Ind AS Technical Facilitation Group (ITFG) Clarification Bulletin 16

Ind AS Technical Facilitation Group (ITFG) of Ind AS Implementation Group has been constituted for providing clarifications on timely basis on various issues related to the applicability and /or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015, raised by preparers, users and other stakeholders. Ind AS Technical Facilitation Group (ITFG) considered some issues received from members and decided to issue following clarifications[1] on September 04, 2018:

However, at the 17th meeting of Ind AS Technical Facilitation Group (ITFG) held on September 07, 2018, the Group reconsidered Issue 1 of Ind AS Technical Facilitation Group (ITFG) Clarification Bulletin 16 on the basis of representations received from stakeholders and decided to revise Issue No. 1 of the said Bulletin.

In accordance with the above, the revised Ind AS Technical Facilitation Group (ITFG) Clarification Bulletin 16 is as follows:

Issue 1: A 100% subsidiary (S Ltd.) gives a financial guarantee to a bank in respect of a loan obtained by its parent (P Ltd.) from the said bank. No guarantee fee/commission is charged by S Ltd. from P Ltd. P Ltd. accounts for the loan in its stand-alone as well as consolidated financial statements on amortised cost basis. The following accounting issues arise in the context of application of Ind AS by S Ltd. and P Ltd.:

(i) How will the financial guarantee be accounted for in the separate financial statements of S Ltd.? S Ltd. has accumulated losses and has not paid any dividend in the past.
(ii) How would financial guarantee be subsequently measured in the separate financial statements of S Ltd.?
(iii) How should the financial guarantee be accounted for in the separate financial statements of P Ltd.?

Response:

(i) The following analysis is based on the presumption that the financial guarantee given by S Ltd. (subsidiary) meets the definition of a 'financial guarantee contract' under Ind AS 109, *Financial Instruments*.

Paragraph B2.5 of Ind AS 109, *inter-alia,* states that, "*If this Standard applies, paragraph 5.1.1*

[1] Clarifications given or views expressed by the Ind AS Technical Facilitation Group (ITFG) represent the views of the ITFG and are not necessarily the views of the Ind AS Implementation Group or the Council of the Institute. The clarifications/views are based on the accounting principles as on the date the Group finalises the particular clarification. The date of finalisation of this Bulletin is September 04, 2018. The clarification must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of clarifications by the ITFG. The clarifications given are only for the accounting purpose. The commercial substance of the transaction and other legal and regulatory aspects has not been considered and may have to be evaluated on case to case basis.

requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 3.2.15–3.2.23 and B3.2.12–B3.2.17 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) the amount determined in accordance with Section 5.5; and

(ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 18[2]."

As per the above paragraph, issuer of a financial guarantee is required to recognise the financial guarantee contract initially at its fair value. This requirement will also apply if the guarantee is issued by a subsidiary in respect of a loan obtained by its parent and no fee/commission is charged by the subsidiary for issuing the guarantee. Accordingly, in the given case, S Ltd. is required to initially recognise a liability (a deferred income such as 'unearned financial guarantee commission') in its separate financial statements.

As regards to determination of the fair value of the financial guarantee, in the absence of any specific guidance on the issue in Ind AS 109 or in any other Ind AS and considering the broad principles of Ind AS 113, *Fair Value Measurement,* the following approaches may be considered:

- One possible measure of the fair value of the financial guarantee (at initial recognition) may be the amount that an unrelated, independent third party would have charged for issuing the financial guarantee.
- Another possible approach may be to estimate the fair value of the financial guarantee as the present value of the amount by which the interest (or other similar) cash flows in respect of the loan are lower than what they would have been if the loan were an unguaranteed loan.
- Yet another possible approach may be to estimate the fair value of the financial guarantee as the present value of the probability-weighted cash flows that may arise under the guarantee (i.e. the expected value of the liability).

If applied properly, the results of the three approaches described above are generally unlikely to differ widely.

