the key clarifications issued by the ITFG.

As is the case each month, we have also included a regular round-up of some recent regulatory updates in India and internationally.

We would be delighted to receive feedback/ suggestions from you on the topics we should cover in the forthcoming editions of AAU.

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Chapter 1

Leases: Emerging implementation challenges

This article aims to:

Discuss key implementation issues of the new standard on leases, Ind AS 116 with the help of practical examples.

The new standard on leases, Indian Accounting Standard (Ind AS) 116, *Leases* has been made applicable to companies following Ind AS framework from 1 April 2019. It brings a paramount shift in accounting of leases by lessees. Lessees will recognise most leases on balance sheet. In effect, the lease definition replaces the lease classification as the key on/off balance sheet test.

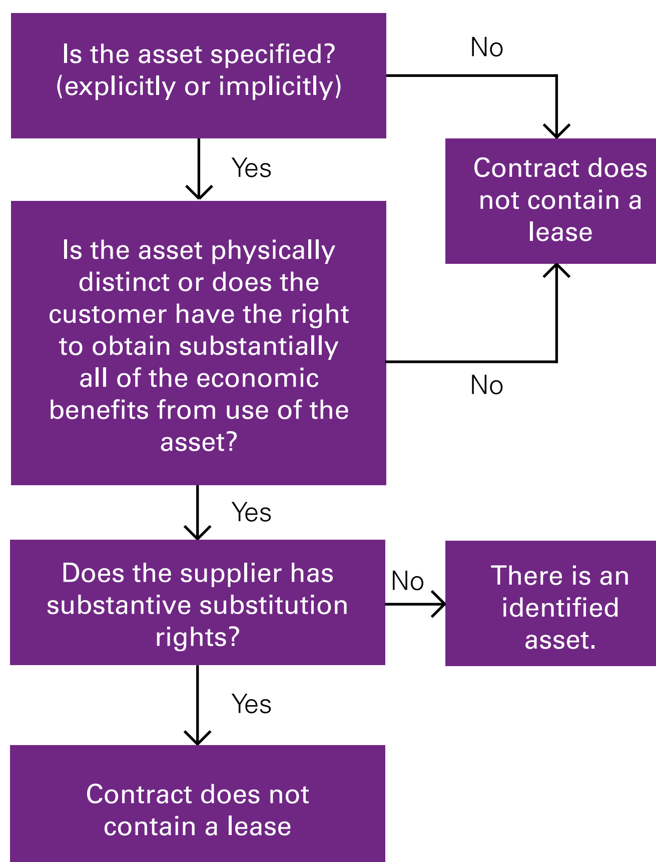
The new standard introduces new estimates and judgements that affect the identification of lease transactions. The impact of the standard is not limited only to financial reporting. It may prompt changes to certain contract terms and business practices - e.g. changes in structuring or pricing of lease agreement, including the type of variability of lease payments and the inclusion of the options in the contract.

In this article, we aim to discuss some of the key challenges faced by the companies while implementing the requirements of Ind AS 116 with the help of practical examples.

Identified asset

Under the new standard, assessment of whether an arrangement is, or contains, a lease is one of the biggest practical issue. A contract contains a lease only if it relates to an identified asset.

An identified asset could be determined as follows:



(**Source:** KPMG IFRG publication 'Lease definition', April 2017)

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Issue: Is the concept of 'identified asset' under the new standard similar to erstwhile standard on leases - Ind AS 17, *Leases?*

Analysis

Under Ind AS 17, determining whether an arrangement is, or contains, a lease is based on the substance of the arrangement and, *inter alia,* requires an assessment of whether fulfilment of the arrangement is dependent on the use of a specific asset(s). This is broadly similar to the requirement under the new standard that there is an identified asset. However, there are two key differences. These relate to the following:

Capacity portion

There is no guidance under Ind AS 17 on whether a capacity portion of a larger asset can be a specific asset. However, under Ind AS 116, a capacity portion of a larger asset is an identified asset if:

a. It is physically distinct (for instance, specified strand of a fibre optic cable) or

b. It is not physically distinct, but the customer has the right to obtain substantially all of the economic benefits from use of the asset (for instance, capacity portion of a fibre optic cable representing substantially all of the capacity of the cable).

Substantive substitution rights

Under Ind AS 17, an asset could be explicitly or implicitly specified in the contract. An asset is implicitly specified if it is not economically or practically feasible for the lessor to perform its obligation under a contract with alternative assets**.**

On the other hand, Ind AS 116 provides detailed guidance on substitution rights. According to it, even if an asset is specified, a customer does not control the use of an identified asset if the supplier has a substantive right to substitute the asset for an alternative asset throughout the period of use.

A lessor's substitution right is considered to be substantive if it meets both the given conditions:

a. The lessor has the practical ability to substitute the asset throughout the period of use. However, as per Ind AS 17, existence of the substitution right does not preclude the existence of a lease up to the date of substitution.

b. The lessor would benefit economically from exercising its right to substitute the asset. However, under Ind AS 17, only economic feasibility is being considered for substituting the asset.

The assessment of substantive substitution right under Ind AS 116 can be understood with the help of an example.

Example: M enters into a contract with L, a freight carrier, to transport a specified quantity of goods. L has a fleet of trucks with particular specifications at its premise to fulfill the contract. Since the trucks are stored at L's premises and it can use any truck to transport the goods at minimal cost, L has a substantive substitution right. Hence, in the given case, there is no identified asset. Therefore, the contract does not qualify to be a lease under Ind AS 116.

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Right to control the use of an identified asset

Under Ind AS 116, 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 of a consideration. A lessee has the right to control the use of an identified asset, if it has both the following:

a. Right to obtain economic benefits from use of an identified asset and

b. Right to direct the use of an identified asset.

Issue: Is the requirement of 'right to direct the use' of an asset under Ind AS 116 similar to the requirement of Ind AS 17?

Analysis

Under Ind AS 17, an arrangement conveys the right to control the use of an asset if any one of the following conditions are met:

a. The customer has the ability or right to operate the asset or direct others to operate the asset while obtaining or controlling more than an insignificant amount of the output.

b. The customer has the ability or right to control physical access to the asset while obtaining or controlling more than an insignificant amount of the output.

c. Facts and circumstances indicate that no other party will take more than an insignificant amount of the output during the term of the arrangement and the unit price is neither fixed nor equal to market price as of the time of delivery of the output.

On the other hand, under Ind AS 116, a more comprehensive analysis of control is required, including an assessment of who determines 'how and for what purpose' the asset is used throughout the period of use. Examples of decision-making rights that are most relevant to changing 'how and for what purpose' the asset is used includes:

a. Right to change the *type* of output that is produced by the asset

b. Right to change *when* the output is produced

c. Right to change *where* the output is produced

d. Right to change *whether* the output is produced and the quantity of that output.

