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IFRS Notes

Ind AS Transition Facilitation Group (ITFG) issues Clarifications Bulletin 7

4 April 2017

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Introduction

The ITFG held its seventh meeting and issued its clarifications bulletin (Bulletin 7) on 31 March 2017 to provide clarifications on nine issues in relation to the application of Indian Accounting Standards (Ind AS), as considered in its meeting.

Background

With Ind AS being applicable to large corporates from 1 April 2016, the Institute of Chartered Accountants of India (ICAI), on 11 January 2016 announced the formation of the Ind AS Transition Facilitation Group (ITFG) in order to provide clarifications on issues arising due to applicability and/or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015 (Rules 2015).

Over the past year, ITFG issued six bulletins to provide guidance on issues relating to the application of Ind AS. This issue of IFRS Notes provides an overview of the clarifications issued by the ITFG in Bulletin 7.

Overview of the clarification in ITFG's Bulletin 7

The following issues relating to the application of Ind AS have been clarified in this bulletin.

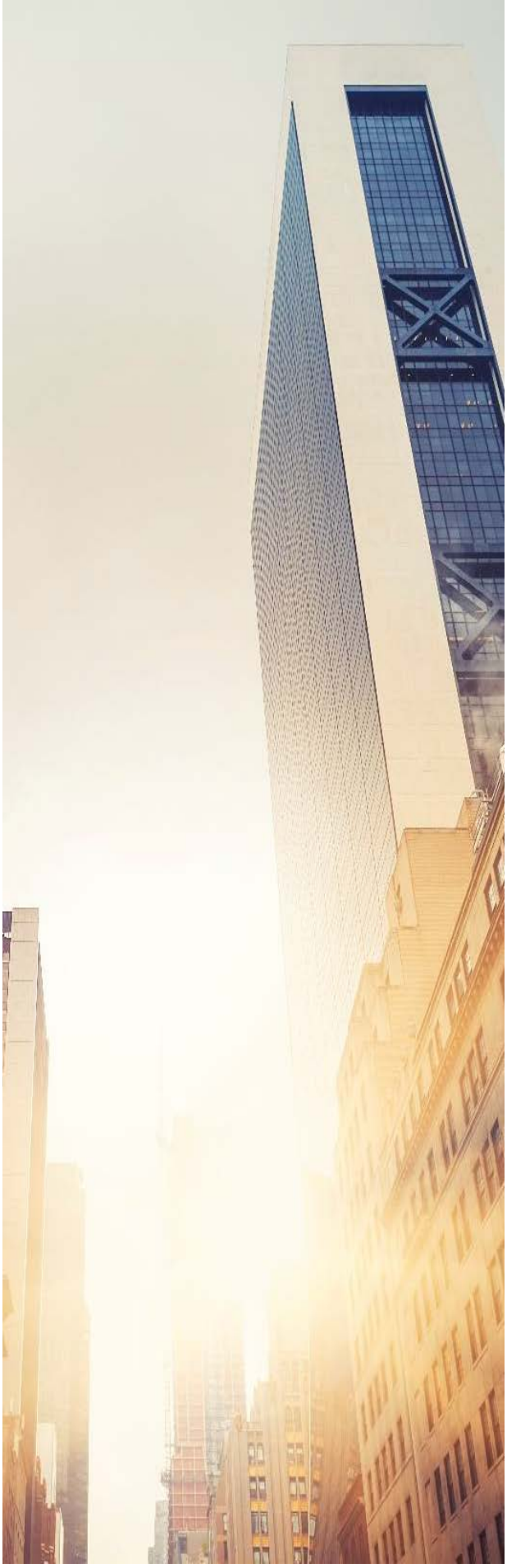
1) Application of the exemption to continue capitalisation of exchange gain/loss on long-term foreign currency loans

The ITFG has provided the following guidance on three application issues relating to the exemption available on first-time adoption of Ind AS to continue the policy adopted under AS 11, *The Effects of Changes in Foreign Exchange Rates* for capitalisation of exchange differences on long-term foreign currency monetary items.

a) Application of the exemption to an undrawn portion of a foreign currency loan

According to the previous generally accepted accounting principles in India (previous Indian GAAP), an entity was permitted by paragraph 46/46A of AS 11 to capitalise foreign exchange gains or losses on long-term foreign currency monetary items. On availing of this option, such exchange gains/losses would be capitalised into the cost of a related item of Property, Plant and Equipment (PPE) or accumulated in a reserve (Foreign Currency Monetary Item Translation Difference Account (FCMITDA)).

Paragraph D13AA of Ind AS 101, *First-Time Adoption of Ind AS*, permits an entity that is transitioning to Ind AS to continue to apply the above mentioned accounting treatment



Overview of the clarification in ITFG's Bulletin 7 (contd…)

to exchange differences arising on long-term foreign currency monetary items that have been recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period, i.e. 1 April 2016 for companies transitioning to Ind AS in phase 1.

