
# ITFG clarifications' bulletin 19

**4 June 2019**

**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

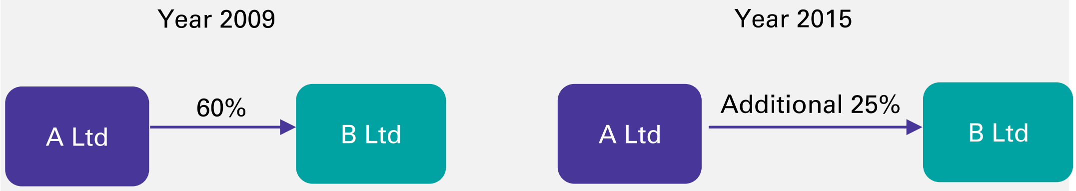
## Background

The Ind AS Technical Facilitation Group (ITFG) of the Institute of Chartered Accountants of India (ICAI) issued its ITFG clarifications' bulletin 19 on 10 May 2018. It provides clarifications on six issues relating to various Ind AS.

This edition of First Notes provides an overview of the issues clarified by the ITFG.

### Issue 1 – Business combination accounting in case of acquisitions by first-time adopter

An entity A with a transition date to Ind AS as 1 April 2017, formed a subsidiary in 2009 by subscribing to its 60 per cent of share capital. During October 2015, entity A acquired additional 25 per cent shares in entity B.




As formation of entity B was not a business combination, the issue raised to ITFG, was whether the option available to a first-time adopter of Ind AS to restate, or not restate, past business combinations as per Ind AS 103, *Business Combinations* be available in respect of entity B. Also should entity A account for the difference between the consideration paid for the additional 25 per cent shares in entity B acquired by it in October 2015 and the amount of reduction in Non-Controlling Interests (NCI) directly in equity while preparing its opening Ind AS balance sheet as at the date of transition to Ind ASs.

In this case, ITFG has clarified that, requirements of Ind AS 110, *Consolidated Financial Statements* apply in respect of consolidation of not only those subsidiaries that were acquired by way of business combination but also those entities which were formed by the parent itself and have been the parent's subsidiaries ab initio.

Accordingly, paragraph 23 and B96 of Ind AS 110 apply to changes in a parent's ownership interest without loss of control of any subsidiary, whether it be a subsidiary whose control was acquired by the parent in a business combination or a subsidiary formed by the parent itself.

However, as the entity is a first-time adopter of Ind AS, there is a specific requirement in paragraph B7 of Ind AS 101, *First-time Adoption of Indian Accounting Standards* in case an entity chooses not to apply Ind AS 103 respectively. This paragraph generally prohibits retrospective application of paragraphs 23 and B96 of Ind AS 110 by a first-time adopter. There is nothing in Ind AS 101 to indicate that the prohibition contained in paragraph B7 on retrospective application of specified requirements of Ind AS 110 is applicable only in respect of subsidiaries acquired by way of business combinations and not in respect of subsidiaries formed by the parent itself. Consequently, if entity A does not restate its past business combinations (paragraph C1 of Ind AS 101), the accounting treatment of purchase of the additional interest in entity B carried out by entity A in accordance with its previous GAAP would continue (i.e., no adjustments to the same would be made) while transitioning to Ind ASs.

## Issue 2 – Timing of revenue recognition

Ind AS 115, *Revenue from Contracts with Customers* provides a control-based approach to be applied to al transactions at the contract inception. An entity needs to evaluate whether it transfers control of the good or service over-time or at a point in time for the purposes of recognising revenue.

**Revenue is recognised…**

At a point in time when the customer obtains control

Over-time if specific criteria are met

Ind AS 115 provides that revenue is recognised over-time when any of the following criteria are met:

a) Customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs

b) Entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced

c) Entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

If none of the above criteria are met, then control of the good or service transfers at a point in time.

