# ACCOUNTING STANDARDS

## For Non Corporates - MSME

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# Agenda

- Why Accounting Standards
- What constitutes Indian GAAP
- Who prescribes Accounting Standards
- To whom is it applicable
- What is SME
- SME and applicability of AS

# Standards to be discussed today

- AS 7 Construction Contracts
- AS 9 Revenue Recognition
- AS 10 Property Plant and Equipment

  (Combination of AS 10 (revised) and earlier AS 6 – Depreciation now deleted)
- AS 15 Employee Benefits
- AS 16 Borrowing Cost
- AS 18 Related Party Transactions
- AS 22 Accounting for taxes on Income
- AS 28 Impairment of Assets

# Objective :

- For the purpose of Applicability of Accounting Standard
- Enterprise are classified under various level.
- Earlier Level I, Level II, Level III
- Now Enterprise classified in to four level categories – Level I,Level II, Level III, Level IV applicable w.e.f. 01.04.2020 as
- Level I entities are required to comply with Fully with all AS.
- Where as Level Iv, III and II entities are as Micro, Small and Medium Sized Entity (MSME) that have been granted certain exemption.

# Earlier Classification of Non Corporate Entity:

- **Level : I : Non Corporate Entities which fall in any one or more of following categories**
  - Entities whose securities are listed or are in the process of listing on any stock exchange, whether in India or outside India Banks (including co-operative banks), financial institutions or entities carrying on insurance business.
  - All entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees 50 crore in the immediately preceding accounting year.
  - All entities engaged in commercial, industrial or business activities having borrowings (including public deposits) in excess of rupees 10 crore at any time during the immediately preceding accounting year.
  - Holding and subsidiary entities of any one of the above

# Earlier Classification of Non Corporate Entity:

- **Level II : Non-Corporate Entities which are not Level I Entities but fall in any one or more of following categories**
  - All entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees 1 crore but does not exceed rupees 50 crore in the immediately preceding accounting year
  - All entities engaged in commercial, industrial or business activities having borrowings (including public deposits) in excess of rupees 1 crore but not in excess of rupees 10 crore at any time during the immediately preceding accounting year.
  - Holding and subsidiary entities of any one of the above.

- **Level : III: Non-Corporate Entities which are not covered under Level I and Level II are considered as Level III entities**

# New Classification of Non Corporate Entity (As per ICAI resolution March 18/19 2021):

- **Level : I : Non-Corporate Entities which fall in any one or more of following categories**
  - Entities whose securities are listed or are in the process of listing on any stock exchange, whether in India or outside India Banks (including co-operative banks), financial institutions or entities carrying on insurance business.
  - All entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees 250 crore in the immediately preceding accounting year.
  - All entities engaged in commercial, industrial or business activities having borrowings (including public deposits) in excess of rupees 50 crore at any time during the immediately preceding accounting year.
  - Holding and subsidiary entities of any one of the above

# New Classification of Non Corporate Entity:

- **<u>Level : II: Non Corporate Entities which are not Level I Entities but fall in any one or more of following categories</u>**
  - All entities engaged in commercial, industrial or business activities, whose <u>turnover</u> (excluding other income) <u>exceeds rupees 50 crore but does not exceed rupees 250 crore</u> in the immediately preceding accounting year
  - All entities engaged in commercial, industrial or business activities <u>having borrowings</u> (including public deposits) in <u>excess of rupees 10 crore but not in excess of rupees 50 crore</u> at any time during the immediately preceding accounting year.
  - Holding and subsidiary entities of any one of the above.

# New Classification of Non Corporate Entity:

- **Level : III: Non-Corporate Entities which are not Level I and Level II Entities but fall in any one or more of following categories**
  - All entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees 10 crore but does not exceed rupees 50 crore in the immediately preceding accounting year
  - All entities engaged in commercial, industrial or business activities having borrowings (including public deposits) in excess of rupees 2 crore but not in excess of rupees 10 crore at any time during the immediately preceding accounting year.
  - Holding and subsidiary entities of any one of the above.
- **Level : IV: Non Corporate Entities which are not covered under Level I, Level II and Level III are considered as Level IV entities**

# Applicability of AS to Level I – Non Corporate Entity :

- **Level I** entities are required to comply in full with **all the Accounting Standards**.

# Applicability of AS to Level II, III, IV – Non Corporate Entity :

| AS | Level II | Level III | Level IV |
|---|---|---|---|
| AS 1 | Applicable | Applicable | Applicable |
| AS 2 | Applicable | Applicable | Applicable |
| AS 3 | Not Applicable | Not Applicable | Not Applicable |
| AS 4 | Applicable | Applicable | Applicable |
| AS 5 | Applicable | Applicable | Applicable |
| AS 6 | Applicable | Applicable | Applicable |
| AS 7 | Applicable | Applicable | Applicable |

# Applicability of AS to Level II, III, IV – Non Corporate Entity :

| AS | Level II | Level III | Level IV |
|---|---|---|---|
| AS 9 | Applicable | Applicable | Applicable |
| AS 10 | Applicable | Applicable with Disclosure Exemption | Applicable with Disclosure Exemption |
| AS 11 | Applicable | Applicable with Disclosure Exemption | Applicable with Disclosure Exemption |
| AS 12 | Applicable | Applicable | Applicable |
| AS 13 | Applicable | Applicable | Applicable with Disclosure Exemption |
| AS 14 | Applicable | Applicable | Not Applicable |
| AS 15 | Applicable with Disclosure Exemption | Applicable with Disclosure Exemption | Applicable with Disclosure Exemption |

# Applicability of AS to Level II, III, IV – Non Corporate Entity :

| AS | Level II | Level III | Level IV |
|---|---|---|---|
| AS 23 | Not Applicable | Not Applicable | Not Applicable |
| AS 24 | Applicable | Not Applicable | Not Applicable |
| AS 25 | Not Applicable | Not Applicable | Not Applicable |
| AS 26 | Applicable | Applicable | Applicable with Disclosure Exemption |
| AS 27 | Not Applicable | Not Applicable | Not Applicable |
| AS 28 | Applicable with Disclosure Exemption | Applicable with Disclosure Exemption | Not Applicable |
| AS 29 | Applicable with Disclosure Exemption | Applicable with Disclosure Exemption | Applicable with Disclosure Exemption |

# Disclosures for MSME and Levels

- All entities under MSME category (Level II,III,IV) will disclose in the notes:
  - That it is a MSME
  - Level of MSME – II, III or IV
  - That it has complied with relevant applicable AS
- Level II/III/IV changes to Level I during the year will disclose in the Notes:

  No need to change previous year figures

  State that the previous years figures not modified

# Disclosures for MSME and Levels

- Level I changes to II/III/IV or from one level to lower level :
  - Apply earlier level unless for 2 consecutive years lower level ie Level I to Level II for 2 consecutive years.
  - Give disclosure in notes
- Exemption available but some not availed will disclose in the Notes:
  - State which exemption have been availed
- All exemptions not availed
  - Disclose in Notes