In case relevant decisions about how and for what purpose the asset is used are predetermined, Ind AS 116 focusses on who operates the asset.

While assessing who directs the use of an asset, unlike Ind AS 17, there is no emphasis on who controls physical access to the asset under Ind AS 116.

Additionally, a lease exists only if the lessee obtains 'substantially all' of the economic benefits from the use of the asset whereas Ind AS 17 measures control with 'more than an insignificant amount of output' from the use of the asset. Further, the way in which the output is priced is not a relevant consideration to identify a lease under Ind AS 116.

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Lessee's incremental borrowing rate

Ind AS 116 requires a lessee to measure the lease liability, initially, at the present value of the lease payments that are not paid at that date. Lease payments are discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee should use the lessee's incremental borrowing rate.

Issue: Whether a lessee's incremental borrowing rate is required to reflect the interest rate in a loan with both similar maturity to the lease and a similar payment profile to the lease payments?

Analysis

The definition of a lessee's incremental borrowing rate requires a lessee to determine its incremental borrowing rate for a particular lease considering the terms and conditions of the lease and determine a rate that reflects the rate that it would have to pay to borrow considering the following factors:

a. Over a similar term to the lease term

b. With a similar security to the security (collateral) in the lease

c. The amount needed to obtain an asset of a similar value to the right-of-use asset arising from the lease and

d. In a similar economic environment to that of the lease.

Based on the above, the IFRS Interpretations Committee (IFRIC) through its agenda decision in September 2019 concluded that the definition of a lessee's incremental borrowing rate does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments. Nonetheless, the IFRIC observed that, in applying judgement in determining its incremental borrowing rate as defined in IFRS 16, *Leases* it would be consistent with the IASB's objective when developing the definition of incremental borrowing rate for a lessee to refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease. It would then adjust such an observable rate to determine its incremental borrowing rate as defined under the new standard. The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for a lessee to determine its incremental borrowing rate.

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Subsurface rights

Entities may enter into agreements for subsurface rights. Typically, this involves obtaining the right to place items (such as pipelines or cables) in an underground space. Such arrangements are common in the telecommunication, power and utilities, oil and gas and mining sectors, as well as for companies with significant land ownership.

IFRIC in June 2019 issued an agenda decision as to whether such subsurface rights would constitute a lease. The decision could be explained with the help of an example as given below.

Example: A pipeline operator obtains the right to place an oil pipeline in underground space for 20 years in exchange of a consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed. The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use. The customer has the right to perform inspection, repairs and maintenance work (including replacing damaged sections of the pipeline when necessary).

Analysis

The new standard on leases is applicable to all leases including leases of right-of-use assets in a sub-lease. However, it is not applicable to the following types of leases/arrangements:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- Leases of biological assets within the scope of Ind AS 41, *Agriculture,* held by a lessee
- Service concession arrangements within the scope of Ind AS 115, *Revenue from Contracts with Customers*
- Licences of intellectual property granted by a lessor within the scope of Ind AS 115
- Rights held by a lessee under licensing agreements within the scope of Ind AS 38, *Intangible Assets,* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

It is to be noted that the none of the above exceptions of the new standard apply to the contract of subsurface rights.

Therefore, firstly, an entity would need to identify whether the contract in the given example constitute a lease under the new standard i.e. it meets both of the following conditions:

a. Right to obtain substantially all the economic benefits from the use of an identified asset

b. Right to direct the use of the identified asset throughout the period of use.

Identified asset

In the given example, the contract's specifications include the path, width and depth of the pipeline, thereby defining a physically distinct underground space. The space being underground does not in itself affect whether it is an identified asset - the specified underground space is physically distinct in the same way that a specified area of space on the land's surface would be physically distinct. Also, the landowner does not have the right to substitute the underground space throughout the period of use. Therefore, the specified underground space qualifies to be an identified asset under the new standard.

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Right to obtain substantially all the economic benefits from use

In the given example, the customer has the right to obtain substantially all the economic benefits from use of the specified underground space throughout the 20-year period of use. The customer has exclusive use of the specified underground space throughout that period of use.

Right to direct the use

In the given example, the customer has the right to direct how and for what purpose the specified underground space will be used i.e. to locate the pipeline with specified dimensions through which oil will be transported is predetermined in the contract. The customer has the right to operate the specified underground space as it has the right to perform inspection, repairs and maintenance work. Also, it makes all the decisions about the use of the specified underground space that can be made during the 20-year period of use.

On the basis of the above, the IFRIC concluded that the contract in the given example meets the conditions of a lease under the new standard. Accordingly, the new standard would apply to such contracts.

Conclusion

Entities should carefully evaluate the terms and conditions of each contract so as to ascertain whether it is eligible to be qualified as a lease under the new standard. This would involve significant judgement. Accordingly, the implementation efforts put in by the company should be robust and properly documented for better understanding of various stakeholders.

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Chapter 2

Recent ITFG clarifications

This article aims to:

Summarise recent ITFG clarifications from bulletin 22 and 23.

The Ind AS Technical Facilitation Group (ITFG) of the Ind AS Implementation Committee of the Institute of Chartered Accountants of India (ICAI) issued its clarifications' bulletins 22 and 23 on 14 October 2019 and 26 October 2019 respectively.

This article summarises the key points clarified in both the bulletins.

Overview of the ITFG clarifications' bulletin 22 and 23

Determination of the lease term

In determining the lease term (and consequently whether a lease is a short-term lease), only the enforceable rights of the lessee to renew or extend the lease beyond the non-cancellable period are taken into consideration. For example,

a. Where a lease agreement grants a lessee a right to renew or extend the lease beyond the non-cancellable period without the consent of the lessor, the lessee has the right to use the asset beyond the non-cancellable period. Accordingly, the period covered by the lessee's option to renew or extend the lease is included in the lease term if the lessee is reasonably certain to exercise that option.

b. In case of a lease agreement, in which the lessee can renew or extend the lease beyond the non-cancellable period only with the consent of the lessor, the lessee does not have the right to use beyond the non-cancellable period. By definition, there is no contract beyond the non-cancellable period if there are no enforceable rights and obligations existing between the lessee and the lessor beyond that term.

Accordingly, ITFG clarified that a lease agreement qualifies as a short-term lease in accordance with Ind AS 116, *Leases*, in case it (i.e. the lease agreement including any addendum thereto or a side agreement) has all of the following characteristics:

- It is for a period of 12 months or less
- It does not grant a renewal or extension option to the lessee
- It does not grant a purchase option to the lessee.

A lease with above characteristics would be considered as a short-term lease even if there is a past practice of the lease being renewed upon expiry for a further period of one year at a time with the mutual consent of both the lessor and the lessee.

