ICAI issues exposure drafts of AS 23, *Borrowing Costs* and AS 24, *Related Party Disclosures*

1 November 2017

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

Background

The Ministry of Corporate Affairs (MCA) through a notification dated 16 February 2015 issued the Companies (Indian Accounting Standards) Rules, 2015 (Ind AS Rules) which laid down a road map for entities (other than insurance entities, banking entities and Non-Banking Financial Companies (NBFCs)) (corporate road map) for implementation of Ind AS converged with International Financial Reporting Standard (IFRS) in a phased manner.

For other class of companies not covered under the corporate road map (i.e. primarily unlisted entities having net worth less than INR250 crore, including non-corporate entities) Accounting Standards (AS), as notified under the Companies (Accounting Standards) Rules, 2006 (AS Rules) continue to remain applicable.

The MCA had also requested the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) to upgrade the AS with a view to bring them nearer to the requirements of Ind AS. In this context, ICAI has recently issued exposure drafts of two new standards and has maintained consistency with the numbering of the standards under Ind AS.

New development

On 5 October 2017, the ASB of the ICAI issued Exposure Drafts (EDs) of the following AS:

a) AS 23, *Borrowing Costs*

b) AS 24, *Related Party Disclosures.*

Comments on the EDs could be submitted up to 31 October 2017.

This issue of First Notes provides an overview of guidance contained in the ED of AS 23 and ED of AS 24. The note also highlighs the areas of key difference between the EDs and the currently applicable AS (i.e. AS 16, *Borrowing Costs* and AS 18, *Related Party Disclosures* respectively).

It is important to note that ED of AS 23 and AS 24 is not identical to Ind AS 23, *Borrowing Costs* and Ind AS 24, *Related Party Disclosures* respectively. Therefore, this First Notes also highlights additional requirements contained in Ind AS 23 and Ind AS 24.

Overview of the ED of AS 23

- **Scope of the standard:** The standard would be applicable in accounting for borrowing costs.

  However, it would not be applicable to the acquisition, construction or production of:

  a) A qualifying asset[1] measured at fair value, for example a biological asset within

[1]Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

the scope of AS 41, *Agriculture*[2]

b) Inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

- **Substantial period of time**: A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. ED on AS 23 provides that a period of 12 months is ordinarily considered as a substantial period of time, unless a shorter or longer period could be justified on the basis of facts and circumstances of the case.

- **Borrowing costs**: Borrowing costs have been defined as interest and other costs that an entity incurs in connection with the borrowing of funds.

  It may include interest expense calculated in accordance with the AS 109, *Financial Instruments*[3], finance charges in respect of finance leases recognised as per AS 19, *Leases* and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to interest costs.

  For exchange difference regarded as an adjustment to borrowing costs, the ED of AS 23 specifies the following manner of arriving at this amount:

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

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

  The ED of AS 23 also includes an illustration to clarify the manner in which the guidance on the treatment of foreign exchange differences as an adjustment to interest costs should be applied.

- **Recognition of borrowing costs**: Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which an entity incurs them.

  Where funds are borrowed specifically for obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

- **Commencement of capitalisation**: The capitalisation of borrowing costs as part of the cost of a qualifying asset should begin on the commencement date, i.e. the date when the entity first meets all of the following conditions:

  a) It incurs expenditure for the asset

  b) It incurs borrowing costs, and

  c) It undertakes activities that are necessary to prepare the asset for its intended use or sale.

- **Suspension of capitalisation**: Capitalisation of borrowing costs should be suspended during extended periods in which an entity suspends active development of the qualifying asset.

- **Cessation of capitalisation**: An entity should cease capitalisation of borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

  In case an entity, completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity should cease capitalisation of borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

- **Disclosures**: An entity is required to disclose the amount of borrowing costs capitalised during the period.

Key differences between ED on AS 23 and AS 16

- **Scope**: ED on AS 23 excludes borrowing costs attributable to the acquisition, construction, or production of a qualifying asset measured at fair value and inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis from its scope.

  AS 16 does not provide such scope exclusions.

- **Calculation of interest expense**: ED on AS 23 requires that interest expense considered as borrowing costs should be calculated in accordance with AS 109.

  However, AS 16 does not specifically provide any method for calculation of interest expense.

  AS 16 provides guidance on amortisation of discounts or premiums relating to borrowings and amortisation of ancillary costs incurred in connection with the arrangement of borrowings. This guidance is not included in the ED on AS 23 as some of these components may be considered as the components of interest expense calculated using effective interest rate method.

- **Group's borrowings for computation of weighted average**: ED on AS 23 specifically provides guidance on the circumstances when it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted

[2]AS 41 is under formulation.