It is noted that S Ltd. has provided the financial guarantee in respect of the loan taken by P Ltd. without charging any guarantee commission (or fee or premium).The economic substance of the

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[2]Ind AS 115,*Revenue from Contracts with Customers* is notified on March 31, 2018. The reference as per Ind AS 115 is as follows:

B2.5(a) (ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with Ind AS 115

arrangement is that by not charging P Ltd. the fair value of the guarantee (which S Ltd. may have charged for issuing a similar guarantee in respect of a loan taken by an unrelated third party), S Ltd. has effectively made a distribution to P Ltd. In order to reflect the substance of the transaction, the debit should be made to an appropriate head under 'equity'. It would not be appropriate to debit the fair value of the guarantee to profit or loss (as if it were a non-reciprocal distribution to a third party) as it would fail to properly reflect the existence of the parent-subsidiary relationship that may have caused S Ltd. not to charge the guarantee commission. Further, S Ltd. may not have issued a similar guarantee for a loan taken by an unrelated third party without charging a fair compensation.

(ii) As per Ind AS 109, after initial recognition of a financial guarantee contract by the issuer under the Standard, the issuer shall (unless paragraph 4.2.1(a) or (b) of the standard applies- *which is not the case in the situation under discussion*) subsequently measure it at the higher of:

(i) the amount of the *loss allowance* determined in accordance with Section 5.5 and
(ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 18[3].

In general, the application of Ind AS 18 would result in the amount of unearned financial guarantee commission recognised initially being amortised over the period of the guarantee as income and consequently, the balance of the unearned financial guarantee commission would decline progressively over the period of the guarantee. However, in addition to amortising the unearned financial guarantee commission to income, at each reporting date, S Ltd. is required to compare the unamortised amount of the deferred income with the amount of loss allowance determined in respect of the guarantee as at that date in accordance with the requirements of section 5.5 of Ind AS 109. As long as the amount of loss allowance so determined is lower than the unamortised amount of the deferred income, the liability of S Ltd. in respect of the guarantee will be represented by the unamortised amount of the financial guarantee commission. However, if at a reporting date, the amount of the loss allowance determined in accordance with section 5.5 is higher than the unamortised amount of the financial guarantee commission as at that date, the liability in respect of the financial guarantee will have to be measured at an amount equal to the amount of the loss allowance. Accordingly, in such a case, S Ltd. will be required to recognise a further liability equal to the excess of the amount of the loss allowance over the amount of the unamortised unearned financial guarantee commission.

(iii) Ind AS 109 states that-

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[3]Ind AS 115 , *Revenue from Contracts with Customers* is notified on March 31, 2018. The reference as per Ind AS 115 is as follows:
the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115, Revenue from Contracts with Customers

"*B5.4.1 In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.*

B5.4.2 Fees that are an integral part of the effective interest rate of a financial instrument include:
(a) origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.
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(c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services."

In the present case, financial guarantee provided by S Ltd. is an integral part of the arrangement for the loan taken by P Ltd. from the bank. As per Ind AS 109, fees associated with evaluating and recording guarantees that are an integral part of generating an involvement with a financial asset or a financial liability are taken into account in determining the effective interest rate for the financial asset/financial liability. In the given case, since the financial guarantee is an integral part of the loan taken by the P Ltd. and is not separately provided for, so in accordance with the principles of Ind AS 109, the same is required to be taken into account for calculation of the effective interest rate.

Ind AS 109 provides principles for accounting by the issuer of the guarantee. However, it does not specifically address the accounting for financial guarantees by the beneficiary. In an arm's length transaction between unrelated parties, the beneficiary of the financial guarantee would recognise the guarantee fee or premium paid as an expense.

As already clarified in ITFG Clarification Bulletin 13, Issue 2, an entity needs to exercise judgment in assessing the substance of the transaction taking into consideration relevant facts and circumstances, for example, whether any benefits are being otherwise obtained for providing

guarantee. Based on such an assessment, an appropriate accounting treatment based on the principles of Ind AS should be followed.

It may be noted that in the Issue 2 of ITFG Clarification Bulletin 13, the guarantee was given by the director. The principle of attribution acquires significance in a parent – subsidiary relationship and in the given case the beneficiary should recognise the guarantee. In the case of a guarantee provided by a subsidiary in respect of the liability of a parent, even if no consideration is received by the subsidiary, it should recognise a liability in its separate financial statements for the fair value of the guarantee. Even if no payments from the parent to the subsidiary are agreed for such a guarantee, the subsidiary has provided the guarantee in its capacity as a investee and should account for the issuance of the guarantee as a distribution to the parent. Consequentially, the transaction should also be recognised by parent.