Conversely, in case a lease agreement grants a renewal or extension option to the lessee, the lessee is required to determine whether it is reasonably certain to extend the lease.

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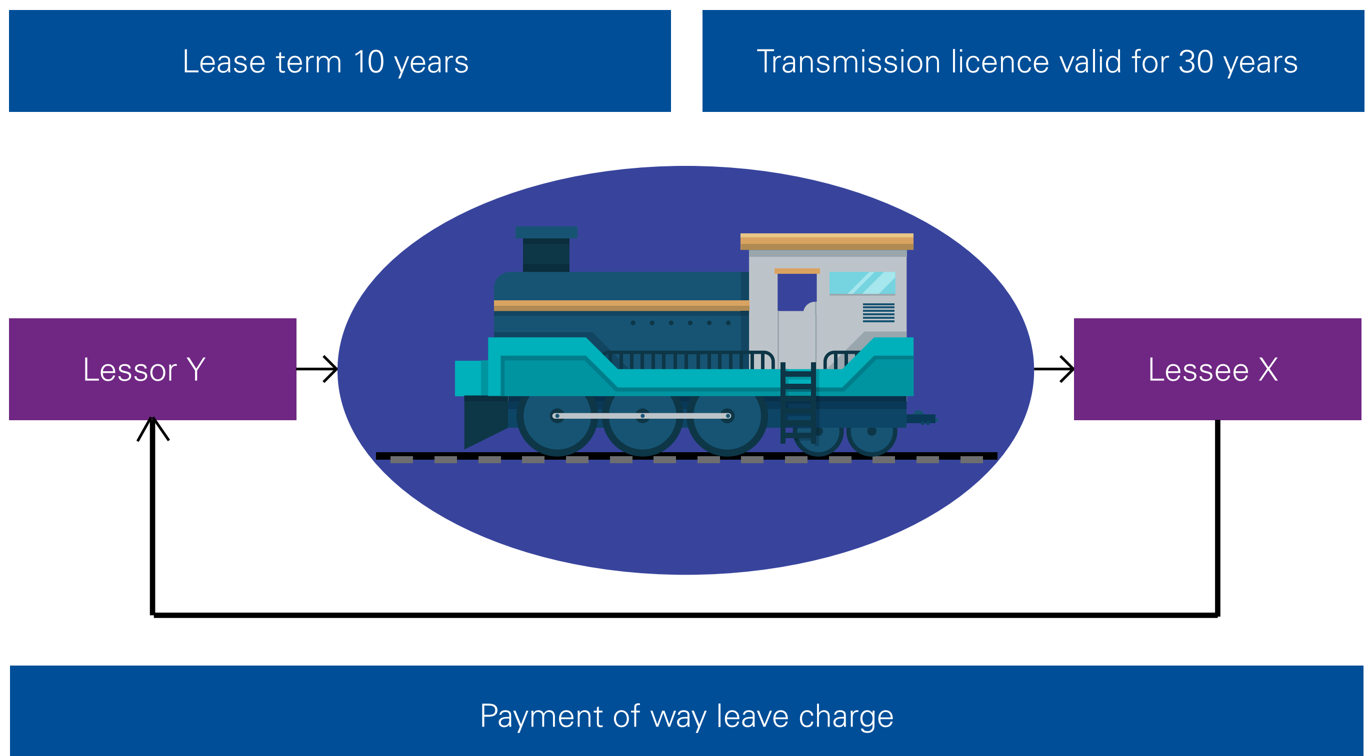
Against the above background, ITFG considered and clarified[1] on three scenarios in which an entity X (which is in the business of power generation and transmission) could avail the recognition exemption for short-term leases in accordance with Ind AS 116 under various lease agreements entered into by it.

Also, X has power transmission licence for a period of 30 years and intends to stay in the business for at least the aforesaid period of 30 years.

Scenario 1: During the year 2015, X (lessee) entered into a lease arrangement with another entity Y (lessor) (which is a government-owned railway operator) for an overhead line facility across the railway track for a period of 10 years. X paid 'way leave' charge to Y for the right of way in advance for the entire period of 10 years. As per the contractual terms, X has no tenancy or right or interest on the land.



As per the past practice followed by Y in respect of its other similar leases, it is likely that the contract will be renewed for another 10 years at the expiry of its current term.

X is reasonably certain to continue the above lease till the validity of transmission licence, i.e. 30 years since shifting of transmission lines would affect its business adversely. Further, in the past, Y has given notice to lessees to shift transmission lines from railway land only in a few rare and unusual cases.

The ITFG has clarified that in determining the lease term, the lessee (i.e. X in this case) is required to make an assessment if, at lease commencement, there is an economic incentive to not exercise the option to terminate the lease prematurely. X would make this assessment by considering all relevant facts and circumstances including any expected changes in facts and circumstances during the 10 years period.

In the current scenario, however, the following factors suggest that at the commencement date, X is not likely to have an economic incentive to exercise the termination option:

- X expects to operate the transmission line for 30 years. It, therefore, needs the right of way for a period of 30 years (which is in excess of the 10 years period covered by the lease).
- In case X wishes to relocate the transmission line so that it crosses over the railway track at a different location, in all likelihood, it would still have to obtain the right of way from Y. This due to the reason that in India, railway tracks and adjoining land are owned mostly by a single entity, viz. Indian Railways. Also, it seems unlikely that the lease rentals for the alternative location would be significantly lesser to justify the relocation.

1. The analysis deals with the issue of determination of lease term under Ind AS 116 and does not deal with any other accounting aspect that may be relevant, e.g., application of transitional provisions.

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- It seems possible that X may not be able to have a complete transmission line without crossing over the railway track. Even where this is technically possible, the alternative route may involve a considerable increase in the length of the transmission line and may, therefore, involve considerable additional cost. Prima facie, any savings to X due to lower lease rentals (which are likely to be the primary drivers behind any relocation decision) are likely to be significantly less than the cost involved in relocation.
- In case the premature termination by X would result in Y forfeiting a significant part of the advance lease rental payment, this would be an additional factor providing economic incentive to X to not terminate the lease prematurely.

ITFG also noted that Y is a government-owned entity. While its agreement with X gives it a right to terminate the lease at any time, it seems that this right is meant to be exercised only in exceptional circumstances. At lease commencement, there seems no economic incentive for Y to terminate the lease prematurely. In case another entity approaches Y for the right of way, it seems that it can provide the right of way at some distance from location of transmission line of X. Y does not need to terminate its existing arrangement with X to provide right of way to another party.

The above factors, all, prima facie suggest that at lease commencement, it is reasonably certain that the termination option will not be exercised. However, as mentioned earlier, the final determination of the issue would have to be made by X on the basis of its detailed and in-depth knowledge of the facts and circumstances of the case. In case X concludes that it is reasonably certain at lease commencement that the termination option would not be exercised, the lease term would be 10 years and, consequently, the lease would not qualify as a 'short term lease'.