# Standards Not applicable to some levels

Following standards not applicable to Level II, III, IV

AS 3 Cash Flow

AS 17 Segment Reporting

AS 20 EPS

AS 21 Consolidated FS

AS 23 Associates

AS 25 Interim Financial Statements

AS 27 Joint Ventures

# Standards Not applicable to some levels

Following standards not applicable to Level III and IV

AS 14 Amalgamation (Level IV)

AS 18 Related Party (Level III, IV)

AS 22 Income tax (Level IV – Deferred tax)

AS 24 Discontinued Operations (Level III, IV)

AS 28 Impairment of Assets (Level IV)

# Exemption and Relaxation in Disclosures

AS 10 PPE – Level III, IV

AS 11 Foreign Exchange – Level III, IV

AS 13 Investments – Level IV

AS 15 Employee Benefits – Level II, III and IV

AS 19 Lease – Level II, III and IV

AS 26 Intangible Asset – Level IV

AS 28 Impairment of Assets – Level II, III

AS 29 Provisions – Level II, III and IV

# Exemption and Relaxation in Disclosures

AS 10 PPE – Level III, IV

Para 87 – disclosure regarding Temporary Idle PPE, Fully Depreciated PPE still in Use, Each Revalue Class of PPE, Carrying Amount of PPE retired from Active use but not held for Disposal.

AS 11 Foreign Exchange – Level III, IV

Para 44 - Disclosure of an enterprise's foreign currency risk management policy.

# Exemption and Relaxation in Disclosures

AS 13 Investments – Level IV

Para 35(f) - other disclosures as specifically required by the relevant statute governing the enterprise

AS 15 Employee Benefits – Level II, III and IV

Level II, III whose employees more than 50

(a) Para 11 to 16 re Accumulated Leave

(b) Para 46 and 139 – Discounting of amts more than 12 mths due

# Exemption and Relaxation in Disclosures

… AS 15 Continued

(c) Recognition and Measurement – Para 50 to 116
Presentation and disclosure – Para 117 to 123
(d) Recognition and Measurement – Para 129 to 131

Level II, III (less than 50) Level IV at any employees
All above – Only addition no Actuarial Valuation required

<u>AS 19 Lease</u> – Level II, III and IV
Certain paras not applicable – Disclosure of Financial and Operating Lease.

# Exemption and Relaxation in Disclosures

AS 26 Intangible Asset – Level IV

Para 90d(iii) and (iv) – Disclosure regarding Impairment Loss recognised and reversed in Stat. of P&L and

Para 98- An enterprise to give a description of any fully amortised intangible asset that is still in use.

AS 28 Impairment of Assets – Level II, III

No need to discount for working out VIU – Level II and Level III

Disclosures under 121(c) (ii)- For Individual asset -Reportable segment to which asset belongs,

# Exemption and Relaxation in Disclosures

… AS 28 Continued

Para 121(d) Disclosure - (i) For CGU-Description of CGU and (ii) Impairment loss recognised and reversed by class of asset and by reportable segment,

Para 123 –Disclosure -key assumptions used to determine the recoverable amount of CGU – Level III

# Exemption and Relaxation in Disclosures

AS 29 Provisions – Level II, III and IV

Para 66 – Disclosure regarding Carrying amount at the beginning and end, Additional provision made, Amount used, unused amount reversed and

Para67 – Disclosure regarding nature of obligation, indication of uncertainties about outflow, amount of any expected reimbursement

# Technical Guide

- In June 22, ICAI had issued a Technical Guide
- Accounting Standards applicable to NCE
- Format of FS applicable to NCE
- Presently an exposure draft of Guidance Note circulated which will supersede Technical Guide.

# AS-7 CONSTRUCTION CONTRACTS

***CA KUSAI GOAWALA***

# What is a Construction Contract ?

- Is a contract:
  - specifically negotiated
  - for a construction of an asset or combination of assets
  - that are closely interrelated or interdependent
  - for their design, technology and function or their ultimate purpose or use.

# Types of Construction Contract

- **Fixed Price Contract**

  - A Lumpsum price is agreed for work
  - Easy to determine the sales contract estimate

- **Cost Plus Contract**

  - The Sale price will depend upon cost to be added by profit as decided
  - The Sales estimate will depend upon cost to be incurred hence cost estimate is critical

# Combining and Segmenting

- **One contract but many assets**
  - If different assets are separately negotiated
  - It is possible to accept one or other
  - Each asset – cost and sales value can be determined
- **Many contracts but considered as one**
  - Group of contracts negotiated as a package
  - They are closely interrelated with similar profit margin
  - They are performed concurrently or in continuous sequence.

# Contract revenue and cost

- **Contract Revenue**

  - Initially agreed
  - Variations :
    - It is probable that it will result in revenue
    - It is possible to reliably measured

- **Contract Cost**

  - Cost directly related to the Contract
  - Cost attributable to contracts in general and to the contract
  - Cost chargeable to customer under the contract

# Criteria for recognition of revenue

- **Under fixed price method**

  - Total contract revenue can be measured reliably
  - Contract cost and Percentage completion can be measured reliably
  - Economic Benefits will flow to the entity
  - Contract cost attributable to contract can be identified and comparable with estimate

- **Under cost plus contract method**

  - Economic Benefits will flow to the entity
  - Contract cost attributable to contract can be identified

# How to compute Contract revenue

- **Under fixed price method**
  - Compute Total Estimated Revenue from the contract
  - Compute total estimated contract cost for the entire project
  - Find out percentage completion of the work done
  - Apply percentage to the Total Contract Revenue less revenue already recognised in earlier years for that contract
  - Deduct cost incurred during the period
  - Net result is contract profit
- **Under cost plus contract method**
  - Compute total cost incurred for the period
  - Apply profit or fee to be added to the cost
  - Compute revenue as total of both

# Issues relating to Construction Contracts

- Transfer of Risks and Reward
- Percentage Completion Method
- Revenue can be measured
- Cost Estimate and validation – Estimation Uncertainty.
- Where outcome cannot be estimated reliably
- Recognition of Expected Losses
- Accounting for Retentions – whether to recognise or not.
- Warranty

  - Standard Warranty arrangement – embedded in price
  - Estimate cost required to service warranty – AS 29
  - Based on past history
  - Possible future incidence based on corrective action on product failures

# Issues relating to Construction Contracts contd…

## Variation in Contract Work

- It is probable that it will result in revenue
- Capable of being measured
- Whether written or verbal confirmation – Trade practice
- Cost escalation clause
- Changes in design, scope, duration or specifications

## Percentage Completion

- Estimation of Cost
- Technical vs Cost Completion percentage
- Should reflect work performed
- Exclude stock of materials except where made specifically for contract
- Changes in revenue and cost estimate
- Cost to complete

# Issues relating to Construction Contracts contd…

## Allocable and Unallocable Cost

**1. Allocable**

- Direct Cost specifically related to contract
- Depreciation on machines used
- Warranty cost
- Insurance
- General technical cost allocated
- Construction overheads
- Borrowing Cost as per AS 16

**2. Unallocable**

- General Administrative Cost
- Selling Cost
- Research and Development
- Depreciation on idle plants

**3. Cost incurred for contract not yet received**

# Issues relating to Construction Contracts contd…

## Claims and Incentives

### 1. Criteria for recognition

- Negotiations have reached an advanced stage
- Probable that the same will be accepted
- Amount can be reasonably ascertained
- In case of incentives – contract at advanced stage and probable that the standard will be met