Based on the above, in the given case, P Ltd. has not paid any guarantee commission to S Ltd. As discussed earlier in the context of accounting for the financial guarantee by S Ltd. **in terms of economic substance**, the provision of guarantee by S Ltd. without charging guarantee commission is analogous to a distribution by S Ltd. to P Ltd. To reflect this substance, P Ltd. should debit the fair value of the guarantee to the carrying amount of the loan (which would have the effect of such fair value being included in determination of effective interest rate on the loan) and credit the same as discussed below:

As per Ind AS 27, *Separate Financial Statements,* in the separate financial statements of the parent, investment in the subsidiary should be accounted for at cost or in accordance with Ind AS 109. (Certain other measurement requirements under particular circumstances are not relevant for the extant case).

(i) If the **investment in the subsidiary is accounted for at cost then,** distribution received should be credited to profit or loss. Impairment loss, if any, will be separately considered.

(ii) If the **investment in the subsidiary is accounted for in accordance with Ind AS 109**,

- if measured at fair value through other comprehensive income- then in accordance with B5.7.1 of Ind AS 109, distribution are recognised in profit or loss in accordance with paragraph 5.7.6 unless the distribution clearly represents a recovery of part of the cost of the investment

- if measured at fair value through profit or loss, distribution received will be credited to profit or loss.

The above transaction also needs to be evaluated for disclosure under paragraph 18 of Ind AS 24, *Related Party Disclosures*.

As per the facts of the case, S Ltd. is in losses and has not paid any dividend to P Ltd. in the past. These limited facts do not per se impact the accounting treatment of financial guarantee given by S Ltd.

The above clarification is given only for the accounting purposes. The commercial substance of the transaction and other legal and regulatory aspects have not been considered by ITFG which may have to be evaluated on case to case basis.

Issue 2: How should an entity account for the interest and penalties related to income taxes, in accordance with the principles of Ind AS?Is there any conflict between the treatment as per Ind AS *vis-a-vis* IFRS?

Response: Paragraph 9.7.1 of 'Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013' issued by the ICAI states as follows:

'*Any interest on shortfall in payment of advance income-tax is in the nature of finance cost and hence should not be clubbed with the Current tax. The same should be classified as Interest expense under finance costs. However, such amount should be separately disclosed.*

Any penalties levied under Income tax laws should not be classified as Current tax. Penalties which are compensatory in nature should be treated as interest and disclosed in the manner explained above. Other tax penalties should be classified under 'Other Expenses'.'

The above recommendations of the Guidance Note are based on the difference between the nature of current tax on the one hand and that of interest or penalties levied on an entity under the income-tax law on the other. As per Ind AS 12, "*current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period*." Thus, an entity's obligation for current tax arises because it earns taxable profit during a period. An entity's obligation for interest or penalties, on the other hand, arises because of its failure to comply with one or more of the requirements of income-tax law (e.g. failure to deposit income-tax). Thus, obligations for current tax and those for interest or penalties arise due to reasons that are fundamentally different in nature. Paragraph 29 of Ind AS 1, *Presentation of Financial Statements*, requires, *inter alia*, that "an entity shall present separately items of a dissimilar nature or function unless they are immaterial except when required by law." It is with a view to properly reflect the difference in the nature of current tax and interest/penalties imposed under income-tax law that the Guidance Note requires interest or penalties to be not clubbed with current tax and to treat penalties that are compensatory in nature and interest as part of finance cost and to treat other penalties as part of other expenses.

It may also be mentioned where an entity is in compliance of all of the applicable requirements of income-tax law, it incurs no obligation to pay any interest or penalties, regardless of the

amount of its taxable profit for the period. The amount of the entity's taxable profit for a period, on the other hand, generally has a direct correlation with the amount of its current tax obligation for the period. However, even if the amount of interest or penalties for non-compliance with requirements of applicable income-tax law in a particular jurisdiction were linked directly to the amount of taxable profit, the differences in nature of current tax and interest/penalties would still warrant that current tax and interest/penalties not be clubbed together. In other words, similarity in a particular jurisdiction in the bases of computation of amount of current tax and interest/penalties for non-compliance is not a sufficient ground for clubbing these items, which are different in terms of their nature.

It is also pertinent to mention that as per a recent IFRIC[4] agenda decision (in the meeting held on 12 September 2017)[5]; entities do not have an accounting policy choice between applying IAS 12 and applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to interest and penalties. Instead, if an entity considers a particular amount payable or receivable for interest and penalties to be an income tax, then the entity applies IAS 12 to that amount. If an entity does not apply IAS 12 to a particular amount payable or receivable for interest and penalties, it applies IAS 37 to that amount. An entity discloses its judgement in this respect applying paragraph 122 of IAS 1 *Presentation of Financial Statements,* if it is part of the entity's judgements that had the most significant effect on the amounts recognised in the financial statements.