[3]AS 109 is under formulation.

average of the borrowing costs. While in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.

No such specific guidance is available in AS 16.

- **Borrowings for calculating capitalisation rate for general borrowings:** Current AS 16 does not provide any exception to borrowings/expenditure to be considered for calculating capitalisation rate for general borrowings, however, the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) in its opinion provided following exceptions:

  a) Borrowings which were borrowed for a specific purpose (other than the capital expenditure under construction)

  b) Borrowings which as per information available with management clearly indicate that proceeds therefrom have been directly used for a specific purpose (other than capital expenditure under consideration).

  No such exceptions are present in ED on AS 23 as well as in Ind AS 23.

Additional requirements of Ind AS 23

- **Specific guidance for hyperinflationary economies**: Ind AS 23 includes specific guidance on recognition of interest expense in case an entity applies Ind AS 29, *Financial Reporting in Hyperinflationary Economies*. According to it, an entity should recognise that part of the borrowing costs as an expense that compensate for inflation during the same period.

  Since it has been decided not to issue any AS corresponding to Ind AS 29 for non-Ind AS compliant companies, no related guidance has been included in the ED on AS 23.

- **Disclosure of capitalisation rate**: Ind AS 23 requires disclosure of capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

  No such disclosure is required under current AS 16 and is not included in the ED on AS 23 as well.

- **Substantial period of time**: Ind AS 23 does not specify any time period as substantial period of time for an asset to be a qualifying asset. It is based on management's judgement.

  However, current AS 16 and ED on AS 23 considers a period of 12 months as substantial period of time.

Overview of the ED of AS 24

- **Scope of the standard**: AS 24 would be applied in identifying and reporting related party relationships and transactions between a reporting entity and its related parties. The requirements of the standard would apply to the financial statements of each reporting entity including Consolidated Financial Statements (CFS) presented by a holding company.

  The standard emphasises that entities should consider the substance of the relationship and not merely the legal form while determining each possible related party relationship.

- **Related party and relative:** ED of AS 24 considers a party as a related party if at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

  Relative in relation to an individual means the spouse, son, daughter, brother, sister, father, mother who may be expected to influence, or be influenced by that individual in his/her dealings with the reporting entity.

- **Key Management Personnel (KMP):** ED of AS 24 defines KMP as those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting entity.

- **Disclosures**: ED of AS 24 and current AS 18 require disclosure of the name of the related party and nature of the related party relationship where control exists, irrespective of whether or not there have been transactions between the related parties.

  Similar to Ind AS 24, ED of AS 24 also considers participation by a parent or subsidiary in a defined benefit plan that shares risk between the group entities as a related party transaction. However, currently AS 18 does not cover such transactions.

  Further, the ED of AS 24 specifically provides that the disclosures with respect to related party relationships between a parent and a subsidiary are in addition to the disclosure requirements specified in AS 27, *Separate Financial Statements* and AS 112, *Disclosure of Interests in Other Entities*[4].

  Additionally, ED of AS 24 provides exemptions from the detailed disclosure requirements of AS 24, for related party transactions and outstanding balances, including commitments with:

  a) State-related entity[5] that has control or joint control of, or significant influence over, the reporting entity and

  b) Another entity that is a related party because the state-related entity has control or joint control of, or significant influence over, both the reporting entity and other entity.

  However, a reporting entity would still be required to disclose the following (in case the given exemption has been applied):

  a) Name of the state-related entity and nature of its relationship

  b) Nature and amount of transaction on aggregate basis.

[4]AS 27 and AS 112 are under formulation.

[5]An entity that is controlled, jointly controlled or significantly influenced by the central, state and/or any local government.

Additional requirements of Ind AS 24

- **Definition of a related party and relative:** The definition of a related party is much wider in Ind AS 24 as compared to current AS 18 and ED on AS 24.

  Both, current AS 18 and ED on AS 24 use the term 'relatives of an individual' whereas Ind AS 24 uses the term 'a close member of the family of a person' in the definition of a related party.

  As per Ind AS 24, a close member of an individual's family is a related party if that person:

  a) Has control or joint control of the reporting entity

  b) Has significant influence over the reporting entity

  c) Is a member of the KMP of a parent of the reporting entity.

  Close family members include a person's:

  a) Spouse/domestic partner

  b) Brother, sister, father and mother

  c) Children of the person or of spouse or of domestic partner

  d) Dependents of the person or of spouse or of domestic partner.

- **Joint venturers as related parties:** Ind AS 24 also covers joint ventures in its scope. According to it, two entities are related to each other in both their financial statements, if they are either co-venturers or one is a venturer and the other is an associate.