In this context, ITFG discussed an issue relating to a shipping entity involved in transportation of petroleum products from one port to another. The contracts with customers state that the contract would not be terminated once the entity takes delivery of goods from the customers at the port and sails to the designated port of destination. The issue raised was whether the performance obligation of the entity under a typical contract with customers is satisfied over time or point in time.

In the given case, the entity would need to evaluate its performance obligation to determine if it satisfies any of the requisite criterion.

For evaluating criteria (a), in the given case an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. The entity is required to evaluate whether another entity would need to substantially re-perform the work carried out by the entity to date. If that work would not need to be substantially re-performed, then revenue would be recognised over time.

Considering the nature of performance obligation of the entity, it would not be meeting criterion (b) as it would not be able to create or enhance an asset that the customer controls as the asset is created or enhanced.

In the given case, for evaluation of criterion (c), an entity should consider whether the performance obligation creates an alternative use to the entity. Additionally, in determining whether it has an enforceable right to payment for performance completed to date requires consideration of the detailed requirements and guidance provided in Ind AS 115. While the right to payment for performance completed to date does not need to be for a fixed amount, the entity must be entitled, at all times throughout the duration of the contract, to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. In assessing the existence and enforceability of a right to payment for performance completed to date, an entity is required to consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms.

Further, ITFG provided that basis the above evaluation, if an entity concludes that that the performance obligation of the entity under its contract with a customer is satisfied over time, then the entity is required to determine an appropriate method of measuring progress on the basis of the relevant requirements and guidance contained in Ind AS 115. Ind AS 115 specifies two types of methods: input method and output method, which an entity should consider based on the nature of the goods or services that the entity promised to transfer to the customer in determining the appropriate method for measuring progress.

## Issue 3 - First-time adopter of Ind AS - Transitional options under Ind AS 115

Under Ind AS transitional provisions can be found at two places:

Ind AS 101 | Individual standards

The transitional provision contained in Ind AS 101 are applicable to first time adopter of Ind AS. A first-time adopter does not apply the transitional requirements of individual standards unless specifically required to do so. The transitional requirements of individual standards are available to entities that already apply Ind AS.

In this regard, ITFG considered a situation where an entity (ABC Ltd.) complying with Ind AS for the first time from 1 April 2018 is required to comply with Ind AS 115, which has superseded Ind AS 18, *Revenue* and Ind AS 11, *Construction Contracts.* Ind AS 115 is applicable for accounting periods beginning on or after 1 April 2018. The issue discussed is whether a first-time adopter of Ind AS could apply simplified transition method under Ind AS 115.

For existing Ind AS users Ind AS 115 provides two methods of accounting for transition i.e. the retrospective method (with or without one or more of four practical expedients) and the cumulative effect method (simplified transition method).

While Ind AS 101 is applicable to first-time adopter of Ind AS, it generally requires a retrospective application of the standards in force at the end of entity's first Ind AS reporting period. There are, however, specific optional exemptions from, and some mandatory exceptions to this general requirement. Ind AS 101 contains specific provisions dealing with the application of transitional provisions of Ind AS 115 by a first-time adopter.

A first-time adopter can apply the transitional provisions contained in Ind AS 115 only to the extent required or allowed to do so under Appendices B-D of Ind AS 101. Appendix B-D allow a firs-time adopter to apply only the full retrospective adoption method (with practical expedients) given in Ind AS 115. Therefore, a first-time adopter does not have the choice of applying the simplified transition method.

## Issue 4 - Application of capitalisation rate for assets acquired under business combination

ITFG considered a scenario where ABC company has Capital Work in Progress (CWIP) of INR100,000 which meets the definition of a 'qualifying asset' as per Ind AS 23, *Borrowing Costs* and capitalised corresponding borrowing cost using capitalisation rate for general borrowings.

The issue raised to ITFG was what would be the accounting treatment of borrowing cost in following two situations:

i. ABC Ltd. merges with PQR Ltd., an independent entity

ii. PQR Ltd. acquires 100 per cent shares and control of ABC Ltd. but ABC Ltd. remains as a separate legal entity which is consolidated by PQR Ltd.