### 2. Nature of Claims

- Cost over runs
- Change orders that either unapproved or disputed
- Customer caused delays
- Contract terminations
- Errors in designs and specifications
- Reimbursement of cost not included in the contract
- Incentives

Example : Percentage Completion for Construction Contract :

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Estimated Contract Value | 1200 | 1200 | 1200 |
| Estimated Cost | 800 | 1000 | 1150 |
| Estimated Profit | 400 | 200 | 50 |
| | | | |
| Cost Incurred Till Date | 400 | 600 | 650 |
| Percentage Completed | 50% | 60% | 57% |
| | | | |
| Revenue Recognised Cumulative | 600 (1200*50%) | 720 (1200*60%) | 678 (1200*57%) |
| Cost Recognised | 400 | 600 | 650 |
| Profit Recognised (Cumulative) | 200 | 120 | 28 |
| | | | |
| Revenue Recognised For the Year | 600 | 120 | -42 |
| Cost Recognised For the Year | 400 | 200 | 50 |
| Profit Recognised For the Year | 200 | -80 | -92 |

# AS-9 REVENUE RECOGNITION

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**Revenue arising from**

- Sale of goods
- Rendering of services and
- Use by others of entity's assets yielding interest, royalties & dividend.

**Excludes revenue arising from**

- Lease Agreements
- Dividends arising from investments which are accounted for under the equity method
- Insurance contracts
- Change in the fair value of financial assets/liabilities
- Change in the value of other assets
- Relating to Biological Assets
- Extraction of mineral ores

**Revenue to be disclosed net of tax**

**Other Income**

- Interest - effective interest method – EAC (As per Standard – silent)
- Dividend - when shareholder’s right to receive payment is established
- Royalty - Charges for the use of assets such as knowhow, patents, trademarks & copyrights on accrual basis in accordance with the substance of the relevant agreement

- Sale of goods – 5 conditions
  - Transfer of significant risks and rewards
  - Does not retain involvement nor effective control
  - Revenue can be measured
  - Economic benefits will be derived
  - Cost can be measured reliably

- Rendering of services – 4 conditions
  - Revenue can be measured
  - Economic benefits will be derived
  - Stage of completion can be measured
  - Cost can be measured

- Only Proportionate Completion method is allowed
- In C&F agency enterprise – recognize only commission.

If significant risks of ownership is retained, transaction is not a sale and revenue is not recognized

**Revenue Recognition – Accounting Challenge**

a) Determines the top line as well as bottom line
b) Impacts true and fair presentation
c) Tax Angle – Direct and Indirect
d) Point of recognition
e) Quantum of recognition
f) Accrual Principles
g) E-Commerce transactions
h) Industry specific issues
i) Substance vs Form

**Special types**

- Contractual Revenue
- Real Estate Sales
- Joint Ventures
- Software
- Telecommunication

**Criteria for Revenue Recognition**

a) Accrued, Earned, Realisable or realised – Entity has substantially accomplished what it must do to be entitled to the contract benefits.
b) Transfer of significant risks and rewards
c) Quantum can be reasonably determined

Multiple Element Contracts

Bundling and Unbundling of Revenue

Combining and Segmenting

- Combining of two interrelated contracts
- Segmenting one contract into separate contracts
- Multiple elements in single arrangements
- Arrangements with similar facts but different accounting treatment
- Turnkey Contracts

**Examples :**

- Contract for construction and operation of Highway or a Gas pipeline
- Broadcasting airtime package – Prime time and Non Prime time slots
- Computer Hardware and embedded software
- Providing logistics services for containerised cargo
- Telecom Industry – Sale of Sim cards and bandwith (telephony + internet, etc)

- No guidance in Indian GAAP/IFRS. However, US GAAP has laid down principles in respect of the same.

- Revenue to be allocated on fair value basis amongst various elements.

- Computer Software which is required to operate the Computer Hardware is part of the hardware.

***Communication Revenue***

- *Revenues from Global Voice Services (GVS) are recognized at the end of each month based upon minutes of traffic completed in such month.*

- *Revenues from Global Data Managed Services (GDMS) are recognized over the period of the respective arrangements based on contracted fee schedules.*

  *Transactions with providers of telecommunication services such as buying, selling, swapping and/or exchange of traffic are accounted for as non-monetary transactions depending on the terms of the agreements entered into with such telecommunication service providers.*

**Special Arrangements**

a) Jointly controlled operations – top line sharing
b) Joint Development – top line sharing
c) Deferred Development Agreements – consideration by way of top line sharing
d) Agreements with allotment of flats against development rights
e) Transferrable Development Rights (TDR)

**Income from Joint Ventures**

- *Revenue from construction/project related activity and contracts executed in joint ventures under work-sharing arrangement [being jointly controlled operations, in terms of Accounting Standard (AS) 27 "Financial Reporting of Interests in Joint Ventures"], are recognised on the same basis as similar contracts independently executed by the Company.*

- *Profit/loss on contracts executed by Integrated Joint Ventures under profit-sharing arrangement [being Jointly Controlled Entities, in terms of Accounting Standard (AS) 27 "Financial Reporting of Interests in Joint Ventures"] is accounted as and when the same is determined by the joint venture. Revenue from services rendered to such joint ventures is accounted on accrual basis.*

**Issues and special considerations .....1**

- Accounting for Gift Vouchers
- Barter Transactions
- Delivered subject to conditions – Installations, Approval, Guaranteed Sales
- Sale/Repurchase Agreements
- Delivery Delayed at buyers request
- Export of Material – Date of Sale
- Software Delivery through Internet
- Principal –Agency Sales

**Issues and Special Considerations ....2**

- Admission Fees/Tuition Fees
- Ballooning of Interest income
- Special Order and shipments
- Volume Discount Received/Receivable
- Inter Unit Sales
- Revenue for Customer Loyalty Schemes

# Disclosures

- Accounting policies for revenue recognition
- If revenue is deferred or not recognised, the reasons for the same

# AS-10

# PROPERTY, PLANT & EQUIPMENT

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# AS 10 : Property Plant and Equipment

- ***Property, plant and Equipment*** : Tangible items that
  - are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
  - are expected to be used during more than a period of twelve months.
- ***Not Apply to*** :
  - Biological Asset other than bearer plant
  - Wasting asset including mineral rights, exp. on exploration for and extraction of minerals, oil, natural gas and similar non regenerative resources.
- Bearer Plant covered but does not apply to bearer produce – Bearer Plant is living Plant-
  - Used in the production or supply of agricultural produce
  - Expected to bear produce/fruits for more than 12 months
  - Has a remote likelihood of being sold as agricultural produce except for incidental scrap sale; example mango tree (But Annual crops are not bearer plant eg. Wheat)

