ITFG clarifications’ bulletin 20

11 July 2019

Background

The Ind AS Technical Facilitation Group (ITFG) of the Institute of Chartered Accountants of India (ICAI) issued its ITFG clarifications’ bulletin 20 on 27 June 2019. It provides clarifications on five issues relating to various Ind ASs.

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

Issue 1 – Disclosure of foreign exchange differences separately from other fair value changes

Generally Ind AS 109, Financial Instruments requires a gain or loss on a financial asset that is measured at fair value to be recognised in profit or loss. In the case of a financial asset denominated in a foreign currency and measured at Fair Value Through Profit or Loss (FVTPL), the fair value is determined in the following two steps:

a) Firstly, the fair value is determined in the relevant foreign currency

b) Next, it is translated into the functional currency in accordance with the requirements of Ind AS 21, The Effects of Changes in Foreign Exchange Rates.

Thus, as explained above, the change in fair value of such a financial asset during a period arises due to following two factors:

a) Change in fair value expressed in terms of foreign currency

b) Change in exchange rate.

In a scenario discussed at ITFG, an entity, P Ltd. holds an investment in debentures denominated in a foreign currency. These debentures are measured at FVTPL in accordance with Ind AS 109, and the functional currency of P Ltd. is INR.

1 The exceptions to this general principle are as follows:

a) It is a part of hedging relationship

b) It is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in Other Comprehensive Income (OCI)

c) It is a financial liability designated as at FVTPL and the entity is required to present the effects of changes in the liability’s credit risk in OCI

d) It is a financial asset measured at Fair Value through Other Comprehensive Income (FVOCI) and the entity is required to recognise some changes in fair value in OCI.

2 This investment is not designated as a hedging instrument in a cash flow hedge of an exposure to changes in foreign currency rates. Accordingly, ITFG was of the view that it would not be covered within the exceptions to the general principle enunciated in Ind AS 109 but would be measured at FVTPL.
ITFG considered the issue whether the foreign exchange difference is required to be presented separately from other fair value changes in the statement of profit and loss.

Ind AS 21 requires disclosure of amount of exchange differences recognised in profit or loss except for financial instruments measured at FVTPL.

Further, Ind AS 109 does not contain a requirement for separation of change in fair value of a foreign-currency denominated financial asset measured at FVTPL into the two constituent parts (i.e. change in fair value expressed in terms of foreign currency and change in exchange rate).

Accordingly, in the given case, ITFG clarified that P Ltd is not required to present change in fair value of the investment in debentures on account of change in relevant foreign exchange rate separately from other changes in the fair value of the investment.

**Issue 2 – Consolidation in case of an investment entity**

Ind AS 110, *Consolidated Financial Statements*, defines an investment entity that has following attributes:

- Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services
- Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both, and
- Measures and evaluates the performance of substantially all of its investments on a fair value basis.

Further, Ind AS 110 provides that an investment entity is not required to consolidate its subsidiaries or apply Ind AS 103, *Business Combinations*, when it obtains control of another entity. Rather, it measures an investment in a subsidiary at FVTPL in accordance with Ind AS 109. However, in case an investment entity has a subsidiary which provides services relating to its own investment, it is required to consolidate such a subsidiary and apply Ind AS 103 to the acquisition of any such subsidiary.

Moreover, a parent of an investment entity is required to consolidate all entities that it controls, including those controlled through an investment entity subsidiary unless the parent itself is an investment entity.

The facts of the case considered by ITFG are as follows:

**In the Year 1**

At the beginning, A Ltd. obtains equity funds from several overseas investors with the express purpose of providing those investor(s) with investment management services. A Ltd. uses these funds to acquire controlling equity stake in several start-up companies (not related parties of A Ltd.).

It subsequently incorporates a wholly-owned subsidiary, S Ltd. which invests in infrastructure like office space, office furniture, Information Technology (IT) equipment and specialised software and hires skilled employees to provide investment management services to the investors as well as to third parties.
S Ltd. is funded by equity contribution from A Ltd. Other than the above, A Ltd. has no other asset, liability, or activity.

A Ltd. concludes that it meets all the conditions for classification as an investment entity within the meaning of Ind AS 110, including exit strategies for each of its investments in the start-up companies. A Ltd. does not have any exit strategy in place for its investment in S Ltd. In its Consolidated Financial Statements (CFS), it values the investments in start-up subsidiaries at FVTPL and consolidates S Ltd. as per Ind AS 110.

**In the Year 2**
The above position continues in Year 2.

**In the Year 3 (i.e. the year of re-structuring)**

At the beginning, A Ltd. transfers investments in start-up companies to a newly formed wholly-owned subsidiary, B Ltd. It also transfers to B Ltd. its investment in S Ltd. Consideration for the transfer is in the form of issue of equity shares by B Ltd.