ITFG considered the issue and discussed the accounting of borrowing cost in two following situations:

*Scenario I:* ABC Ltd. is merged into PQR Ltd.

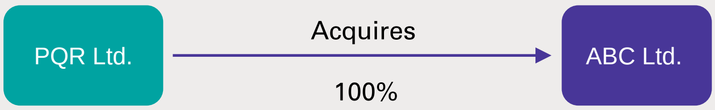
ABC Ltd. —Merged with→ PQR Ltd.

ITFG clarified that where ABC Ltd. is merged into PQR Ltd. and merger meets the definition of a 'business combination' as per Ind AS 103, the CWIP would appear as an asset in the separate (and consequently, in the consolidated) financial statements of PQR Ltd. At the time of merger, PQR Ltd. needs to make a fresh, independent assessment to evaluate whether CWIP meets the definition of a qualifying asset from its perspective.

In the given case, PQR Ltd made independent assessment and asserted that the CWIP still meets the definition of a qualifying asset and attributed an amount of INR120,000 as a consideration towards purchase of the CWIP as part of the purchase price.

The value of CWIP and timing of incurrence of the aforesaid expenditure should be determined from the perspective of PQR Ltd. and not from the perspective of ABC Ltd. Consequently in separate and consolidated financial statements of PQR Ltd., INR120,000 would represent the expenditure incurred by PQR Ltd. on the CWIP and for purposes of applying the requirements of Ind AS 23 relating to capitalisation of borrowing costs.

*Scenario II: ABC Ltd. is not merged into PQR Ltd.*



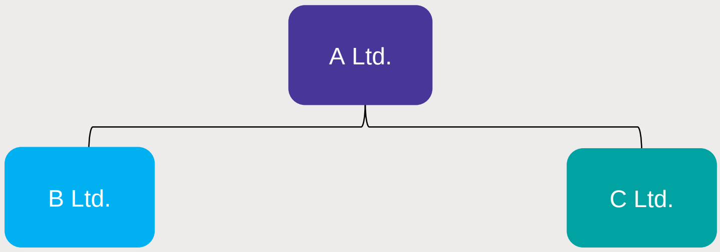

Where PQR Ltd. acquires 100 per cent shares and consequently control of ABC Ltd. which continues to remain in existence, PQR Ltd.'s consolidated financial statements would include the CWIP as an asset but not in its separate financial statements. For the purpose of consolidated financial statements, the determination of whether an asset meets the definition of a 'qualifying asset' and assessment of the amount of expenditure incurred thereon would made from the perspective of the group rather than from the perspective of the subsidiary which owns or holds the CWIP.

In the issue under consideration, the group has incurred an expenditure of INR120,000 to acquire the CWIP from a party outside the group. For the purpose of applying the requirements of Ind AS 23 relating to capitalisation of borrowing costs at the group level, it is determined that the CWIP meets the definition of 'qualifying asset' from the group's perspective and the amount of expenditure on the CWIP would be considered to be INR120,000.

While the separate financial statements of PQR Ltd. would include the investment in ABC Ltd. rather than individual assets and liabilities of ABC Ltd. As investment is a financial asset, borrowing costs cannot be capitalised as part of carrying amount as per the requirements of Ind AS 23 which specifically provides that financial assets are not qualifying assets.

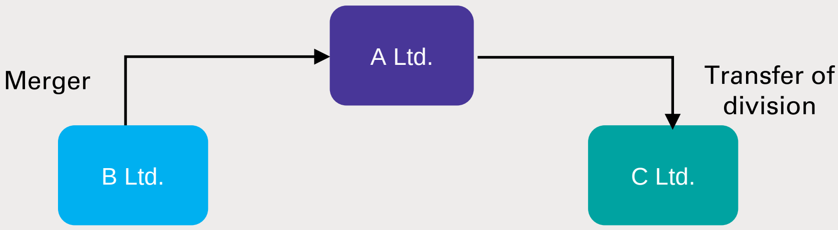
## Issue 5 – Accounting for business combinations of entities under common control

ITFG considered a situation where a company (A Ltd.) has two subsidiaries (B Ltd. and C Ltd.) and explained common control business combinations with respect to following situations in a same financial year.