It is noted that as per the IFRIC agenda decision, there *might* be situations where an amount payable (or receivable) for interest or penalties may be in the nature of income-taxes and thus will be within the scope of IAS 12. In considering whether an amount of interest or a penalty is in the scope of IAS 12, an entity considers whether the interest or penalty is a tax and whether that tax is based on taxable profits.

In some situations it might be difficult to identify whether an amount payable to (or receivable from) a tax authority includes interest or penalties. For example, this might be the case when the total amount payable to a tax authority is negotiated as a single amount and the tax authority often issues a single demand for unpaid taxes, which might also include interest and penalties. In such situations, since it may not be possible to segregate interest and penalty component, entire amount would qualify within meaning of IAS 12.

It is noted that the applicability of IFRSs is across a large number of jurisdictions, each with its own income-tax law, therefore, an entity should determine whether a particular amount payable or receivable for interest and penalties is in the scope of IAS 12 (or Ind AS 12) considering the tax laws applicable in its individual jurisdiction. For this purpose, an entity should consider whether tax laws in the jurisdiction and other facts and circumstances indicate that this amount is

[4]The IFRS Interpretations Committee (Interpretations Committee) is the interpretative body of the International Accounting Standards Board (Board). The Interpretations Committee works with the Board in supporting the application of IFRS Standards.
[5]Source: https://www.ifrs.org/news-and-events/updates/ifric-updates/september-2017/#8

based on a taxable profit – i.e. a 'net' amount. For example, in India, interest and penalty payable under section 234A/B/C will not qualify as income-taxes within the meaning of IAS 12 (or Ind AS 12). Thus, the related amount will be recognised as interest (similar to the approach under the guidance note).Other interest and penalties under the Indian income tax act are also generally not expected to qualify as income-taxes.

Issue 3: DG Ltd. had taken foreign letter of credit from a scheduled bank in financial year 2011-12 at a rate linked to LIBOR (which was 4.50% at that time). DG Ltd. was unable to meet its repayment obligation on the due date and the bank crystallised the liability into INR. As the loan was not serviced by DG Ltd. it became NPA for the bank. Thereafter, the bank assigned the loan to an Asset Reconstruction Company (ARC). The loan which was taken over by ARC was subsequently negotiated between the ARC and DG Ltd. to arrive at a settlement as part of the above assignment.

The above arrangement was agreed upon between the parties in the form of hair cut by the ARC for some balance of the loan, partial settlement of the loan by issue of fully paid up equity shares at traded market price and the balance loan amount to be paid in installments over 7 years. The revised interest agreed upon by the ARC is linked to the marginal cost of funds based lending rate (MCLR) and with certain additional discount of some basis points which is lesser than the normal bank funding rates. This arrangement between the parties was entered into post implementation date of Ind AS for the Company.

Whether the above is a modification of debt from the perspective of DG Ltd. If so, how such modification will be accounted for?

Response: In the given case, the above arrangement between ARC and DG Ltd. towards the outstanding loan has been entered during the year when Ind AS is applicable to DG Ltd. The loan taken by DG Ltd. is a 'financial liability' as defined in Ind AS 32. The timing as well as the manner of recognition of effects of the above arrangement between ARC and DG Ltd. will be governed by Ind AS 109, *Financial Instruments*.

The response in the following paragraphs is based on the assumption that the carrying amount of the loan as on to the date of transition to Ind AS and the original effective interest rate referred to in paragraph B3.3.6 of Ind AS 109 have been correctly determined by the entity in accordance with the requirements of Ind AS 109, read with Ind AS 101, *First-time Adoption of Indian Accounting Standards*.

Paragraphs 3.3.1 – 3.3.3 of Ind AS 109 provide the following guidance in this regard:

"*3.3.1 An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.*

3.3.2 *An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.*

3.3.3 *The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss."*

Paragraphs B3.3.1 of Ind AS 109 Appendix B states as under:

B3.3.1 A financial liability (or part of it) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

[*It is assumed in the following discussion that no costs or fees have been incurred in connection with modification of the terms of the loan.]*

As per paragraphs 3.3.1 and B3.3.1, DG Ltd. is required to assess that whether change of the lender (assignment of loan) from bank to the ARC is a legal release from the primary liability to the bank. If it is so concluded, then the entire amount of the existing loan will be derecognised and new arrangement with ARC shall be accounted for as a new loan and the difference shall be recognised in profit or loss.