Scenario 2[2]: A part of the transmission line also passes through private land held by Z. During the year 2015, X (lessee) entered into a lease agreement with Z (lessor) for a period of 12 months for overhead facility. Since the year 2015, the contract has been renewed every year for a further period of one year at a time.

2. A similar issue related to renewal of lease requiring mutual consent of lessor and lessee and not just at the option of lessee has been clarified in ITFG clarification bulletin 21 (Issue 1).

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The following are some of the principal terms of agreement:

- The lease can be renewed or cancelled with the mutual consent of both the parties.
- Either party should be at liberty to put an end to the arrangement by giving one month's prior notice in writing to that effect and in the event of such a notice neither of the party shall have any claim for any compensation whatsoever.
- X should not transfer or sublet the rights granted by Z and the benefit of the facility should be restricted to it only.

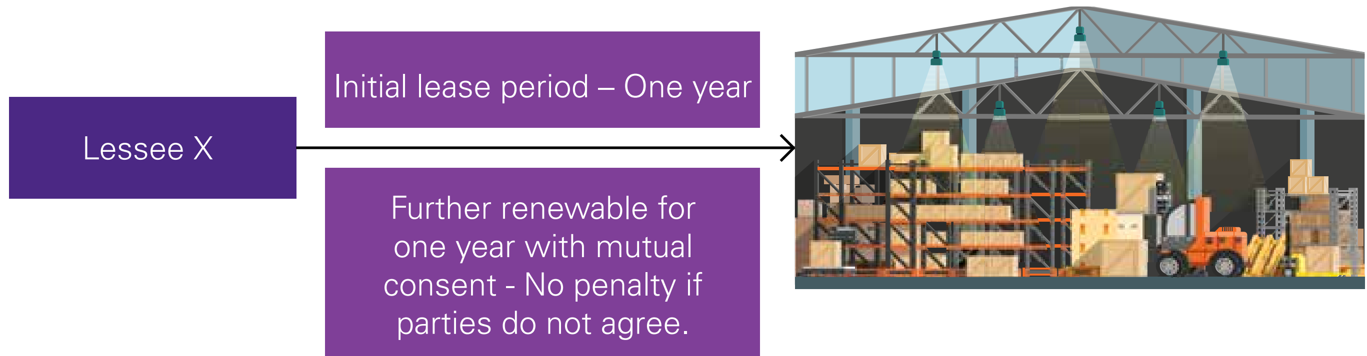
X is reasonably certain to continue the above lease till the validity of transmission licence, i.e. 30 years since shifting of transmission lines would affect its business adversely.

As per the past practice, it is likely that the contract will be renewed for another one year at the expiry of its current term.

The lease agreement does not provide any purchase option in respect of the leased asset to the lessee.

Accordingly, ITFG has clarified that the lease agreement is for a period of 12 months as the agreement does not grant a renewal, extension, or purchase option to X (i.e., the renewal of lease requires mutual consent of both parties and is not at the option of X only). Accordingly, the lease qualifies as a short-term lease, notwithstanding the fact that in the past, upon expiry of each 12 months' period, the lease has been renewed for a further period of 12 months. X could, therefore, avail the exemption of not applying the lessee accounting model to this particular lease.

Scenario 3[2]: In the year 2016, X enters into a lease agreement with a warehouse for an initial non-cancellable period of one year. The lease can be renewed for a further period of one year with the mutual consent of both the parties. There is no penalty if the lessee and the lessor do not agree. Since 2016, the contract has been renewed every year for a further period of one year at a time.



As per the past practice, it is likely that the contract will be renewed for another one year at the expiry of its current term. The lease agreement does not provide any purchase option in respect of the leased asset to the lessee.

ITFG has clarified that in this scenario as well, the lease agreement is for a period of one year i.e.12 months.

The agreement does not grant a renewal, extension, or purchase option to X. Thus, the lease in this scenario qualifies as a short-term lease, even though in the past, the lease has been renewed for a further period of one year. X could, therefore in this scenario, avail the exemption of not applying the lessee accounting model of the standard to the lease.

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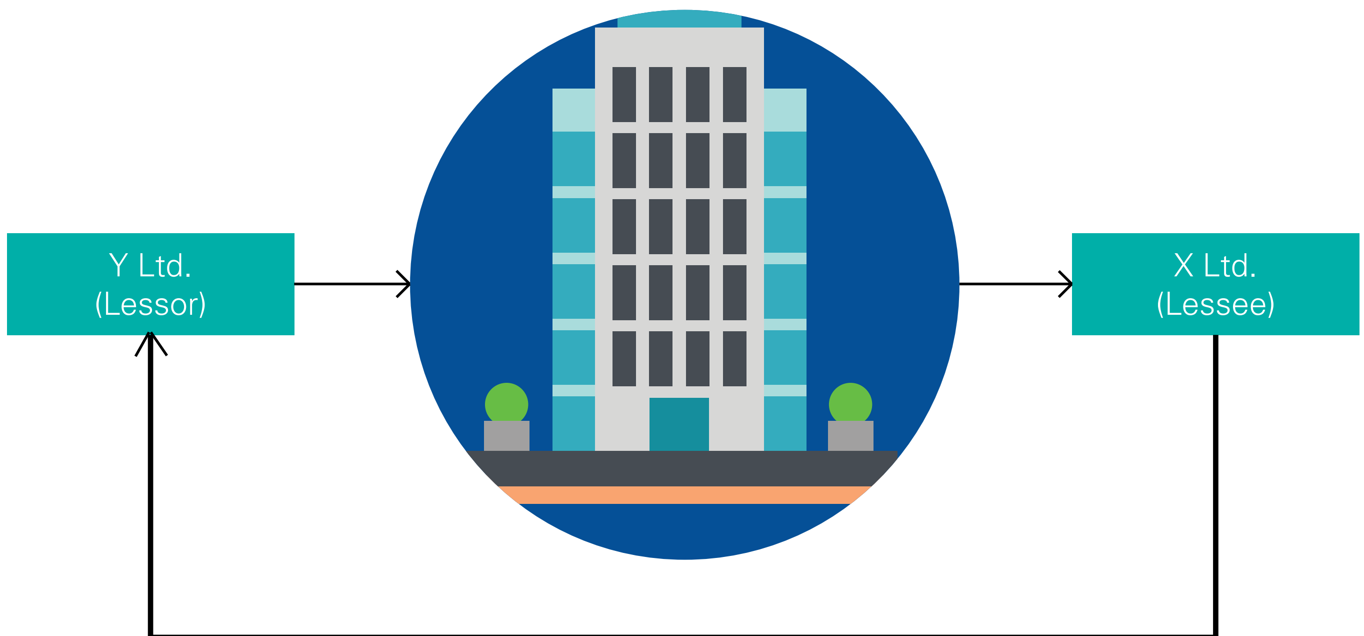
Accounting for lease rental income in case of operating lease by a lessor

In respect of accounting for operating leases by a lessor, Ind AS 17, *Leases*[3] did not require or permit scheduled lease rental increases to be recognised on a straight-line basis over the lease term if lease rentals were structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases. Instead, Ind AS 17 required such increases to be recognised in the respective period of increase. This was a significant difference (a carve out) from its corresponding International Financial Reporting Standard (IFRS), IAS 17, *Leases*.