- ***Recognition of an item of PPE*** – When Probable future economic benefits, Cost of item can be measured reliably
- ***Measurement of an item of PPE at the time of Recognition*** : at Cost
- Measurement of Bearer plant – same as self constructed Item of PPE – Cost of constructing an asset excluding internal profits and abnormal cost of wasted material, labor.
- ***Cost of PPE*** – Cash price equivalent at recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognized as interest over the period of credit unless such interest is capitalized in accordance with AS 16.
  - Eg: A Ltd purchases an asset at the value of Rs. 77,00,000 payable after 6 months, which is available on cash price of Rs. 70,00,000, in such case difference amount Rs. 7,00,000 shall be treated as Interest charged over the credit period, which shall be debited to Profit and loss account.
- When asset exchanges for non-monetary asset – Cost measured at fair value unless, Exchange transaction lack commercial substance or fair value is not reliably measured. When fair value not reliably measured, cost determined at carrying amount of asset given up.
- When Several item of PPE purchased at consolidated price, consideration shall be apportioned between various item on the basis of their respective fair value.
- Cost of Item shall be reduced by Government grant as per AS 12

- ***Measurement after Recognition :*** Cost model or Revaluation model
- If Revaluation model – Assess at regular intervals when Value fluctuations are volatile – annually, Else every 3-5 years – to ensure that the carrying amount does not differ materially from its fair value at the balance sheet date.
- If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

- ***Revaluation of an item of PPE :***
  - Upward = Revaluation Surplus a/c – Revaluation Reserve
  - Downward = P&L a/c
- Revaluation reserve transfer to Revenue reserve when asset is derecognized.
- Major Inspection Cost – Capitalize –recognized as Replacement
- Any remaining carrying amount of the cost of previous inspection is derecognized.

- ***Depreciation***
- Each part of item of PPE is with a cost that is significant in relation to the total cost should be depreciated separately.
- Depreciation method : SLM or WDV or Units of Production Method
- Useful life of item is specified in Schdule II of Companies Act, 2013

- Rate of depreciation is calculated on the basis of useful life of asset by using the formula given in companies Act, 2013 – Rate of Depre = [1-(S/C)^1/N]*100
  - Where S = Salvage Value (5% of Cost)
  - C = Cost of Item
  - N = Useful life of Asset
- Change in method of Depreciation : Change in accounting policy – Prospective effect
- Useful life of asset and Residual value of the Asset is reviewed at each financial year-end. If expectation differs – change in accounting estimates as per AS 5

- **Change in Existing Decommissioning, Restoration and Other Liabilities:**
- Cost of PPE Changes subsequently – when changes in liabilities, price adjustments, changes in duties, changes in initial estimates.
- How to dealt with above changes :
  - If asset is measured using Cost model:
    - Change in liabilities should be added to/deducted from the cost
    - If adjustment result in addition to the cost of asset, whether is there indication that carrying amount may not be fully recoverable – Test the impairment by estimating its recoverable amount.

- If asset is measured using Revaluation model:
  - Changes in liabilities alter the revaluation surplus or deficit previously recognised on that asset
- Once the asset reached at end of useful life, all subsequent changes in the liability should be recognised in the statement of profit and loss as they occur.

- ***Impairment*** of Asset as per AS-28
- Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately.
- Compensation for impairment – included in statement of profit and loss when the compensation become receivable

- ***Retirement*** of item – When item retired from the active use and held for disposal should be stated at the lower of their carrying amount and net realisable value. Written down shall be recognised immediately in the statement of profit and loss.

- **Derecognition :** Carrying amount of an item of PPE shall be derecognized
  - On disposal; or
  - When no future economic benefits are expected from its use or disposal.
- **Gain/loss on derecognition**
  - Gain/loss and derecognition shall be included in the statement of profit and loss
  - Gain/loss = Net disposal proceeds – carrying amount of the item.

- **Component Accounting**
- Schedule II to the Companies Act 2013 requires that useful life for significant components of tangible assets should be determined separately. This requirement is commonly known as 'Component Accounting'

To depreciate significant components separately if Useful life differs. Option to depreciate insignificant parts separately.

Eg. 1. Aircraft – The airframe, the engine interiors have different individual useful lives. If the life of airframe is taken as life of aircraft, then how should the expenditure on replacement of interiors and engines during the life dealt with? Hence component of a single asset is treated as different assets for accounting purpose.

2. A composite asset costs R100. It has a major component X, whose cost is R40. This component is expected to have a life of 4 years while the rest of the asset is expected to have a life of 20 years. Here component is treated as separate asset.

a) Depreciation on major component – (40/4) = 10
b) Depreciation on rest of the asset – (60/20) = 3
c) Total Depreciation = 13

- **Replacement of Components**

The new part shall be capitalized if it fulfills the recognition criteria and the replaced part shall be derecognized.

# AS-15 Employee Benefits

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To recognize expense of benefit to employees during their service period which may be paid :

- Short term employee Benefit, such as wages, salary currently
- Post employment benefit such as gratuity, pension, other retirement benefit on Retirement
- Other long term employee benefit including long service leave, sabbatical leave, bonuses post retirement
- Termination benefits

Covers all kinds of employees

- Permanent
- Casual
- Temporary

# Scope

**It covers all employee benefits as per –**

- Formal Agreement
- Legislative Requirement
- Informal Practice

**Does not Cover –**

- Employee share based payments – Guidance Note
- Accounting and reporting by employee benefits plans.

# Definitions:

**a. Employee benefits**: All form of consideration given by an enterprise in exchange of service rendered by employees

**b. Vested employee benefits**: benefits that is not conditional on future employment.

**c. Current service cost**: Increase in present value of defined benefit obligation from employee service in current period.

**d. Plan assets:**

- Assets held by long term employee benefit fund and
- Qualifying insurance policies

**e. Fair value** : Amount for which asset could be exchanged or liability settled between knowledgeable, willing parties in an arm's length price.

# Nature of benefits :

## Short term Benefits:

(payable within 12 months after providing service)

- Wages, Salaries and Social Security contributions
- Leave Compensation (Compensated Absences)
- Profit sharing and Bonus
- Non Monetary benefits
  - Free and subsidized goods and services

## Post employment Benefits:

- Falls due only after completion of employment
- Retirement Benefits ex: gratuity and pension
- Provident Fund
- Post employment medical care

## Long term Benefits:

(payable after 12 months after providing service)

- Long service or sabbatical leave
- Long term disability benefits
- Profit sharing and bonus
- Deferred compensation

## Termination Benefits :

- Falls due when employer-employee relation ends
- Compensation & other benefits on termination or premature retirement.
- Example:VRS

# Profit sharing & Bonus:

**Recognition (only when)**

- Present obligation to make payments as result of past events
- Reliable estimate of obligation can be made:
  - Formal terms of plan contain formula for determination
  - Enterprise determines amount to be paid before financial statements are approved
  - Past practice gives clear evidence of amount.
  - Eg: A profit-sharing plan requires an enterprise to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of net profit. The enterprise estimates that staff turnover will reduce the payments to 2.5% of net profit. The enterprise recognises a liability and an expense of 2.5% of net profit.

# Post Employment Benefits

- Defined Contribution Plan
- Defined Benefit Plan

# Defined Contribution Plan

- Enterprise pays fixed contribution into separate fund and will have no obligation to pay amount in future.
- In event of shortfall in fund- No further obligation
- If Actuarial risk (benefits will be less than expected) and Investment Risk (assets invested will be insufficient to meet expected benefits) fall on employees – DCP else DBP

**Accounting Treatment:**

- Obligation falls due within 12 months – Adopt Accrual Basis of accounting
- Obligation to pay doesn’t fall due within 12 months – Present value Concept

# Defined Benefit Plan

- Post employment benefit plan other than defined contribution.
- Obligation to pay arises as employee render services.
- The provision is required even if the benefits are not vested
- Adopt present value concept and recognize future liability.