If it is concluded that change of the lender (assignment of loan) does not result in legal release from primary liability to the bank then DG Ltd. needs to consider the requirements of paragraph 3.3.2 of Ind AS 109. As per paragraph 3.3.2, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) is accounted for as an extinguishment of the original financial liability (or part of the financial liability) and the recognition of a new financial liability. For determining whether a modification of the terms of an existing financial liability (or a part of it) is substantial, paragraph B3.3.6 of Ind AS 109 Appendix B lays down a quantitative test. As per paragraph B3.3.6, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the

original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

In case a modification of the terms of a financial liability fails to meet the 10% quantitative threshold laid down in paragraph B3.3.6, an issue arises whether it can be concluded without carrying any further analysis that the modification is not substantial. While Ind AS 109 does not provide any specific guidance on this issue, the quantitative test alone may not be sufficient to reach the above conclusion in all cases. This is because some or all of modification to the terms of a financial liability may be of such nature that their effect is not captured by the quantitative test.

Determining whether the terms are substantially different, from a qualitative perspective, is judgemental and will depend on the specific facts and circumstances of each case. Where a modification of the terms of a financial liability does not meet the quantitative threshold of 10%, a qualitative analysis may be required to be carried out to determine whether modifications of the terms that are not captured by the quantitative analysis are substantial. There may be situations where the modification of the debt is so fundamental that derecognition is appropriate whether or not the 10% test is satisfied.

It is noted that as per the terms of settlement with ARC, DG Ltd. was required to settle a part of the loan immediately by way of issue of its own equity shares at fair value. The partial settlement of the existing loan by issuing equity will be accounted for in accordance with Appendix D of Ind AS 109, *Extinguishing Financial Liabilities with Equity Instruments* and paragraph 3.3.4 of Ind AS 109.

The balance should be tested by DG Ltd. for de-recognition i.e. whether there is a substantial modification of the terms of an existing financial liability or a part of it. In the present case, as per the facts of the case, the modifications relate to terms that are captured by the quantitative test (viz.the 'haircut', rescheduling of repayment, and change in interest rate); there are no additional factors requiring a qualitative analysis in the given case. Hence, if the quantitative threshold of 10% is met, the modification should be considered to be substantial (and vice versa).

If the modification of balance loan is considered to be substantial, then DG Ltd. should de-recognises the balance loan and recognises the new modified loan and any difference between the carrying amount of the original balance loan and new modified loan is recognised in profit or loss.

Issue 4: Whether investments made by an entity in units of money-market mutual funds (i.e., those investing in money-market instruments such as treasury bills, certificates of deposit and commercial paper) that are traded in an active market or are puttable by the holder to the fund at net asset value (NAV) at any time can be classified as cash equivalents as per Ind AS?

Response: Paragraph 6 of Ind AS7, *Statement of Cash Flows*, defines the term "cash equivalents" as follows:

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Further paragraph 7 of Ind AS 7, *inter-alia* states that, "Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value."

As per the above, Ind AS 7 prescribes the following three cumulative conditions to be met for an investment to be classified as a 'cash equivalent' under the standard:

(a) The investment must be for meeting short-term cash commitments.
(b) It must be highly liquid, i.e. readily convertible to cash.
(c) The amount that would be realised from the investment must be known, with no more than an insignificant risk of change in value of the investment.

The investment must be for meeting short-term cash commitments

Whether an investment is for meeting short-term cash commitments or not is essentially a matter of management intent which can generally be inferred from such documentary sources as investment policy, investment manuals, minutes of relevant committee meetings, etc. and can be corroborated by the actual experience of buying and selling those investments. However, it is to be noted that such investments are to be held only as a means of settling liabilities, and not as an investment or for any other purposes. Therefore, whether this condition is met or not requires an assessment of the particular facts and circumstances of a case.

Investment must be highly liquid, i.e. readily convertible to cash.

Units of a money market mutual fund that are traded in an active market or that can be put back by the holder at any time to the fund at their net asset value may meet the condition of the investment being highly liquid.

The amount that would be realised from the investment must be known, with no more than an insignificant risk of change in value of the investment.