The ITFG considered a situation where a company had availed the option to capitalise exchange differences under AS 11 on a foreign currency loan that was partially drawn down as at 31 March 2016. The issue under consideration was whether the exemption under Ind AS 101 would also be available for the balance undrawn portion of the loan, which was expected to be drawn after 1 April 2016.

The ITFG clarified that the exemption under paragraph D13AA of Ind AS 101 is available only for exchange differences arising on long-term foreign currency loans that have been recognised in the financial statements prior to the first Ind AS financial reporting period. Therefore, the exemption would not apply to the undrawn portion of the foreign currency loan and the company would be required to recognise exchange differences on this portion of the loan in accordance with the applicable Ind AS, as and when the loan is drawn down.

b) *Application of the exemption to long-term forward exchange contracts*

The ITFG considered a situation where under previous GAAP a company had availed of the option to capitalise foreign exchange differences on long-term forward exchange contracts covered by paragraph 36 of AS 11. This was permitted as per the clarification issued by the ICAI in its Frequently Asked Questions (FAQs) on the AS 11 notification.

In this context, the ITFG clarified that the exemption in Ind AS 101 relates only to foreign exchange differences on long-term foreign currency monetary items recognised in the financial statements prior to the first Ind AS financial reporting period and would not apply to long-term forward exchange contracts. Long-term forward exchange contracts would generally meet the definition of a 'derivative' and are within the scope of Ind AS 109, *Financial Instruments*.

c) *Reversal of the effects of paragraph 46/46A of AS 11 from the previous GAAP carrying amount of PPE on transition to Ind AS*

Paragraph D7AA of Ind AS 101 permits a company transitioning to Ind AS to elect to continue with the carrying value for all of its PPE as recognised in its financial statements under previous GAAP on the date of transition to Ind AS, as its deemed cost under Ind AS. The ITFG considered a situation where a company had availed of the option under paragraph 46 of AS 11 to capitalise foreign exchange differences on long-term foreign currency items to the cost of the related PPE.

The issue analysed by the ITFG was whether the company would be permitted to reverse the impact of paragraph 46 of AS 11 (i.e. reverse the impact of the capitalised exchange differences) when applying the deemed cost exemption in paragraph D7AA of Ind AS 101. The ITFG clarified that a company that avails of this deemed cost exemption would be required to carry forward the entire previous GAAP carrying amount for all of its PPE on transition to Ind AS. Ind AS 101 does not permit any further adjustments to the deemed cost of PPE. Therefore, the company would not be permitted to reverse the impact of paragraph 46/46A of AS 11 from the deemed cost of PPE on transition to Ind AS.

2) **Presentation currency for consolidated financial statements of an Indian company which does not have INR as its functional currency**

The ITFG considered an issue where an Indian company (company X) that has USD as its functional currency, is a wholly owned subsidiary of an Indian parent entity (company Y) that has INR as its functional currency. Company X in turn has subsidiaries and joint ventures outside India and prepared stand-alone as well as consolidated financial statements. The consolidated financial statements are to be provided to the parent, company Y, in INR for consolidation and statutory financial reporting at the ultimate parent level.

The ITFG considered whether company X would present its annual financial statements in its functional currency, being USD, or in INR, being the functional and presentation currency of the parent.

The ITFG clarified that Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*, requires each entity to determine its functional currency and translate foreign currency items into functional currency and report the effects of such translation in the financial statements. Ind AS 21 also permits an entity to use a presentation currency for reporting its financial statements that differs from its functional currency.

Overview of the clarification in ITFG's Bulletin 7 (contd…)

Ind AS 21 provides specific guidance on translating the results and financial position of an entity into a different presentation currency. Therefore, company X may select INR as the presentation currency if it is statutorily required to present its consolidated financial statements in INR. Further, the audit report for company X would be given by the auditors on the financial statements prepared in INR.

3) Classification of long-term lease of land as finance or operating lease

The ITFG considered a situation where a company has obtained land from the government on a long-term lease of 99 years or above. At the end of the lease term, the lease may be extended or the land could be returned to the government. The company is required to classify the lease as either a finance or an operating lease under Ind AS.

The ITFG clarified that in accordance with guidance in Ind AS 17, *Leases* the following factors may be relevant in classifying a long-term lease of land:

a) A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an asset.

b) One of the indicators of a finance lease is that 'at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset'.

c) Another important indicator is that 'the lease term is for the major part of the economic life of the asset even if title is not transferred.' Land normally has an indefinite economic life and it is expected that the value of land generally appreciates. Therefore, this could indicate that the lease is an operating lease.

d) Additional indicators to consider in an overall context of whether substantially all risks and rewards have been transferred, include the company's ability to renew the lease for another term at substantially below market rent, option to purchase the land at a price significantly below fair value, etc.