  However, as per ED on AS 24 and current AS 18, co-venturers or co-associates are not related to each other.

- **Wider definition of KMP**: Ind AS 24 covers KMP of the parent. It also covers the entity, or any member of the group of which it is a part, providing KMP services to the reporting entity or to the parent of the reporting entity.

  Current AS 18 and ED on AS 24 cover KMP of the entity only. Further, AS 18 by way of an explanation specifically excludes a non-executive director of a company from the definition of KMP.

- **Detailed disclosure requirements**: Following are the additional disclosure requirements under Ind AS 24:

  a) Disclosure of the next most senior parent which produces CFS for public use, in case neither the entity's parent, nor the ultimate controlling party produces CFS available for public use

  b) Disclosures are required for compensation of KMP under different categories (such as short-term employee benefits, termination benefits and share-based payment)

  c) Ind AS 24 also requires disclosure of transactions made on terms equivalent to those in arm's length transactions, if such terms could be substantiated.

  Above disclosures are not required under current AS 18 and ED on AS 24.

Our comments

With the issuance of EDs of AS 23 and AS 24, ICAI has incorporated some of the key principles of Ind AS into the standards applicable to unlisted or non-corporate entities (to whom Ind AS is not applicable as per the corporate road map). This is expected to ensure a more robust accounting framework for such entities, although it is expected to entail additional efforts and require greater disclosure when the standards become applicable.

The proposed AS (i.e. AS 23 and AS 24) if notified, would ensure that while preparing financial statements, entities apply guidelines that are conceptually consistent with those prevalent for larger companies in India and that the methodologies adopted are at par across various classes of entities.

The bottom line

Entities should consider the potential impact of the proposed AS 23 and AS 24 once they become applicable.

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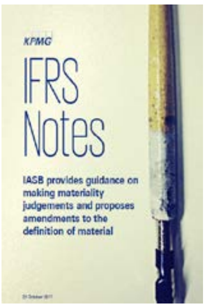
The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.



IASB provides guidance on making materiality judgements and proposes amendments to the definition of material

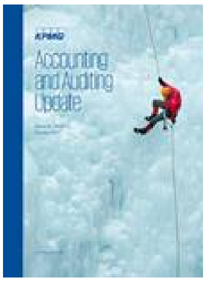
23 October 2017

Recently, the IASB issued the following two documents in relation to the definition of 'material' and guidance on making materiality judgements:

- IFRS practice statement on 'making materiality judgements'.
- Amendments to IAS 1 and IAS 8 by issuing an Exposure Draft ED/2017/6 Definition of Material.

This issue of IFRS Notes provides an overview of these publications.

Missed an issue of Accounting and Auditing Update or First Notes



Issue no. 15 – October 2017

The topics covered in this issue are:

- Expected credit loss assessment by banks
- Disclosures for impairment of non-financial assets
- The Companies Act, 2013 - Revision or reopening of financial statements
- Revised educational material on Ind AS 18, *Revenue*
- Regulatory updates

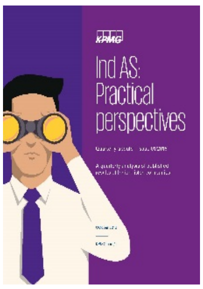
SEBI defers disclosures of loan defaults from banks by listed entities

4 October 2017

In order to bridge the gap in the availability of information to investors and other stakeholders, the Securities and Exchange Board of India (SEBI) through its circular dated 4 August 2017 (the circular) required specified listed entities to provide disclosures to the stock exchanges in case of defaults in repayment of interest/instalment obligations on loans from banks and financial institutions, debt securities (including commercial paper), etc.

While the above mentioned circular was to be effective from 1 October 2017, SEBI through a press release dated 29 September 2017 has decided to defer the implementation of the circular until further notice.

This issue of First Notes provide an overview of the SEBI press release issued on 1 October 2017.



Ind AS - Practical perspectives

KPMG in India's Ind AS - Practical perspectives through aims to put a finger on the pulse of India Inc's adoption of Ind AS and capture emerging trends and practices.

Our impact assessment is based on Nifty 50 companies which would be the first group of companies to report Ind AS results. The Nifty 50 companies have released their financial results for the quarter ended 31 December 2016.

Out of the companies comprising Nifty 50 index, eight companies are banks, one is Non-Banking Financial Company (NBFC) and two companies follow a different date of transition to Ind AS. Therefore, our analysis would comprise the remaining 39 companies.

This can be accessed on KPMG in India website - **'Ind AS- Practical perspectives' webpage**

Feedback/queries can be sent to aaupdate@kpmg.com

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