It is pertinent to note that the amount of cash that will be received must be known at the time of the initial investment. Accordingly, the investments in units of money market funds cannot be considered cash equivalents simply because they can be converted to cash at any time at the then market price in an active market. Further, the entity would have to satisfy itself that the investment is subject to an insignificant risk of changes in value for it to be classified as a cash equivalent. Hence, the purpose of holding the instrument and the satisfaction of the criteria should both be clear from its terms and conditions.

Accordingly, it requires careful assessment of each of the investments of the entity considering the definition given under Ind AS 7 as well as the purpose of holding the investments. An entity should satisfy itself and able to demonstrate that the investment is subject to an insignificant risk of change in value for it to be classified as a cash equivalent.

As a general proposition, the third condition, *viz*. that the investment must be convertible into a known amount of cash and the risk of change in the value of the investment should not be more than insignificant is usually not expected to be met by units of a money-market (or other) mutual fund which can be put back by the holder to the fund at any time for redemption at net asset value (or can be sold in an active market). It is well-known that even though the money market instruments have a relatively short life, their value keeps changing primarily due to changes in interest rates. Consequently, the amount of cash that will be received from redemption or sale of the units may not be known at the time of the initial investment and the value of such units may be subject to a more than insignificant risk of change during the period of their holding. However, there may be cases wherein this condition is met e.g. where such units are acquired only for a very brief period before the end of tenure of a mutual fund and the maturity amounts of the fund's investments are pre-determined and known – in such a case, it might be possible to argue that the redemption amount of the units is known and subject only to an insignificant change in value.

Issue 5: Company A is a subsidiary of Company B. Both are under Phase II of Ind AS implementation. During the year 2016-17, Company B demerged one of its businesses under the order of the High Court and sold the same to Company A. Under IGAAP, the assets and liabilities of the demerged business of Company B was taken by Company A at their fair value and issued its shares as consideration (calculated on the basis of the fair value of the business of Company B) accordingly. Under Ind AS 103, *Business Combinations*, acquisition of a business within the companies under Common Control has to be accounted by the acquirer at book value as appearing in the books of the acquiree. In facts of case the acquisition of business by subsidiary (Company A) from parent (Company B) qualifies as common control business combination within Appendix C of Ind AS 103.

Whether Company A is required to apply Ind AS 103 on the acquisition of the business from Company B?

Response: It is noted that the demerger (of one of the businesses of Company B into Company A) occurred during the financial year 2016-17. It is further noted that in their financial statements for the financial year 2016-17, the transferee company (Company A or the company) as well as the transferor company (Company B) were not required to, and did not apply, Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015.

The Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 do not specifically deal with accounting for demerger. It has been mentioned in the query that

"under IGAAP, the assets and liabilities of the demerged business of Company B were taken by Company A at their fair value and Company A issued its shares as consideration (calculated on the basis of the fair value of the business of Company B) accordingly." We interpret this to mean that in its financial statements for the year 2016-17, Company A accounted for the assets and liabilities acquired under the scheme of demerger at their respective fair values as at the date of demerger.

It is noted that in the case of Company A, the first Ind AS financial statements would be those for the financial year 2017-18. In those financial statements, the comparative amounts to be presented as per Ind ASs would be those for the year 2016-17. It is also noted that the demerger occurred during the financial year 2016-17, i.e., after the 'date of transition to Ind ASs' by Company A (i.e., April 1, 2016) within the meaning of the said term under Ind AS 101, *First-time Adoption of Indian Accounting Standards.*

Scenario A: Accounting treatment of demerger not prescribed in the court-approved scheme

An entity can choose not to restate any business combination that occurred prior to its transition to Ind AS, and it can apply Ind AS 103 prospectively from the date of transition. In case the court-approved scheme of demerger did not prescribe the accounting treatment for the demerger in the books of Company A, the demerger is then no different from any other transaction occurring on or after the date of transition to Ind ASs. A transaction occurring on or after the date of transition to Ind ASs is required to be accounted for as per relevant requirements under Ind ASs, irrespective of how it was accounted for under previous GAAP. In case the accounting treatment of a transaction (occurring on or after the date of transition to Ind ASs) under the previous GAAP was different from the treatment thereof required under Ind ASs, the comparative amounts to be presented in the first Ind AS financial statements also need to be restated as to conform to accounting required under Ind ASs.