In summary, the ITFG clarified that classification of a lease of land as an operating or finance lease requires judgement based on an evaluation of specific facts and circumstances while considering the indicators in Ind AS 17.

4) Accrual of dividend on a financial instrument classified as a liability

The ITFG considered a situation where a company has declared dividend on a financial instrument that has been correctly classified as a financial liability in accordance with Ind AS 32, *Financial Instruments: Presentation*. If such financial instrument is classified as a liability then paragraph 35 of Ind AS 32 would be applicable. This paragraph states that 'interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of equity shall be recgonised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity'.

ITFG further clarified that even if dividend on an instrument classified as a financial liability has been declared after the end of the reporting period, the company would be required to accrue such dividends in the financial statements for the year.

The ITFG clarified that the requirements of Ind AS 10 *Events after the reporting period* relating to dividends declared to holders of equity instruments after the reporting period, apply only to those financial instruments that are classified as equity instruments. Accounting for dividends on financial instruments classified as liabilities is based on the guidance in Ind AS 109. If the financial liability is classified as measured at amortised cost in accordance with Ind AS 109, dividend would have to be accrued as part of interest expense based on the effective interest method.

5) Recognition of deferred tax on freehold land

The ITFG considered a situation where a company holds freehold land which it expects to sell on a slump-sale basis and not individually. The issue is whether the company would not recognise a deferred tax asset on such land since it will be sold on a slump sale basis and hence a temporary tax difference would not exist.

Ind AS 12, *Income Taxes* requires a deferred tax asset/liability to be created for all deductible/taxable temporary differences, except in specified situations, e.g., if it arises from a transaction that affects neither accounting profit nor taxable profit at the time of the transaction (initial recognition exemption). Further, Ind AS 12 requires the measurement of deferred tax assets or liabilities to reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets/liabilities. This may require the exercise of judgement based on facts and circumstances.

Overview of the clarification in ITFG's Bulletin 7 (contd…)

Ind AS 12 also specifies that if a non-depreciable asset is measured using the revaluation model under Ind AS 16, the related deferred tax asset/liability is measured based on the tax consequences of recovering the carrying amount of such asset through sale, regardless of the basis of measuring its carrying amount.

In this case, the ITFG clarified that the company would be required to exercise judgement to determine whether the freehold land will be sold through a slump sale. If so, then the tax base of the land would be the same as its carrying amount as an indexation benefit is not available in case of slump sale under the Income Tax Act, 1961. Therefore, there would be no temporary difference and no deferred tax asset would be recognised.

6) Accounting for investment in debentures of a subsidiary company

In this scenario, a holding company has invested in the debentures of its subsidiary company (in addition to its investment in shares). The ITFG considered whether such investment would be covered under the provisions of Ind AS 27, *Separate Financial Statements* and the exemptions in paragraph D15 of Ind AS 101.

Ind AS 109 is not applicable to interest in subsidiaries, associates and joint ventures that are accounting for in accordance with Ind AS 110, *Consolidated Financial Statements*, Ind AS 27, or Ind AS 28, *Investments in Associates and Joint Ventures*. However, Ind AS 27 permits an entity, in its separate financial statements, to account for its investments in subsidiaries, associates or joint ventures at either cost, or in accordance with Ind AS 109. Further, paragraph D15 of Ind AS 101 provides an exemption to measure the cost of such an investment at either the cost determined in accordance with Ind AS 27 or at a 'deemed cost' based on its fair value at the date of transition to Ind AS or its previous GAAP carrying amount.

The ITFG clarified that the requirements of Ind AS 27 and the exemption in Ind AS 101 would only apply to those investments in a subsidiary, which meet the definition of an equity instrument under Ind AS 32 (from the issuer, i.e. the subsidiary's perspective). Hence, if the debentures are classified as a financial liability by the subsidiary, the company would have to classify its investment as a financial asset and account for it under Ind AS 109.

7) Application of exemption related to service concession arrangements in Ind AS 101 to toll roads under construction at the beginning of the first Ind AS financial reporting period

The ITFG considered a situation where a company has entered into a service concession arrangement with the government in 2014, relating to toll roads. The company has adopted Ind AS from the financial year 2016-17. The toll road is under construction as on 1 April 2016.

The ITFG considered whether the company would be permitted to apply the exemption in paragraph D 22 of Ind AS 101 relating to the accounting policy for amortisation of intangible assets arising from toll road service concession arrangements. This exemption permits a first time adopter to continue the amortisation policy adopted under previous GAAP for toll road intangibles recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period. In India, companies that have adopted a revenue based amortisation policy under previous GAAP for their existing toll road intangible assets (as permitted by Schedule II to the Companies Act, 2013) would be able to continue this amortisation method on applying this exemption.