- Eg : A defined benefit plan provides a lump-sum benefit of Rs. 100 payable on retirement for each year of service. A benefit of Rs. 100 is attributed to each year. The current service cost is the present value of Rs. 100. The present value of the defined benefit obligation is the present value of Rs. 100, multiplied by the number of years of service up to the balance sheet date.

# Recognition:

**Liability** = Present value of defined benefit obligation – fair value of plan assets – Past service cost net yet recognised

**Profit & loss:**

- Current service cost
- Interest Cost
- Expected return on plan asset
- Actuarial gain or losses
- Effect of any curtailments & settlements
- Past service cost

- Actuarial Profit/Loss to be debited to Profit and Loss account immediately.
- Use Projected Unit Credit (PUC) Method
- Provision required for Gratuity even if employees have not completed 5 years
- Restrictions on recognition of Asset  - Para 55 of AS15

# Obligation under Post Employment benefit plan

- Funded Obligation
  - Company has planned asset
    - Multi-Employer Plans
    - State Plans
    - Insured Plans
- Non- Funded Obligation
  - Company does not have planned asset

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## Multi-Employer Plan:

- Pool the asset contributed by various enterprises that are not under common control
- Assets provide benefits to employees of more than one enterprise
- Contingent liability for Actuarial loss of other employers

## State Plans:

- Established by legislation
- Operated by national or local government

## Insured Plans:

- Contribution is made in form of insurance premiums.
- Generally classified as defined contribution plan
- If enterprise retains such obligation, it is treated as defined benefit plan.

# Actuarial Assumptions

- Unbiased

| Demographic Assumptions | Financial Assumptions |
|---|---|
| Mortality (during & after employment) | Discount rate – Government Rate |
| Rate of employee turnover, disability & early retirement. | Future salary & benefit levels |
| Proportion of plan members with dependants eligible for benefits | Expected rate of return on plan assets |
| Claim rates under medical plan | In case of medical benefits, future medical costs, cost of administering claims. |

# Termination Benefits

- Golden Hand shake – VRS
- Legal liability vs Constructive Liability
- Initial deferment clause has expired - Effective 1.4.2010 - write off to P&L

# Disclosure

- The amount recognized as an expense for defined contribution plans.

**<u>Defined benefit plan:</u>**

- Accounting policy for recognizing actuarial gains & losses.
- Nature of Defined Benefit plan & effect of changes if any.
- Reconciliation of opening & closing balances of present value of defined benefit obligation.
- A reconciliation of opening & closing balance of fair value of plan asset and reimbursement right recognized as an asset.
- Total expense recognized in statement of profit & loss.
- Principal actuarial assumptions used at balance sheet date.

# Audit Perspective

- Reliance on Certificate of an Expert – Actuary
- Disclaimer given by Actuary and Management Representation
- Inputs given to Actuary are the basis of valuation – to be verified by Auditor

Case Study :

1. The following are the data apply to X Ltd. Defined Benefit Plan for the year ended 31.03.2002. Calculate the actual return for plan asset.

| | ` |
|---|---|
| Employer Contribution | 2,80,000 |
| Fair Market value of Plan Asset as on 31.03.2002 | 11,40,000 |
| Fair Market value of Plan Asset as on 31.03.2001 | 8,00,000 |
| Benefits Paid | 2,00,000 |

- Solution :

| | ` |
|---|---|
| Fair Market value of Plan Asset as on 31.03.2001 | 8,00,000 |
| Add : Employer Contribution | 2,80,000 |
| Less: Benefit paid | 2,00,000 |
| (A) | 8,80,000 |
| Fair Market Value of Plan Asset as on 31.03.2002 (B) | 11,40,000 |
| Actual Return of Plan Asset (B-A) | 2,60,000 |

# *AS-16 Borrowing Costs*

***CA KUSAI GOAWALA***

Objective

To prescribe the **accounting treatment for** borrowing costs

**Accounting treatment of *any cost***

Include in the cost of the asset

Recognise it as an expense in the P&L Statement

AS 16- *Flow of Study*

Meaning and Computation of Borrowing Costs

Accounting Treatment of Borrowing Costs

**What is Borrowing Cost?**

Para 3 of AS 16:**-**
Borrowing costs are interest and other costs incurred by an enterprise **in connection with the borrowing of funds.**

Explanatory Para 4 of AS 16 Borrowing

Borrowing costs may include:
(a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
(b) **amortisation of discounts or premiums relating to borrowings;**
(c) **amortisation of ancillary costs incurred in connection with the** arrangement of borrowings;
(d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
(e) exchange differences arising from foreign currency borrowings **to the extent that they are regarded as an adjustment to interest** costs.

**Query:**

The company has replaced high cost debt from a bank with low cost debts from another bank by making a 2% prepayment fee. As per AS 16, borrowing costs include amortisation of ancillary costs incurred in connection with the arrangement of borrowings. Whether 2% prepayment fee could be treated as being in the nature of a borrowing cost for purposes of capitalisation under AS-16?

**Ans**:- The question will be solved with reference to AS 16 "Borrowing Costs" issued by ICAI and notified under the Companies (Accounting Standards) Rules, 2006.

According to AS 16 Borrowing costs means interest and other cost incurred by an enterprise in connection with the borrowing of funds.

In a given case, the prepayment fee is incurred by the company for the extinguishment of borrowings . It is not incurred for the arrangement of borrowings. Further there is no nexus between borrowings from the earlier lending bank and the new lending bank, it can not be regarded as borrowing cost under AS 16.

Para 4(e) of AS 16

exchange differences arising from foreign currency borrowings **to the extent that they are** regarded as an adjustment to interest costs.

**ASI 10**

According to ASI 10 Adjustment to the interest cost means the difference between the interest on foreign currency loan and the interest that would have paid on local currency loan had this loan been in local currency

Illustration on para 4(e)

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was Rs.45 per USD. The exchange rate, as at March 31,20X4,is Rs.48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 20X3.

**Solution:**

Explicit cost = $10000 x 5% x 48 = 24000

Implicit Cost = $10000 x (45-48) = Rs.30000

AS 16

AS 11

4500

The difference between :-
Interest Paid on $ Loan
$10000 x 5% x 48 = 24000

AND

Interest that would have paid on = 49500
INR Loan $10000 x 45 x 11% 25500

Total Borrowing Costs as per AS 16 = 24000 + 25500 = 49500

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**Additional Question**

How will your answer change in the above case if the local interest rate is 13% instead of 11%

**Solution:**

Explicit cost = $10000 x 5% x 48 = 24000

Implicit Cost = $10000 x (45-48) = Rs.30000

AS 16

The difference between :-

Interest Paid on $ Loan
$10000 x 5% x 48 = 24000

AND

Interest that would have paid on
INR Loan $10000 x 45 x 13% = 58500

34500

Maximum that can be considered under AS 16 = 30000

Total Borrowing Costs as per AS 16 = 24000 + 30000= 54000

AS 11

NIL

## Accounting Treatment of Borrowing Costs

- **Concept of Qualifying Asset:-**

(Para 3 of AS 16)

A qualifying asset is an **asset that necessarily takes a substantial period of time to get ready for its** intended use or sale.