As the demerger occurred after the date of Company A's transition to Ind ASs, it should be accounted for as per the relevant requirements of Ind ASs. As per the query, from the perspective of Company A, the demerger qualifies as a common control business combination within the meaning of this term under Appendix C of Ind AS 103. Accordingly, in the financial statements of Company A for the comparative year 2016-17, the demerger would need to be accounted for as per the 'pooling of interest method' laid down in Appendix C of Ind AS 103. This would involve, *inter alia*, recognition of assets and liabilities of the acquired business at their respective book values as appearing in the books of Company B. This implies that the figures at which the assets and liabilities of the demerged business were recognised by Company A in its financial statements for the year 2016-17 prepared as per previous GAAP demerger would need to be restated as per the 'pooling of interests method' when presenting the comparative amounts in the Ind AS financial statements of Company A for the financial year 2017-18. 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 (1 April 2016) in the financial statements, irrespective of the actual date of the combination. This is on the basis of assumption that the acquirer and acquiree both were under common control on 1 April 2016.

Scenario B: Accounting treatment of demerger prescribed in the court-approved scheme

An announcement of the Council of the institute of Chartered Accountants of India, "Disclosures in cases where a Court/Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard[6], states that-

"………….. if an item in the financial statements of a Company is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

1. A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/ Tribunal Order.

2. Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.

3. The financial impact, if any, arising due to such a difference.

………"

Thus, as per the above announcement, accounting treatment of a transaction as required under an order of a court or tribunal (or other similar authority) overrides the accounting treatment that would otherwise be required to be followed in respect of the transaction and it is mandatory for the company concerned to follow the treatment as per the order of the court/tribunal.

In the context of the above requirement, if the court-approved scheme of demerger prescribed the accounting treatment for the demerger in the books of Company A (e.g., recognition of assets and liabilities acquired at their respective fair values as at the date of demerger) then Company A will follow the treatment prescribed in the scheme in its financial statements for the year 2016-17 and if the effect of such treatment is to be carried over in subsequent years also then the same treatment of court approved scheme will be followed in the subsequent years subject to compliance of auditing standards. It is to be noted that the Company A is required to follow the accounting requirements of Ind AS which are not in conflict with provisions of the court scheme.

Issue 6: A Ltd. has entered into a long term lease of 99 years for a land in a textile park. As per the lease agreement, A Ltd.is required to pay nominal annual rent at the rate of Re. 1/ sq.mtr. without any upfront payment. Further A Ltd. has made a payment of a material

[6]Published in 'The Chartered Accountant', December 2004 (pp. 825)

amount (say 150 crores) as the lumpsum payment towards using the common infrastructure facilities of the park for the period of 99 years.

Whether the above lease transaction should be classified as an operating lease or finance lease as per Ind AS, provided the following terms:

- **No initial amount has been paid towards such lease.**
- **A Ltd. has no option to purchase the land at a price that is sufficiently lower than fair value at the date option is exercisable.**
- **The renewal of the lease is based on the mutual acceptance at the end of lease term.**
- **Lessor has not agreed to renew lease on expiry of lease term**

Further, whether the infrastructure usage rights should be classified under intangible assets or should be considered as part of land lease?

Response: It is noted that as per the terms of agreement between A Ltd and the owner of the textile park, A Ltd. is required to pay annual lease rent at the rate of Re. 1/ sq.mtr. during the entire lease term of 99 years. Additionally, A Ltd. has made a large lump sum payment upfront which is stated to be towards using the common infrastructure facilities of the park for the said period of 99 years. In the given case the stated lease rental for land is no more than nominal, the lump sum amount paid upfront also includes an element towards land lease rentals, notwithstanding that the agreement states that the lump sum payment is (only) towards use of common infrastructure facilities of the park.

The entity is required to evaluate whether the lease of land is a finance lease or an operating lease based on the definitions of 'finance lease' and 'operating lease' and indicators for classification of lease given under Ind AS 17, *Leases*. Reference may also be made in this regard to ITFG Clarification Bulletin 7 (Issue 5) which emphasises that the classification of a lease under Ind AS 17 requires exercise of judgement in the context of facts and circumstances of each case.