Except for the above, there is no change, e.g. in the objectives or activities. Post transfer, A Ltd.’s only asset is its investment in B Ltd. and it does not have any liabilities.

A Ltd. does not have an exit strategy in place for its investment in B Ltd., but the exit strategies for each of the investments in start-up companies continue to be in place.

ITFG3 considered and clarified on the following accounting issues:

**a) In the post-restructuring scenario, whether A Ltd. is still an investment entity**

In the post-restructuring scenario, A Ltd. holds the investments in subsidiaries indirectly through B Ltd. As per the facts of the case, the restructuring does not result in any change in objectives pursued or activities carried out prior to the restructuring. Thus, the change seems to be merely in form – in place of A Ltd. directly controlling and evaluating the performance of its subsidiaries (including the start-up companies), it does so now through B Ltd. Assuming that this is indeed so, B Ltd. satisfies all the three conditions of definition of the investment entity as given in Ind AS 110 for classification as an investment entity.

While A Ltd. has no exit strategy in place for its investment in B Ltd., exit strategies for each of the investments in start-up companies are still in place.

In the context of the restructuring undertaken by A Ltd., ITFG noted the below guidance contained in Ind AS 110:

> “An investment entity may have an investment in another investment entity that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the investment entity investor need not have an exit strategy for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.”

Accordingly, in view of above, even if A Ltd. does not have an exit strategy in respect of B Ltd. it still qualifies as an investment entity since B Ltd. has exit strategies in place in respect of start-up companies and satisfies the other conditions for classification as an investment entity.

Thus, ITFG clarified that in the given case A Ltd. is an investment entity in the post-restructuring scenario also.
b) Whether B Limited qualifies to be an investment entity?
In the post-restructuring scenario, as per the principles of Ind AS 110, B Ltd. is required to consolidate S Ltd. and measure the investments in start-up companies at FVTPL.

Accordingly, in the given case, ITFG clarified that B Ltd. qualifies to be an investment entity.

c) Whether post-restructuring, A Ltd. is required to prepare CFS? If yes, will it consolidate its direct investment in B Ltd. or its indirect investment in S Ltd. and the start-up companies and what would be the valuation basis?
A Ltd. is an investment entity in the post-restructuring scenario also. The start-up companies and S Ltd. are still its subsidiaries (albeit held and controlled indirectly).

Accordingly, ITFG clarified that in accordance with Ind AS 110, as in the pre-restructuring scenario, A Ltd. should consolidate S Ltd. and measure investments in start-up companies at FVTPL. As per the facts of the case, A Ltd. does not hold any assets other than its investment in B Ltd. and also has no liabilities. Hence, the CFS of A Ltd. would be identical to the CFS of B Ltd.

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Issue 3 – Accounting for accumulated arrears of dividend on cumulative preference shares on transition to Ind AS

The ITFG considered an issue, where an entity (P) had issued cumulative preference shares prior to transition to Ind AS. Since P was making losses in the past years, it did not pay dividend to its preference shareholders. Accordingly, the accumulated arrears of cumulative preference dividend were disclosed as ‘contingent liability’ in the notes to the financial statements. On transition to Ind AS, the preference shares were classified as financial liability in accordance with the principles of Ind AS 32, Financial Instruments: Presentation. The issue under consideration was the accounting for the accumulated arrears of preference dividend post transition to Ind AS.

Ind AS 32 establishes principles for classification of financial instruments into financial assets, financial liabilities and equity instruments. Post such classification, the financial instruments are subsequently measured at amortised cost or at fair value, based on the principles of Ind AS 109.

The ITFG noted that the preference shares would be classified as financial liability in their entirety. Therefore, the covenants of their terms of issue relating to dividends would represent a contractual obligation of P to pay such dividends. Accordingly, these dividends would be accrued in the same manner as interest on debentures or loans.

As per Ind AS 109, certain financial liabilities are subsequently measured at amortised cost (except in certain cases, which as per ITFG, did not appear to be the case based on the tenor of the query). While computing the amortised cost of the preference shares using the effective interest method, the dividends that have accrued but not paid would be reflected in the carrying amount of the liability. Further, considering that Ind AS 101, First-time Adoption of Indian Accounting Standards did not provide any mandatory exception or optional exemptions for this purpose, the amortised cost of the shares (which includes unpaid dividend) would be computed retrospectively from the date of their issue and would be computed accordingly as at the date of transition.

The difference between the amortised cost and the carrying amount of the preference shares as per the previous GAAP as at the date of transition would, in accordance with the provisions of Ind AS 101, be adjusted directly in retained earnings (or, if appropriate, another category of equity). Dividend for periods after the date of transition would be accrued in each period, in the same manner as interest, and if unpaid would get reflected in the amortised cost as at the end of the period.
The ITFG considered a situation where a company (X Ltd.) had invested in two operating companies (A Ltd. and B Ltd.), such that both the companies were its associates, but were not under common control within the meaning of Ind AS. X Ltd. carries its investments in associates at cost in its separate financial statements.