**Concept of Asset**

Asset is a resource **controlled by an enterprise** from which **future economic benefits are** expected to flow to an enterprise.

**Substantial Period of time (ASI 1)**

The issue as to what constitutes a substantial period of time primarily depends on **the facts and circumstances of each case. However, ordinarily, a** period of **twelve months is considered as substantial** period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case

*Examples of Qualifying Asset*

**Recognition of Borrowing Costs**

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing cost should be recognised as an expense in the period in which they are incurred.

**Commencement of Capitalisation**

3 Conditions

- Expenditure for the acquisition, construction or production of a qualifying asset is incurred;
- Borrowing costs are being incurred;
- Activities that are necessary to prepare the asset ready for its intended use or sale are in progress

Borrowing Cost eligible for capitalisation

Specific Borrowings

Actual Borrowing Costs
incurred
MINUS
Temporary Investment
Income of those
borrowings

General Borrowings

Use Capitalisation
Rate
(Weighted Average
of borrowing costs)

**Example**

X Ltd borrowed the following as on 1st April 2012:-

| | |
|---|---|
| 12% SBI Loan | Rs.100 lacs |
| 13% Debentures | Rs.200 lacs |

The amount is utilised on the following assets

Power Plant- Rs.150 lacs (Work started from 1st May 2012 and completed on 31st March 2013)

Working Capital -Rs.150 Lacs

Compute the Borrowing Costs and give the treatment thereof for FY 2012-2013.

**Solution**

Computation of Borrowing Costs

| | |
|---|---|
| 12% SBI Loan 100 lacs x 12% | = 12 lacs |
| 13% Debentures 200 lacs x 13% | = 26 lacs |
| Total Borrowing Cost | 38 lacs |

Since the borrowings are General Borrowings we need to calculate capitalisation rate.

Capitalisation Rate = 26 lacs + 12 lacs/ 300 lacs

= 12.67%

**Solution**

Treatment of Borrowing Costs

Power Plant 150 lacs x 12.67% x 11/12 = 17.42 lacs

Revised Cost of Plant = 150 + 17.42 = 167.42 lacs

Working Capital= 150 lacs x 12.67% = 19 lacs

Since Working capital is not qualifying asset, borrowing cost cannot be capitalised.

**Solution**

Total Borrowing Cost in 2012-2013= 38 lacs

Capitalised as per AS 16

Recognised as an Expense in P&L Statement

Rs.17.42 lacs

Rs.20.58 lacs

Para 17 - Suspension of Capitalisation

Capitalisation of borrowing cost should be suspended during extended period in which active development is interrupted.

Suspension of Capitalisation

Avoidable Reasons

The Capitalisation of borrowing costs should be suspended as the borrowing cost incurred during such period is the cost of holding incomplete asset

Unavoidable Reasons

Enterprise can continue to capitalise the borrowing cost subject to prudence

**Cessation of Capitalisation**

Capitalisation of borrowing cost should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

e.g. *Construction of Cinema Hall completed on 1 Jan 2013. However license to exhibit the shows is obtained from local authority as on 1st March 2013. Assuming the construction is out of borrowed funds when shall enterprise cease to capitalise the borrowing cost?*

**Cessation of Capitalisation**

When the construction of qualifying asset is completed in parts and completed part is capable of being used while the construction continues for the other parts, capitalisation of borrowing cost in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete

**Disclosures**

- The accounting policy adopted for borrowing costs and
- the amount of borrowing costs capitalised during the period