The agreement provides A Ltd. the right of use of both land and common infrastructure facilities even though the right of use of land is exclusive whereas the right of use of common infrastructure facilities is non-exclusive. It may also be argued that common infrastructure facilities such as access roads are essential for A Ltd to be able to utilise its rights in relation to land. Accordingly, while applying Ind AS 17, the right of use of both land and common infrastructure facilities may be viewed as a single set of rights unless the terms of the agreement such as tenure, renewal option, etc. in respect of the two are different (which does not seem to be the case). If the two rights are accounted for as a single item, the relevant line item in the balance sheet may bring out clearly that it relates to right of use of both land and common infrastructure facilities. If on the other hand the two rights are accounted for separately (because of differences in the terms and underlying benefits relating to the two), accounting for each right should be based on the particular terms and underlying benefits associated with it.

It also needs to be assessed that whether the textile park is providing services in the form of common infrastructure facilities. As per Ind AS 17, costs for services are excluded from minimum lease rentals. Where it is concluded that textile part is providing services for tenure of the land then in such case the upfront payment has to be split between minimum lease payment towards lease of land and prepayment for future services. The amount allocated to MLPs towards lease of land has to be considered for the purpose of determining classification of lease between operating or finance lease.

Issue 7: S Ltd. has availed loan in financial year 2012 (no concession in rate of interest is given by bank by virtue of guarantee from parent) from banks. The said loan has been guaranteed by its Parent P Ltd). Parent is in phase -2 of implementation of Ind AS where transition date is 1st April 2016. S Ltd. is 61.5% subsidiary of P Ltd. Initial estimate/tenure of the borrowing was 10 years. However, the S Ltd. repaid the whole loan amount within the period of 6 years in financial year2018. On transition date, P Ltd. recognised the financial liability obligation in its separate financial statements and presented resultant 'Investment in subsidiary' to that extent.

What shall be the accounting treatment of the 'financial guarantee' provided by the P Ltd. in respect of loan/borrowing availed by S Ltd., in case the underlying loan is repaid earlier than estimated initially?

Response: As per the requirements of Ind AS 109 *Financial Instruments*, on the date of transition, P Ltd. recognised the 'Financial guarantee obligation' in its separate financial statement with the corresponding impact in the 'Investment in subsidiary' on initial recognition after considering the terms of the guarantee.

With regard to subsequent measurement, as stated in Issue 1, financial guarantee contract is subsequently measured at the higher of: (i) the amount of the loss allowance and (ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 18[7].
As per the facts in the given case, the parent company initially recognised the financial guarantee obligation at its fair value, based on the estimated term of the loan/borrowing as 10 years but, S Ltd. repaid the entire amount of loan after the expiry of 6 years.

There is a change in the expected tenure in terms of contractual life which was earlier estimated for 10 years while the actual tenure came out to be 6 year. With regard to change in estimate with respect to the tenure of the instrument, guidance given under Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* may be considered.

Paragraph 36 and 37 of Ind AS 8 states as follows:

[7]Ind AS 115,*Revenue from Contracts with Customers* is notified on March 31, 2018 and superseded Ind AS 11 and Ind AS 18.

"36 The effect of change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively by including it in profit or loss in:

(a)the period of the change, if the change affects that period only; or

(b)the period of the change and future periods, if the change affects both.

37 To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change."

In accordance with the above, it may be noted that where change in the accounting estimate gives rise to changes in assets, liabilities and equity, then the same shall be adjusted in the carrying amount of the related asset, liability or equity item in the period of the change. As per the facts mentioned above, there is change in the estimate of expected life of the instrument (i.e. loan is repaid in 6 year rather than repaying it after 10 years) and since no obligation exists for parent in respect of the financial guarantee provided by the parent, the parent may reverse the amount of obligation.

The attribution debited to investment upon providing guarantee is in substance the consideration that the parent would have collected for providing similar guarantee to an unrelated third party. In case of prepayment of loan by an unrelated third party, the parent would generally not have refunded the consideration and would have recognised the entire unrecognised commission in profit & loss. Similar approach should be followed for guarantee given to the subsidiary.

Accordingly, in the given case, on initial recognition P Ltd. recognised a financial guarantee obligation of Rs. 1000. As required by paragraph 4.2.1(c)(ii) of Ind AS 109, this amount initially recognised is amortised as income in each accounting period. By the end of the year 6, Rs.400 is standing as carrying value of financial guarantee in the financial statement of P Ltd. But since S Ltd. has repaid the loan, there is no obligation existing for P Ltd. Accordingly, P Ltd. should reverse the balance outstanding as guarantee obligation with corresponding recognition of revenue of Rs. 400 in profit and loss account.

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