However, it is important to note that above carve out has not been carried forward in Ind AS 116. Thus, Ind AS 116 requires operating lease rentals to be recognised on a straight-line basis (or on another systematic basis if such other basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished).

Therefore, in a situation where an entity Y Ltd. (lessor) had entered into a lease agreement to provide on lease an office building to another entity X Ltd. (lessee) for a period of five years beginning 1 April 2017. The lease rental for each subsequent year was to increase by 10 per cent over the lease rental for the immediately preceding year. The scheduled 10 per cent annual increase in lease rentals was in line with expected general inflation to compensate for Y Ltd.'s expected inflationary cost increases.

Thus, Y Ltd. did not recognise the lease rental income on a straight-line basis.



3. Ind AS 116 is applicable for annual reporting periods beginning on or after 1 April 2019 and Ind AS 17 has been superseded.

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The ITFG considered and clarified the accounting of the rental income of the operating lease by the lessor, in accordance with Ind AS 116 as follows:

- Y Ltd. is required to recognise operating lease rentals from the office building given on lease on a straight-line basis over the lease term, even though the lease rentals are structured to increase in line with expected general inflation to compensate for its expected inflationary cost increases.
- The resultant change in manner of recognition of operating lease rentals by Y Ltd. represents a change in an accounting policy which would need to be accounted for as per Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* in the absence of specific transitional provisions in Ind AS 116 dealing with the change.

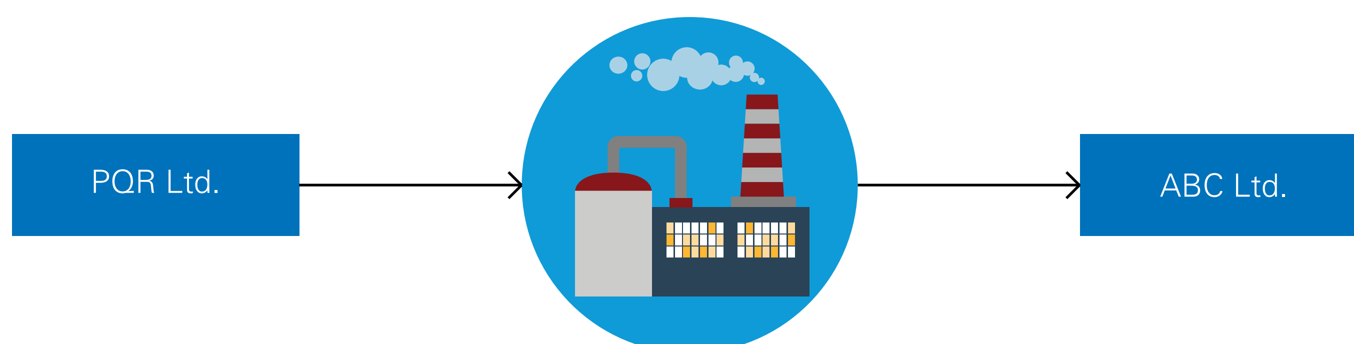
Accounting for mining lease rights as intangible assets after demonstration of technical feasibility and commercial viability of extracting a mineral resource

Ind AS 16, *Property, Plant and Equipment* does not apply to mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources. Additionally, Ind AS 116, excludes from its scope the leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources.

Though, accounting guidance related to exploration for and evaluation of mineral resources is provided in Ind AS 106, *Exploration for and Evaluation of Mineral Resources,* however, Ind AS 106 too does not apply after both the following characteristics of extracting a mineral resource are demonstrable:

- The technical feasibility and
- Commercial viability.

ITFG considered a scenario of ABC Ltd., which is a cement manufacturer and has entered into a lease agreement with PQR Ltd. for rights for the extraction of limestone which is the principal raw material for manufacture of cement.



In the current scenario, ITFG considered the following two issues related to extraction of mineral resources (such as limestone), after the establishment of technical feasibility and commercial viability of extracting the mineral resource:

- Classification of such rights as assets
- Amortisation of such rights i.e., whether to be based on lease term in years (period-based) or based on quantity of mineral reserves (quantity based).
- **Classification of such rights as assets:** In the current scenario, the ITFG considered the following:

  a. The rights do not relate to a mine in exploration and evaluation stage but to a mine for which the technical feasibility and commercial viability of extracting the limestone has already been determined

  b. The payment made (or to be made) by the entity for obtaining the mining lease rights is neither expenditure on 'development' nor on 'extraction' of minerals or other non-regenerative resources.

  In view of the above, the ITFG concluded that the mining rights under the current scenario would be classified as intangible assets and accordingly be accounted for as per Ind AS 38, *Intangible Assets.*

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- **Amortisation of such rights:** In accordance with the guidance provided by Ind AS 38, the depreciable amount of an intangible asset with a finite useful life is to be allocated on a systematic basis over its useful life.

  Further, Ind AS 38 requires that the amortisation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method should be used. The Standard recognises that a variety of amortisation methods could be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the following:

  - The Straight-Line Method (SLM)
  - The diminishing balance method and
  - The Units of Production (UoP) method.

  The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset and is to be applied consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits.

  Also, Ind AS 38 recognises that in choosing an appropriate amortisation method, an entity could determine the predominant limiting factor that is inherent in the intangible asset. For example, the contract that sets out the entity's rights over its use of an intangible asset might specify the entity's use of the intangible asset as a predetermined number of years (i.e. time), as a number of units produced or as a fixed total amount of revenue to be generated.

  Identification of such a predominant limiting factor could serve as the starting point for the identification of the appropriate basis of amortisation, but another basis may be applied if it more closely reflects the expected pattern of consumption of economic benefits.

  In accordance with the above, ITFG noted that selection of an appropriate amortisation method for the mining lease requires consideration of the exact facts and circumstances of the case.

  Therefore, ITFG clarified that this assessment would need to be made by the entity itself in the light of its detailed and in-depth knowledge of the facts and circumstances of its particular case.

Applicability of Ind AS 115, *Revenue from Contracts with Customers* to distribution of gifts

Revenue is accounted for in accordance with Ind AS 115, only in case the counterparty to the contract is a customer. Further, a contract should create enforceable rights and obligations.