# *AS-18 -Related Party Disclosures*

***CA KUSAI GOAWALA***

**Related Parties :**

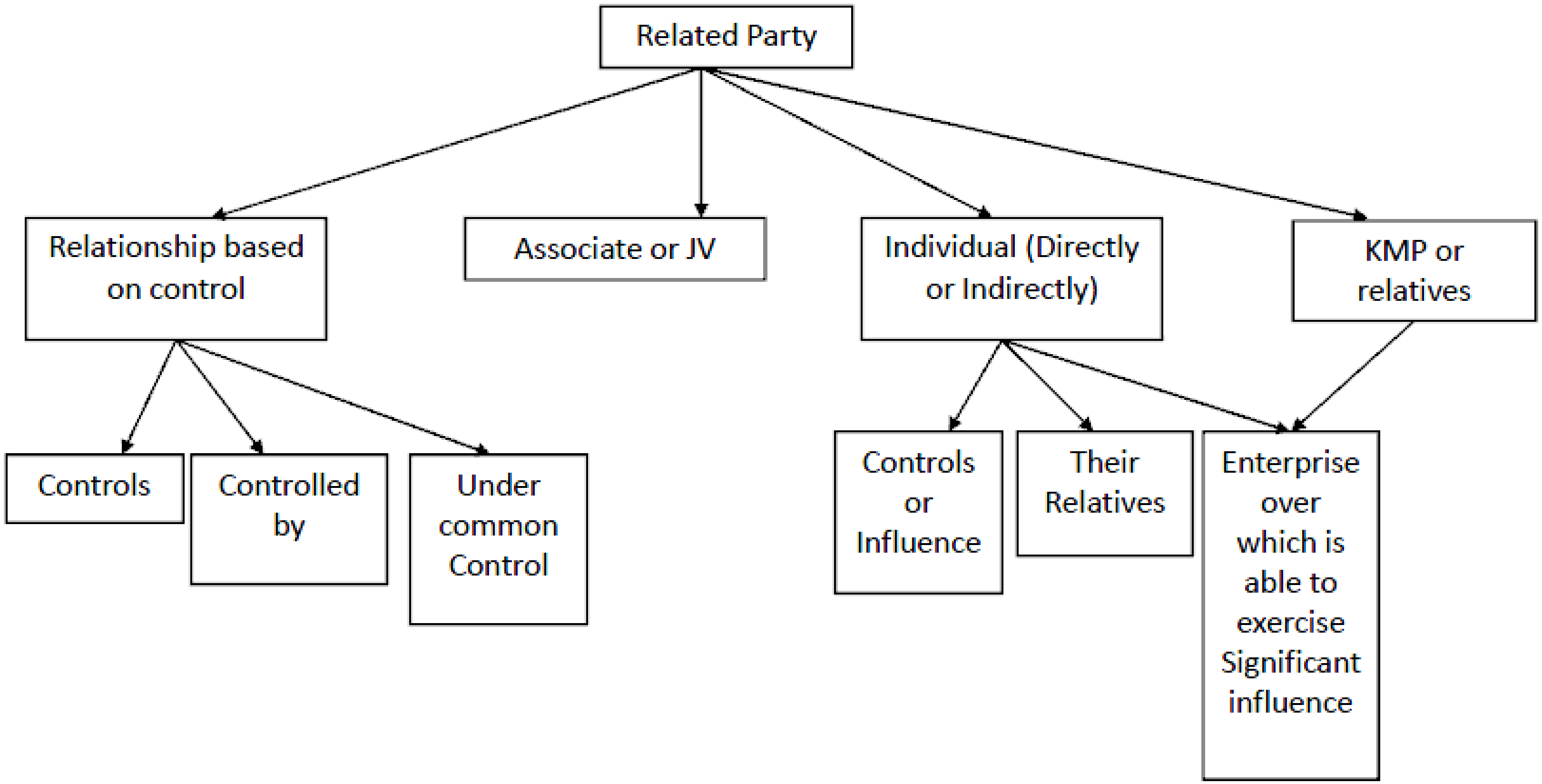
**Category 1**

- Holding – Subsidiaries
- Joint Ventures
- Associates

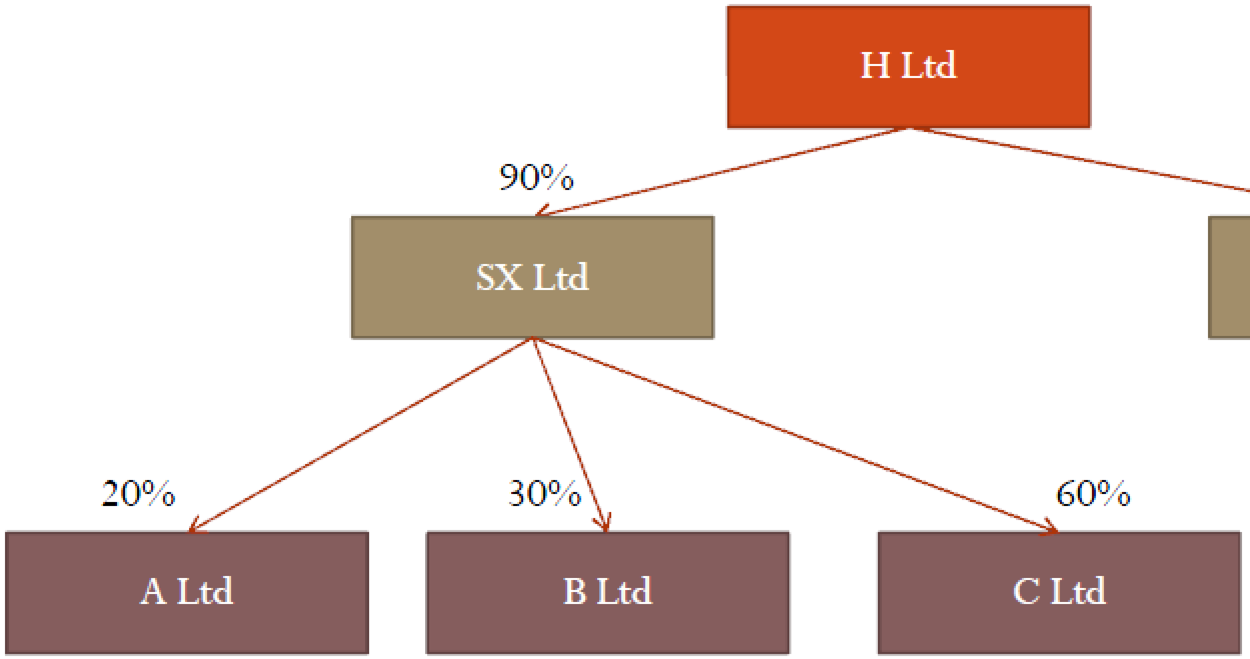
**Category 2**

- Key Management Personnel of Entity or parent
- Close Relatives of KMP
- Entities which are controlled/jointly controlled/ having significant influence of KMP/Relatives
- Employees Retirement Benefit Plans

- KMP who has authority and responsibility for planning/directing
- Common director need not mean Related Party
- Common KMP – Yes
- KMP in one and director in another – ability to exercise significant influence
- Indirect relationship - meaning
- Relatives – Spouse/Domestic Partner, Children of both, Dependants of self/partner.
- Names to be given in cases where absolute control exists even if no transactions

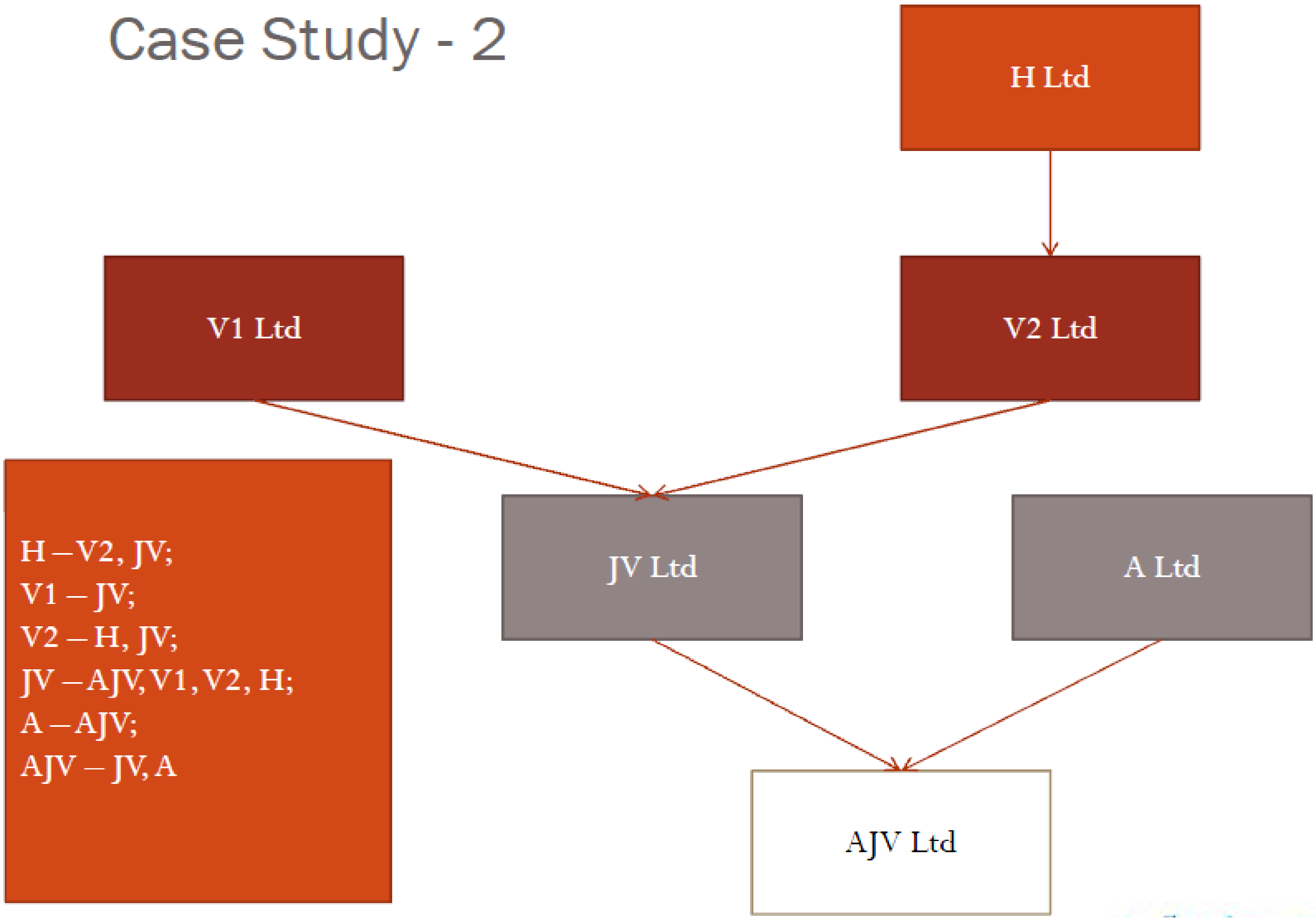

Related Party
Relationship based on control
Associate or JV
Individual (Directly or Indirectly)
KMP or relatives
Controls
Controlled by
Under common Control
Controls or Influence
Their Relatives
Enterprise over which is able to exercise Significant influence