Situation 1: Where B Ltd. merges with A Ltd. and appointed date for the merger is 1 October 2018.

Situation 2: Where A Ltd transferred one of its division to C Ltd and appointed date for the transfer is 1 October 2018.




The issue under consideration is while preparing the financial statements for the year ended 31 March 2019, would previous year's figures in the financial statements of A Ltd. and C Ltd. have to be restated as per requirements of Appendix C, *Business combinations of entities under common control* to Ind AS 103.

***Situation1***

ITFG has dealt with this issue in its Bulletin 9 – Issue 2. In this bulletin, ITFG clarified that when a subsidiary (B Ltd.) merges with its parent (A Ltd.), nothing changes, and the transaction only means that the assets, liabilities and reserves of B Ltd., which were appearing in the consolidated financial statements of Group A immediately before the merger, would now be a part of the separate financial statements of A Ltd. Separate financial statements of A Ltd. to the extent of this common control transaction would be considered as a continuation of the consolidated group. Accordingly, it would be appropriate to recognise the carrying value of the assets, liabilities and reserves pertaining to B Ltd. as appearing in the consolidated financial statements of A Ltd. Post merger, separate financial statements to the extent of this common control transaction should be considered as a continuation of the consolidated group.

ITFG also stated, that the legal merger of a subsidiary with its parent or legal merger of fellow subsidiaries is an intra-group transaction. As per Ind AS 110, all intra-group transactions should be eliminated in preparing consolidated financial statements. Hence, in the given situations, the effect of legal merger is required to be eliminated while preparing the consolidated financial statements of A Ltd.

***Situation 2:***

ITFG assumed that transfer of division from A Ltd. to C Ltd. constitutes a transfer of business under Ind AS 103. The transfer would be qualified as a common control business combination transaction from the perspective of C Ltd on the basis the following analysis:

- C Ltd obtains control of a business that it did not previously control
- Both the combining parties, i.e., C Ltd. (the acquirer) and the division transferred, are controlled by A Ltd. before and after the transfer.
- Control of A Ltd. over the transferee (C Ltd) and the transferor (the transferred division) cannot be said to be transitory since C Ltd. has been a subsidiary of A Ltd. since January 2016

Since the transfer qualifies as a common control business combination, C Ltd. would be required to account for the transfer of the division in its financial statements by applying the pooling of interests method as per Appendix C to Ind AS 103.

Further C Ltd. would be required to prepare its financial statements (including comparative information) for the year ended 31 March 2019 as if the transfer of the division had occurred from the beginning of the comparative period presented in the financial statements for the year ended 31 March 2019 i.e., 1 April 2017, and not the appointed date of 1 October 2018 specified in the scheme.

## Issue 6 – Application of Ind AS to entities in a group

The Ind AS corporate road map applies to all the companies which meet the specified criteria (as mentioned below) would be required to follow Ind AS from the implementation dates prescribed in the road-map i.e. 1 April 2016 or 1 April 2017 respectively:

1. Listing criteria
2. Unlisted companies meeting the net worth criteria i.e. has net worth greater than INR500 crore or INR250 crore, respectively
3. Holding, subsidiary, joint venture or associate of companies covered in (1) or (2)

In this context, ITFG considered a situation where a parent (ABC Ltd) and its unlisted subsidiary PQR Ltd. (with net worth of INR50 crore) complied with Ind AS beginning 1 April 2017 considering the requirements of the road-map. During financial year 2018-19, ABC Ltd. sold off substantially all of its investment in PQR Ltd. to an unrelated unlisted company, XYZ Ltd.

The issue under consideration is after the sale of its shareholding in PQR Ltd. by ABC Ltd., would PQR Ltd. and XYZ Ltd. be required to apply Ind AS.