As part of a proposed transaction, A Ltd. would demerge an identified business undertaking (representing one or more business divisions), which would vest in B Ltd. As a result, A Ltd. would continue to survive as a separate legal entity with some of its other business divisions. The consideration for the demerger would be determined on the basis of the fair value of the underlying business, and would be issued in the form of fresh shares of B Ltd. to all shareholders of A Ltd. (including to X Ltd.). The query related to the accounting treatment of a demerger in the separate financial statements of X Ltd., which measures investments in associates at cost.

The ITFG noted that the two principal issues to be determined in the present case were:

a) What amount should be derecognised (to give accounting effect of the potential reduction in value of shares held in A Ltd. due to transfer of its business division), and

b) What amount should be recognised (to give effect to the accounting treatment for the receipt of additional shares of B Ltd. pursuant to the demerger)?

**Amount to be derecognised**

Prior to demerger, X Ltd.’s investment in the shares of A Ltd. represented its interest in both the demerged business undertaking as well as other businesses, whereas post demerger, it was represented only by its interest in businesses retained by A Ltd. Although X Ltd. did not pay any explicit consideration for the shares allotted to it in B Ltd. as part of the demerger scheme, there is an implicit cost associated with them to the extent of reduction of its interest in A Ltd. Currently Ind AS does not deal specifically with this kind of issue, i.e. how the amount to be derecognised should be determined. Thus, reference should be made to Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Ind AS 8, *inter alia*, states that in the absence of an Ind AS that specifically applies to a transaction, event or condition, judgement should be applied in developing and applying an accounting policy that provides relevant and reliable information to the users of the financial statements. While applying such judgement, entities should consider the requirements in Ind AS dealing with similar and related issues and guidelines prescribed in the Conceptual Framework.

In view of the above, ITFG drew analogy from:

a) Paragraph 2(b) of Ind AS 103, which states that Ind AS 103 does not apply to the acquisition of an asset or a group of assets that does not constitute a business. In such cases, the cost of assets purchased should be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.

b) Principles of Ind AS 115, *Revenue from Contracts with Customers*, which require use of standalone selling prices to allocate the transaction price to each performance obligation identified in a customer contract.

In accordance with the above, the carrying amount of X Ltd.’s investment in A Ltd. would be split between the demerged business undertaking and business retained by A Ltd. on the basis of the relative fair values of the two. On demerger, the portion of carrying amount allocated to the demerged business would be derecognised.

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4 The Conceptual Framework for Financial Reporting sets out the fundamental concepts for financial reporting that guide the International Accounting Standards Board (IASB) in developing IFRS Standards. It helps to ensure that the Standards are conceptually consistent and that similar transactions are treated the same way, so as to provide useful information for investors, lenders and other creditors.
Amount to be recognised

In the current case, X Ltd. has adopted an accounting policy of recognising investment in associates at ‘cost’. Since Ind AS 27, *Separate Financial Statements*, does not define cost, the cost of additional shares in B Ltd. may be represented either by their fair value or by the (allocated) carrying amount of the investment in A Ltd., which is derecognised by X Ltd.

a) **Cost represented by fair value:** Where the additional shares in B Ltd. represent a new or different investment acquired in exchange for a part of investment in A Ltd., they would be measured initially at their fair value, with consequent recognition of gain or loss on derecognition of part of investment in A Ltd.

However, in order to determine whether these additional shares in B Ltd. represent a new or different investment acquired in exchange for a part of investment in A Ltd., analogy may be drawn to Ind AS 16, *Property, Plant and Equipment* and Ind AS 38, *Intangible Assets*, with regard to determination of cost of property, plant and equipment or of intangible assets acquired in exchange for a non-monetary asset. As per this, the additional shares in B Ltd. may represent a new or a different investment acquired, in exchange for a part of investment in A Ltd., if the demerger results in a more than insignificant\(^5\) change in:

- The risks and rewards associated with the business undertaking transferred from A Ltd. to B Ltd. or those associated with the other businesses carried on by B Ltd. or A Ltd., and/or

b) **Cost representing the continuance of the pre-existing investment:** In the present case, there is no ‘exchange’ of investments. X Ltd. continues to hold the same number and proportion of equity shares in A Ltd. after the demerger as it did before the demerger. Accordingly, in the given facts of the case, it would be an appropriate view to take that the ‘cost’ of the additional shares is represented by the amount derecognised by X Ltd. in respect of its investment in A Ltd. while accounting for the demerger.