ITFG considered a scenario, where ABC Ltd. (a pharmaceutical company) distributed gifts (mobile phones, decorative items and the like) along with its product catalogues to doctors to encourage them to prescribe medicines manufactured by it. No conditions were attached with the items that were distributed.

The ITFG considered the following two issues:

- **Applicability of Ind AS 115 to such gifts:** The ITFG considered the following aspects in the given scenario:

  a. Gifts are distributed to doctors as a part of sales promotion activities without any agreement between ABC Ltd. and the doctors creating enforceable rights and obligations

  b. Doctors to whom gifts were distributed were not customers of ABC Ltd. since they do not have a contract with ABC Ltd. to obtain goods or services in exchange for consideration

  c. The items distributed as gifts are not an output of ABC Ltd.'s ordinary activities.

  In the given case, the ITFG clarified that as above conditions have not been met, the distribution of gifts to doctors does not fall under the scope of Ind AS 115.

- **Accounting treatment of distribution of such gifts by the entity (a pharmaceutical company i.e. ABC Ltd.) to doctors as a part of sales promotion activities:** Ind AS 38 applies, among other things, to expenditure on advertising, training, start-up, research and development activities. Further, Ind AS 38 prohibits an entity from recognising internally generated goodwill, brands, customer lists and items similar in substance as intangible assets on the basis that expenditure on such internally generated items cannot be distinguished from the cost of developing the business as a whole.

  Items acquired by ABC Ltd. to be distributed as gifts as a part of sales promotion activities have no other purpose than to undertake those activities. In other words, the only benefit of those items for ABC Ltd. is to develop or create brands or customer relationships, which in turn generate revenue.

  Additionally, Ind AS 38 specifically requires an

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entity to recognise expenditure on such items as an expense when the entity has a right to access those goods regardless of when the goods are distributed.

Accordingly, in view of the above, the ITFG clarified the timing of recognition of expenditure on items to be distributed as gifts as an expense when it owns those items or otherwise has a right to access them regardless of when it distributes the items to doctors.

Restatement of comparative information in case of common control business combinations

Appendix C, Business combinations of entities under common control of Ind AS 103, *Business Combinations* require 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.The ITFG considered two scenarios as below:

- **Restatement in case of change in composition of reporting entity retrospectively**

  In a situation, a company ABC Ltd. merges into PQR Ltd. The merger is a common control business combination included within the scope of Appendix C of Ind AS 103. The order of the National Company Law Tribunal (NCLT) approving the scheme of merger was received on 27 March 2019 and the appointed date for the merger is 1 April 2016. PQR Ltd. has been applying Ind AS with effect from financial year beginning 1 April 2016 (transition date is 1 April 2015).

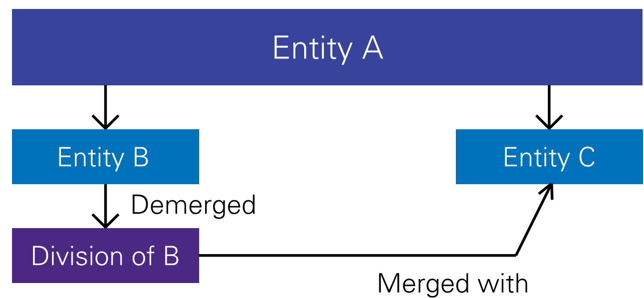
  The issue under consideration is while preparing the financial statements for the year ended 31 March 2019, would comparative figures only for the year ended 31 March 2018 have to be restated or a third balance sheet as of 1 April 2017 is also required to be presented.

  Appendix C of Ind AS 103 requires only restatement of comparative information and does not require a third balance-sheet at the beginning of the preceding period, (unless the beginning of the preceding period also happens to be the date of transition to Ind AS in a particular case).

  Accordingly, PQR Ltd would be required only to restate financial statements for the year ended 31 March 2019 with comparative information for 31 March 2018.

- **Applicability of restatement of comparative information to the transferor and transferee in case of common control business combination**

  Entity B and Entity C (both under common control of Entity A) filed a scheme of arrangement with NCLT in the year 2017. As per the scheme, one of the business divisions of Entity B was to be demerged and merged with C. The scheme was approved by the NCLT in June 2019 i.e. before the approval (by the board of directors) of the financial statements for the year ended 31 March 2019.



  The appointed date of merger as per the scheme was 1 April 2018. Both the entities, B and C are required to prepare their first Ind AS financial statements for year ended 31 March 2018.

  In this situation, ITFG considered the following two issues:

  a. **Whether the financial statements of the Entity C for the financial year 2017-18 should be restated considering that the appointed date of the merger is 1 April 2018**

     The ITFG clarified that as per Appendix C of Ind AS 103, Entity C would be required to restate financial statements for the year ended 31 March 2019 with comparative information for 31 March 2018 (financial year 2017-18) regardless of appointed date as 1 April 2018.

  b. **Whether the financial statements of Entity B (demerged entity) for the financial year 2017-18 should be restated given the fact that Ind AS 103 is not applicable to the demerged entity**

     The issue under consideration is with regard to applicability of Appendix C of Ind AS 103 to demerged entity (i.e. transferor in the given case) with respect to restatement of comparative information.

     It was noted that Appendix C of Ind AS 103 requires accounting for a common control business combination only from the perspective of the transferee. Accordingly, restatement of comparative information only applies to the

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transferee (Entity C) and not the transferor (Entity B). However, Entity B is required to evaluate any disclosure to be made in consonance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations.*

Accounting treatment and presentation of waiver of interest on the loan taken

Entity A has an outstanding loan as at the year-end 2018-19 in its Ind AS financial statements. The outstanding loan (repayable on demand and not related to a qualifying asset) was taken from one of its directors during the year 2015-16. In previous years, the interest was charged and paid to the directors. However, in respect of interest on the loan for the year, 2018-19, a waiver was obtained from the director without an amendment of the loan agreement.

The ITFG considered the issue related to the accounting treatment of interest on the loan for the year 2018-19.

ITFG noted[4] that Entity A is contractually obligated to pay interest on the loan obtained from the director but the same has been waived off in the current year. In accordance with Ind AS 1, *Presentation of Financial Statements,* presentation of true and fair view requires the faithful representation of the effects of transaction, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses as set out in the *Framework for the Preparation and Presentation of Financial Statements in Accordance with Indian Accounting Standards* (the Framework).

ITFG clarified that in order to achieve fair presentation, appropriate accounting treatment would be to recognise contractual obligation for payment of interest as well as the waiver thereof. Thus, Entity A would be required to recognise interest as an expense and the waiver thereof as an item of income.

Further, the same would also require to be disclosed as related party transactions.