ITFG clarified that PQR Ltd. is required to continue to follow Ind AS, considering the requirements of Rule 9 of Ind AS rules which provides that once a company adopts Ind AS voluntarily or mandatorily would continue to prepare financial statements under the Ind AS for all the subsequent years.

XYZ Ltd. is a holding company of PQR Ltd. XYZ Ltd. does not meet the specified criteria (either the net worth or the listing criteria) of the Ind AS road map. PQR Ltd. is required to comply with Ind AS only for the sole reason that it was earlier subsidiary of ABC Ltd. Ind AS does not apply to XYZ Ltd. simply by virtue of being PQR's parent. However it may opt to apply Ind AS voluntarily.

## Our comments

The ITFG clarifications are aimed at resolving various implementation challenges faced by companies while transitioning to Ind AS.

**Timing of revenue recognition**

The new standard emphasises on the concept of transfer of control as against transfer of risks and rewards while recognising revenue. For the purposes of recognising revenue an entity must determine whether the performance obligation is satisfied over time or at a point in time. The determination of recognition of revenue is based on facts and circumstances and requires careful assessment of terms of the contract.

In the given case a shipping company needs to consider various factors in the new standard to determine when it transfers control over goods or services to the customer, including whether another company would need to substantially re-perform work if it were to fulfil the remaining performance obligation.

**Applicability of Ind AS road map to group entities**

In the earlier bulletins also, ITFG discussed issues relating to applicability of Ind AS. It has again been clarified that once an entity complies with Ind AS it is mandatorily required to present its financial statements under Ind AS for subsequent years. In the case discussed in this bulletin, an entity (subsidiary) that applied Ind AS as its parent entity was within Ind AS road map. When parent entity transferred control on this entity to an unlisted entity (unlisted entity does not fall in Ind AS road map), it has been clarified that subsidiary would continue to apply Ind AS. The new parent (unlisted entity) would not be required to follow Ind AS as it does not fulfil any of the criteria to apply Ind AS. This will require the subsidiary to maintain multiple books of accounts both under Ind AS and AS.

**Transitional provisions on first-time adoption *vis-à-vis* Ind AS users**

The ITFG has clarified that the transitional provisions contained in Ind AS 101 are applicable to first time adopter of Ind AS. A first-time adopter does not apply the transitional requirements of individual standards unless specifically required to do so. The transitional requirements of individual standards are available to entities that already apply Ind AS.

**Borrowing cost**

The issue discussed by ITFG explains the application of borrowing cost standard when there is business combination between two entities.

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## Missed an issue of Accounting and Auditing Update or First Notes


**Issue no. 34 – May 2019**

The topics covered in this issue are:

- Ind AS 116, *Leases* – Transition options
- Clarity on reflecting tax uncertainty
- Impact of IBOR reforms
- Regulatory updates.

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## MCA notified amendments to NCLT Rules

**23 May 2019**

**Background**

Section 245 of the Companies Act, 2013 (2013 Act) deals with class action suit that can be filed by a certain number of members or depositors (or any class of members/depositors). However, the 2013 Act was silent on the percentage of members/depositors required to file a class action suit.

**Recent development**

On 8 May 2019, the Ministry of Corporate Affairs (MCA) has notified requisite percentage of the members/depositors who may apply for a class action suit through an amendment to National Company Law Tribunal (NCLT) Rules. The amendments are applicable from 8 May 2019.

This issue of First Notes provides an overview of amendments notified by MCA to the NCLT Rules.

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## 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 22 May 2019, KPMG in India organised a special session of VOR webinar to discuss significant impact areas of Ind AS 116, *Leases* on life sciences sector.

Also we discussed other important updates e.g. Appendix C, *Uncertainty over Income Tax Treatments* of Ind AS 12, *Income Taxes*. The new guidance seeks to bring clarity to the accounting for income tax treatments that are yet to be accepted by tax authorities. The appendix is effective for accounting periods beginning on or after 1 April 2019.

Click here to access the audio recording (mp3) and presentation (pdf).

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