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**Issue 5 – Application of equity method in the CFS of investor in case of overseas associate**

*Ind AS 28, Investments in Associates and Joint Ventures*, is to be applied by all the entities where investors have joint control of or significant influence over, an investee. The standard prescribes the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

The equity method requires entities to prepare its financial statements using uniform accounting policies for like transactions and events in similar circumstances unless in case of an associate, it is impracticable to do so. If different accounting policies are being used for like transactions and events in similar circumstances, adjustments should be made to make the associate’s or joint venture’s accounting policies conform to those of the entity (investor) for applying the equity method.

In this regard, ITFG considered an issue where Entity L has an overseas associate Entity M. Entity M prepares its annual financial statements by following its local GAAP and laws. The local GAAP and laws followed by Entity M has difference in following accounting policies/estimates as compared to Ind ASs used by Entity L:

- a) Business combinations
- b) Depreciation method
- c) Useful lives of items of Property, Plant and Equipment (PPE) (or their significant parts).

The issue raised was how should the difference of accounting policies/estimates of Entity M be dealt with while applying equity method by Entity L.

In this case, ITFG clarified considering the requirements of Ind AS 28, in the case of an overseas associate for the purpose of applying the equity method, the associate’s financial statements would need to be redrawn on the basis of Ind ASs, except to the extent the exception relating to impracticability applies. The redrawn financial statements would be special-purpose financial statements and do not replace general purpose financial statements prepared in accordance with local laws.

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\(^5\) What is considered significant or insignificant is a matter of judgement.
The preparation of special-purpose financial statements are for the limited purpose of application of equity method by the investor and would not tantamount to breach or non-compliance of the local laws applicable to the associate.

Additionally, it clarified following treatment in applying the equity method for the specific issue raised:

**Business combinations**

The business combinations should be accounted for as per the principles of Ind AS 103, i.e. a transaction that meets the definition of a common control business combination from the perspective of the associate should be accounted for as per the pooling of interests method and other business combination transactions should be accounted for as per the acquisition method.

**Depreciation method(s)**

As per the requirements of Ind AS 16, the depreciation method to be applied in respect of an item of PPE should reflect the expected pattern of consumption of the future economic benefits embodied in the asset. Thus, under Ind AS 16, depreciation method is a matter of an accounting estimate, and not an accounting policy. While preparing financial statements of the associate as per Ind ASs, the requirements of Ind AS 16 need to be considered in determining an appropriate depreciation method for each item of PPE (or significant part) even though the resultant method may be different from the method applied by the associate in preparing and presenting its financial statements as per applicable local laws.

**Useful lives**

Ind AS 16 contains detailed guidance regarding the factors to be considered in determining the useful life of an item of PPE (or significant part). While preparing financial statements of the associate as per Ind ASs the requirements of Ind AS 16 need to be considered in relation to determination of the useful life of each item of PPE.

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**Our comments**

The ITFG clarifications are aimed at resolving various implementation challenges faced by companies while transitioning to Ind AS. Following are the key points that should be considered:

- The ITFG has clarified that in view of specific exclusion for financial instruments measured at FVTPL under Ind AS 109 in relation to disclosure requirements of Ind AS 21, entities are not required to separately disclose the change in fair value of the investment in relevant foreign exchange rate from other changes in the fair value of the investment.

- An investment entity is not required to prepare CFS subject to conditions specified in Ind AS 110. Determination of whether an entity would be classified as an investment entity in accordance with Ind AS 110 requires assessment of specific facts and circumstances.

- Where an instrument is classified as a financial liability, all coupon payments (dividends in this case) are recognised as part of finance costs in the statement of profit and loss under the effective interest method.

If in the above case, the dividends were discretionary, then the issuer considers whether unpaid dividends are added to the redemption amount of the preference shares. If any unpaid dividends are added to the redemption amount and the entity does not have the unconditional ability to avoid redemption before liquidation, then the dividends are not in substance discretionary and the entire instrument including the discretionary dividend feature is a financial liability, and the treatment for the accumulated arrears continues. Furthermore, if an entity is or may be obliged to redeem the instrument at fair value, then unpaid dividends are implicitly added to the redemption amount if the payment of dividends decreases the fair value of the instrument being redeemed.

Also an entity should evaluate implication on Minimum Alternate Tax (MAT) computation under the Income Tax Act with regard to dividend on preference shares.
In the earlier bulletins also, ITFG discussed issues relating to applicability of equity method in case of accounting of associates in CFS of investors. In this bulletin, ITFG clarified accounting for overseas associate that follows different accounting policies/estimates from the investor that comply with Ind AS. Considering the requirements of Ind AS 28, ITFG clarified that for the purpose of applying the equity method, the adjustments should be made to the associate’s financial statements and would need to be redrawn on the basis of Ind ASs, except to the extent the exception relating to impracticability applies.
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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.

In our recent Voices on Reporting webinar on 4 July 2019, we discussed key financial reporting and regulatory matters that are expected to be relevant for the stakeholders for the quarter ended 30 June 2019.

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