Measurement of current tax and DTA or DTL to give effect to lower tax rate in accordance with the Ordinance 2019

The Taxation Laws (Amendment) Ordinance, 2019 (Ordinance 2019) came into effect from 20 September 2019. It has brought out significant changes to corporate income-tax rates. In accordance with the Ordinance 2019, the domestic companies have now been provided with an option to pay income-tax at a rate lower than the normal corporate income-tax rate of 30 per cent depending upon certain specified conditions. However, the option to pay income-tax at a lower rate is dependent upon not availing certain exemptions or incentives as specified in the Ordinance 2019.

The issue under consideration was whether a domestic company could give effect to lower tax rate (in accordance with the Ordinance 2019) while determining current tax and Deferred Tax Asset (DTA) or Deferred Tax Liability (DTL) with the purpose to present interim results/interim financial statements as on 30 September 2019 (financial year 2019-20).

Even though, the lower rates of corporate income-tax have been enacted (on 20 September 2019) well before the interim reporting date of 30 September 2019, the ITFG has clarified that such lower rates should be applied by a company for measurement of current and deferred taxes only if it expects to opt for the lower rates. This is in accordance with the requirements of Ind AS 12, *Income Taxes.*

Accordingly, if the company **expects to opt** for the lower tax rate (**with an intention appropriately evidenced**), the current and deferred taxes are required to be measured using lower tax rate as per the Ordinance 2019 for the purpose of presenting interim results/interim financial statements for the quarter/half-year ended 30 September 2019.

Additionally, it was clarified that in case the company expects to opt for the lower tax rate from the next financial year 2020-21 onwards, the lower tax rate is required to be applied only to the following extent:

- The DTA is expected to be realised or
- The DTL is expected to be settled

in the periods during which the company expects to be subject to lower tax rate.

The normal tax rate is required to be applied to the extent DTA/DTL is expected to be realised (settled) in earlier periods.

Accounting treatment of deferred tax adjustments recognised in equity on first-time adoption of Ind AS in accordance with Ind AS 101, *First-time Adoption of Ind AS* at the time of transition to Ind AS 115 and Ind AS 116

The principle laid down in Ind AS 12 for accounting of current and deferred tax effects is as follows:

Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or the event itself.

Accordingly, an entity is required to account for tax consequences of transactions and other events in the same way that it accounts for the transaction and other events themselves. Thus, for transactions and other

4. ITFG assumed in the present scenario that the director is not a shareholder and is not compensated through remuneration for the interest waived.

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events recognised in statement of profit and loss, any related tax effects are also recognised in it. Similarly, for transactions and other events recognised outside the statement of profit and loss (i.e. either in Other Comprehensive Income (OCI) or directly in equity), any related tax effects are also recognised either in OCI or directly in equity respectively.

The ITFG considered a situation where an Entity X at the time of first-time adoption of Ind AS, made adjustments resulting from recognition of DTA and DTL directly in equity as required by Ind AS 101.

Subsequently, similar deferred tax adjustments were made directly in equity at the time of initial application of Ind AS 115 and Ind AS 116.

In the financial year 2019-20, Entity X decided to opt for the lower tax rate as per the Ordinance 2019. As a result, DTA and DTL (as referred to above), to the extent unrealised/not settled, would be required to be remeasured.

The issue under consideration is whether Entity X should recognise the resultant differences in amount of DTA and DTL arising from change in tax rates directly in equity.

The ITFG deliberated the intended meaning of terms 'directly in equity' and 'transaction or event' as envisaged in Ind AS 12. Consequently, the emerging view was that the words 'directly in equity' relate to the base transaction/event and the term 'transaction or event' refers to the source which gave rise to the deferred tax implication.

The ITFG considered following examples with respect to the term 'directly in equity':

- An entity at the time of first-time adoption of Ind AS restates a previous business combination. This was earlier accounted under previous GAAP on book value basis. As a result, the entity recalculates the depreciation charge for items of property, plant and equipment acquired as a part of the business combination on the basis of fair value for the previous periods from the date of business combination to the date of transition to Ind AS and adjusted the resultant increase (or decrease) in retained earnings (in cumulative depreciation) as on the date of transition to Ind AS. ITFG clarified that, in doing so, the entity, in effect, restated the depreciation charge in profit or loss for each of the previous periods from the date of business combination to the date of transition to Ind AS. (Had the entity presented comparative information for all such previous periods, the increased (or decreased) depreciation for a period would have reflected in statement of profit and loss for that period). Accordingly, it was highlighted that the cumulative adjustment to retained earnings at the date of transition to Ind AS is not an adjustment 'directly in equity'.
- An entity at the time of first-time adoption of Ind AS remeasures certain equity investments at Fair Value through Other Comprehensive Income (FVOCI). Under previous GAAP, the investments were measured at cost less diminution (other than temporary in nature). The resultant increase/decrease in carrying value of investments were adjusted under an appropriate equity head (e.g. OCI) on the date of transition to Ind AS. ITFG clarified that in doing this, the entity in effect, reflected the fair value changes in OCI for each of the previous periods up to the date of transition.(Had the entity presented comparative information for all such previous periods, the increase(or decrease) in the fair value for a period would be reflected in OCI for that period). Accordingly, it was highlighted that the cumulative adjustment to equity at the date of transition to Ind AS is not a transaction or event recognised 'directly in equity' and the remeasurement of deferred tax on such item is required to be recognised in OCI.
- An entity at the time of first-time adoption of Ind AS adjusts the unamortised balance of costs of issue of equity shares in an appropriate equity head on the date of transition to Ind AS. The adjustment was made in accordance with Ind AS 32, *Financial Instruments: Presentation* that 'transaction costs of an equity transaction shall be accounted for as a deduction from equity'. Accordingly, ITFG clarified that even if the entity were an existing adopter of Ind AS at the time of issuance of the equity share, it would still have adjusted the issue costs directly in equity. Hence, it was highlighted that the adjustment to equity at the date of transition to Ind AS is an adjustment 'directly in equity'. Additionally, the remeasurement of deferred tax on such item is required to be recognised directly in equity.

The ITFG clarified that entity is required to determine (using the current accounting polices) the underlying items (source transaction/events) with respect to which deferred taxes were recognised by it at the time of first-time adoption of Ind AS or at the time of transition to Ind AS 115 or Ind AS 116.

Accordingly, ITFG concluded that depending on the nature of an underlying item, the change in the amount of the related DTA or DTL resulting from the remeasurement of the same at lower tax rates introduced by the Ordinance 2019 should be recognised in statement of profit and loss, OCI or directly in equity.

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Chapter 3

Regulatory updates

The Taxation Laws (Amendment) Act, 2019

Background

On 20 September 2019, the Ministry of Law and Justice issued the Taxation Laws (Amendment) Ordinance, 2019 (tax ordinance) and made certain amendments to the provisions of the Income-tax Act, 1961 (IT Act) and the Finance (No.2) Act, 2019 with effect from Financial Year (FY) 2019-20.