However, the ITFG clarified that this exemption would only apply to intangible assets (relating to service concessions for toll roads) recognised in the financial statements before the first Ind AS financial reporting period. Since the toll road is under construction on 1 April 2016, the company would not have recognised the intangible asset under previous GAAP. Therefore, it would not be eligible to apply the exemption in Ind AS 101.

Our comments

The ITFG clarifications are expected to resolve various practical implementation issues faced by several companies transitioning to Ind AS. The companies should consider the interpretations provided by the ITFG in their implementation efforts. It should be noted that some of the issues require the exercise of judgement based on a consideration of facts and circumstances while analysing each individual situation.

Our comments (contd…)

However, further consideration may be required on the following issues.

- Ind AS 109 requires accrual of interest expense in accordance with the effective interest method on an instrument classified as a financial liability, subsequently measured at amortised cost. Therefore, dividends on an instrument that is classified as a liability would have to be accrued. However, dividends that are completely discretionary in nature and relate to an instrument that is classified as a compound instrument (partly equity in nature) may relate to the equity component of the instrument. In this scenario, the issuer would generally recognise these as dividends on the equity component of the instrument, i.e. subject to declaration, and would not accrue for these dividends as an interest expense.
- As clarified above, companies that have availed of the option to apply paragraph 46/46A of AS 11 under previous GAAP would not be able to continue capitalising exchange differences on forward exchange contracts acquired to hedge long-term foreign currency loans. In its previous bulletin, ITFG had clarified that companies that continue to capitalise exchange differences on long-term foreign currency loans would not be able to apply cash flow hedge accounting to derivatives that hedge the currency risk on such loans. Based on this view, companies may have to recognise the related forward exchange contracts at fair value through profit or loss under Ind AS 109. This continues to be an area of complexity and uncertainty for companies that have elected to apply the exemption to continue the accounting treatment in paragraphs 46/46A of AS 11 to existing loans. Further clarity may be required on this issue.

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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.

Voices on Reporting

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

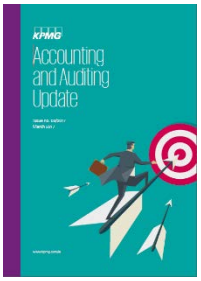
In our next call on Wednesday, 5 April 2017, we will cover key financial reporting and regulatory matters that are expected to be relevant for stakeholders as they approach the quarter ending 31 March 2017.

Our call will include updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), etc.

Our Voices on Reporting conference call will be held on Wednesday, 5 April 2017 between 04:00 – 05:00 PM.

We look forward to your presence and active participation on this call.

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



Issue no. 8/2017 – March 2017

Continuing with our series of articles on the revised requirements of the Companies Act, 2013 (2013 Act), this month's edition of the Accounting and Auditing Update (AAU) carries an article on the requirements relating to Corporate Social Responsibility (CSR) under the 2013 Act. Our article summarises the requirements, amendments, clarifications and frequently asked questions issued by the Ministry of Corporate Affairs (MCA) on this topic.

Our article examines an important accounting matter relating to the factors to consider while determining if entities such as e-commerce companies and trading companies are acting as an agent or a principal based on the principles of Ind AS.

Our article also features an interaction with Mr. Ashish Chauhan, MD and CEO, BSE Ltd. Our conversation with him explores the incentives and value propositions of International Financial Service Centre (IFSC), opportunities available to Small and Medium Enterprises (SMEs) to list, various regulatory changes and reporting requirements.

Our publication also brings you the highlights of the Second Annual KPMG Accounting, Reporting and Compliance Conference.

As in the case each moth, this publication also carries regular round up of regulatory updates in India and internationally.

CBDT issues FAQs on ICDS

28 March 2017

On 31 March 2015, the Ministry of Finance (MoF) issued 10 Income Computation and Disclosure Standards (ICDS) operationalising a new framework for computation of taxable income by all assessees in relation to their income under the heads 'Profit and gains of business or profession' (PGBP) and 'Income from other sources'. The ICDS are applicable to the specified assessees from Assessment Year (AY) 2017-18.
However, certain changes have been made to them. They are:

- Revised ICDS issued
- Revised Tax Audit Report (Form No. 3CD)
- MAT computation formulae for Ind AS companies

The CBDT received a number of queries on various aspects of ICDS. Therefore, on 23 March 2017, CBDT issued clarifications in the form of Frequently Asked Questions (FAQs) on issues relating to the application of ICDS.

This issue of First Notes provides an overview of the responses issued by the CBDT corresponding to the ICDS related issues raised.

Previous editions are available to download from: www.kpmg.com/in