The key amendments relate to the following:

- Tax concession for domestic companies
- Tax concession for new domestic manufacturing companies
- Reduction in Minimum Alternate Tax (MAT) rate and
- Buy-back provisions.

New development

Recently, the Taxation Laws (Amendment) Bill, 2019 (Tax Bill) which seeks to replace the tax ordinance has been passed by the Parliament. The Tax Bill received the presidential assent on 11 December 2019. Consequently, the Taxation Laws (Amendment) Act, 2019 (the Tax Act) has been made effective from 20 September 2019.

In addition to the changes made by the tax ordinance, the Tax Act has introduced certain other amendments to the IT Act and the Finance (No.2) Act, 2019. The key amendments are as follows:

- **Business of manufacture - Specific exclusions:** The Tax Act clarified that the business of manufacture or production of any article or thing referred in Section 115BAB of the IT Act should not include business of:

  a. Development of computer software in any form or in any media

  b. Mining

  c. Conversion of marble blocks or similar items into slabs

  d. Bottling of gas into cylinder

  e. Printing of books or production of cinematograph film or

  f. Any other business as may be notified by Central Government (CG) in this behalf.

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- **Set-off of unabsorbed depreciation/loss not allowed from total income:** In order to avail the option to pay tax at concessional rates under Section 115BAA/Section 115BAB of the IT Act, the total income of the company should, *inter alia,* be computed without set-off of any loss or allowance for unabsorbed depreciation deemed so under Section 72A of the IT Act[1], if such loss or depreciation is attributable to any of the prescribed ineligible deductions.
- **Failure to comply with the conditions specified for concessional tax rates:** As per the Tax Act, in case a person fails to satisfy the conditions specified under Section 115BAA/Section 115BAB of the IT Act in any previous year, then the option (to pay tax at the reduced rate of 22 per cent/15 per cent) would become invalid in respect of assessment year relevant to that previous year and subsequent assessment years.

(Source: The Taxation Laws (Amendment) Act, 2019 issued by the Ministry of Law and Justice dated 12 December 2019)

Extension of the last date of filing Form NFRA-2

An auditor of a company and a body corporate covered under the National Financial Reporting Authority (NFRA) Rules, 2018 is required to furnish an annual return[2] (in Form NFRA-2) with the NFRA. The Ministry of Corporate Affairs (MCA) through its circular dated 27 November 2019 clarified that the time limit for filing Form NFRA-2 would be 90 days from the date of deployment of the form on the website of NFRA.

On 9 December 2019, Form NFRA-2 has been deployed on the NFRA website. Accordingly, auditors are required to submit the annual return in Form NFRA-2 by 8 March 2020.

(Source: MCA general circular no. 14/2019 dated 27 November 2019)

Guidelines for preferential issue of units and institutional placement of units by listed InvITs and REITs

The Securities Exchange Board of India (SEBI) through its circular dated 27 November 2019 issued guidelines for preferential issue of units and institutional placement of units by listed Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs). The guidelines, *inter alia,* include conditions and manner of issuance of units and disclosures to be made by the issuer.

Key conditions for preferential issue/institutional placement of units to be complied by a listed InvIT/REIT are as follows:

- The preferential issue/institutional placement of units should be approved by the existing unitholders of InvIT/REIT by passing a resolution.
- The units of the same class which are proposed to be allotted have been listed on a stock exchange for a period of at least six months in case of preferential issue/12 months in case of institutional placement prior to the date of issue of notice to its unit holders for convening the meeting to pass a resolution.
- An in-principal approval has been obtained from the stock exchange(s) for listing of units proposed to be issued.
- None of the promoters, partners or directors of the sponsor, manager or trustee of the InvIT/REIT is a fugitive economic offender declared under the Fugitive Economic Offenders Act, 2018.
- Subsequent institutional placement should not be made by the REIT/InvIT until the expiry of six months from the date of prior institutional placement.

(Source: SEBI circular no. SEBI/HO/DDHS/DDHS/CIR/P/2019/142 and circular no. SEBI/HO/ DDHS/DDHS/CIR/P/2019/143 dated 27 November 2019)

1. Pertaining to amalgamation or demerger.

2. The annual return includes general information of the auditor, details relating to entities covered under the NFRA Rules for which audit reports Whave been issued by the auditor and details of any disciplinary or other proceedings initiated against the auditor in the past five years.

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IASB issued an exposure draft on general presentation and disclosures

Recently, the International Accounting Standards Board (IASB) has issued an Exposure Draft (ED) on '*General Presentation and Disclosures*'. The proposals in the ED aim to improve how information is communicated in the financial statements, with a focus on information in the statement of profit and loss.

As per the proposals, companies are required to:

- Present new defined subtotals in the statement of profit and loss. These subtotals would provide relevant information and create a more consistent structure to the statement of profit and loss, thereby improving comparability among companies.
- Disaggregate information in a better way. IASB proposes disaggregation principles, disaggregation of operating expenses either by nature or by function in the statement of profit and loss, a requirement for disaggregation of large 'other' balances, a requirement to disaggregate information about unusual income and expenses and additional minimum line items in the statement of financial position.
- Disclose management-defined performance measures i.e., performance measures not specified by IFRS standards (non-GAAP measures). To promote transparency, IASB proposes reconciliations between some management-defined performance measures and subtotals specified by IFRS standards.

Additionally, IASB proposes to issue a new IFRS standard, replacing IAS 1, *Presentation of Financial Statements* and amend some IFRS standards to reflect these proposals.

Comments on the proposals can be submitted up to 30 June 2020.

(Source: IASB's ED on 'General Presentation and Disclosures' (ED/2019/7) issued on 17 December 2019)

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KPMG in India's IFRS institute

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The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

First Notes

SEBI mandates disclosure on loan defaults by listed entities and other updates

3 December 2019

Background

On 20 November 2019, the Securities and Exchange Board of India (SEBI) in its board meeting approved certain matters relating to disclosures on loan defaults, portfolio managers and rights issue.

To bring effect to proposal approved in board meeting, SEBI through its circular dated 21 November 2019 mandated listed entities to provide disclosure to the stock exchanges when there is a default in payment of interest/instalment obligations on loans, including revolving facilities like cash credit, from banks/financial institutions and unlisted debt securities.

The provisions of the circular are effective from 1 January 2020.

This issue of First Notes provides an overview of the SEBI circular and other decisions approved at the SEBI board meeting.

Voices on Reporting

KPMG in India is pleased to present Voices on Reporting (VOR) - a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

On 7 November 2019, KPMG in India organised a VOR webinar to discuss certain accounting and financial reporting impact areas of recent tax amendments and few challenges with regard to Ind AS 115, *Revenue from Contracts with Customers* with focus on technology sector.

Please visit KPMG in India's website to access the audio recording and presentation.

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