# Case Study - 1




H – SX, SY, C;
SY – H, SX;
SX – H, SY, A, B, C;
C – SX, H, SY;
A, B - SX

# Case Study - 2


H Ltd
V1 Ltd
V2 Ltd
JV Ltd
A Ltd
AJV Ltd
H – V2, JV;
V1 – JV;
V2 – H, JV;
JV – AJV, V1, V2, H;
A – AJV;
AJV – JV, A

## Case Study - 3

- A husband and wife controls 35% of voting power in A Ltd.
- They also are partners in HW Suppliers
- HW suppliers sells goods to A Ltd.
- Will it be considered as a related party transaction?

YES

- All kinds of transactions to be reported:
  - Sales
  - Purchases
  - Services received/rendered
  - Loans received/given
  - Guarantees given/received
  - Dues from/to
  - KMP Compensation
  - Any other transactions Lease, Transfer of R & D, transfer under license agreements etc
- Transactions of 10% of aggregate to be disclosed separately – whether 10% of total or related parties

# Relatives

- Father, Mother
- Brother, sister
- Son, Daughter
- Spouse

# Disclosure

- Name of the related party
- Nature of transaction
- Amount in absolute or proportion
- Outstanding balance
- Amounts written off

# AS 22 – Accounting for Taxes on Income

***CA KUSAI GOAWALA***

# AS 22 : Accounting for Taxes on Income

- Scope : This Standard should be applied in accounting for taxes on income. Which includes :
  - determination of the amount of the expense or saving related to taxes on income in respect of an accounting period and
  - the disclosure of such an amount in the financial statements.
- **Why Deferred Tax Provision:**
  - Making a provision for tax on income in the same year of its accrual irrespective of its actual due

## Situation before Deferred Tax provisions :

| Particulars | Year 1 (Figures in Lakh) | | Year 2 (Figures in Lakh) | |
|---|---|---|---|---|
| | Books | IncomeTax | Books | IncomeTax |
| Profit Before Tax | 110 | 110 | 110 | 110 |
| Depreciation | 10 | 110 | 10 | 0 |
| Profit Before Tax | 100 | 0 | 100 | 110 |
| Provision for Income Tax | 0 | 0 | 33 | 33 (110*30%) |
| Profit After Tax | 100 | | 67 | |
| EPS (PAT / No. of Share) | 10 | | 6.7 | |

Here assumes that

1. The profit before tax is same for year 1 and year 2, where Depreciation is allowed 100% in the 1st year as per Income Tax.
2. Total No. of Shares are 10 Lakh.

## Situation after Deferred Tax provisions :

| Particulars | Year 1 (Figures in Lakh) | | Year 2 (Figures in Lakh) | |
|---|---|---|---|---|
| | Books | IncomeTax | Books | IncomeTax |
| Profit Before Tax | 110 | 110 | 110 | 110 |
| Depreciation | 10 | 110 | 10 | 0 |
| Profit Before Tax | 100 | 0 | 100 | 110 |
| Provision for Income Tax | 0 | 0 | 33 | 33 (110*30%) |
| Provision for Deferred Tax Liability/ (Asset) | 30 (100*30%) | | (-3) (-10*30%) | |
| Net profit after Tax | 70 | | 70 | |
| EPS (PAT / No of Shares) | 7 | | 7 | |

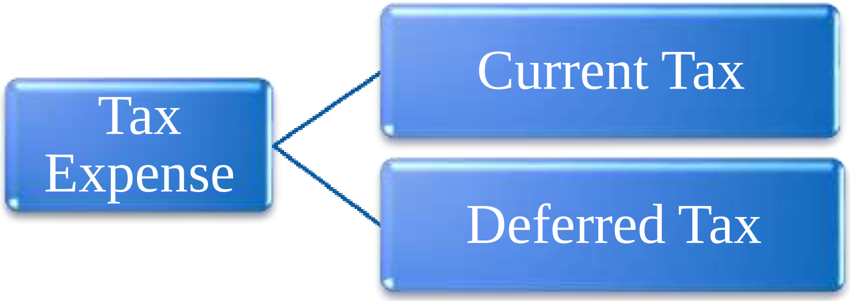
Here assumes that

1. The profit before tax is same for year 1 and year 2, where Depreciation is allowed 100% in the 1$^{st}$ year as per Income Tax.
2. Total No. of Shares are 10 Lakh.

- **Taxable Timing Differences vs Permanent Differences**
  - Timing Differences are those difference which originate in one period and capable of being reverse in one or more subsequent period
    - Eg. 1.Difference in depreciation charge as per income tax and as per Companies act

      2.Expense disallow U/s 43B later allowed when actually pays etc.
  - Permanent Difference are those difference which originate in one period and do not reverse subsequently Eg. Income Exempt from tax, Expense not allowed as deduction

- **Recognition :**




- The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or deferred tax liabilities, in the balance sheet
- Permanent differences do not result in deferred tax assets or deferred tax liabilities.

## Re-assessment of Unrecognized Deferred Tax Assets :

- At each balance sheet date, an enterprise re-assesses unrecognized deferred tax assets to the extent that it has become reasonable certain or virtually certain. Sufficient future taxable profit will be available against which deferred tax asset can be realized.
  - Eg: Improvement of Trading conditions may make reasonably certain that there will be sufficient taxable profit in future.

## Measurement :

- Current Tax :- at the amount expected to be paid to the taxation authorities, using applicable tax rate and tax laws.
- Deferred Tax assets and liabilities :- Tax rate and tax laws that have been enacted/ substantively enacted by the balance sheet date on timing difference
- Explanation : 1. The payment of tax under section 115JB of the Income Tax Act is a current tax for the period.

  2. When company pays current tax u/s 115JB, deferred tax measured at the regular tax rate and not tax the rate specified u/s 115JB.

  3. Deferred tax assets and liabilities should not be discounted to their present value

4. The deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised

5. Unabsorbed depreciation and carry forward of losses which can be set off against future taxable income are also considered as timing differences and result in deferred tax assets, subject to consideration of prudence, supported by convincing evidence.

# When to create DTA, When DTL :

Book profit higher than the taxable profit → Pay less tax now → Pay more Tax in Future → Create Deferred Tax Liabilities (DTL)

Book profit less than the taxable profit → Pay more tax now → Pay less Tax in Future → Create Deferred Tax Asset (DTA)

## Presentation and Disclosure :

- An enterprise should **offset assets and liabilities representing current tax** if the enterprise: (a) has a legally enforceable right to set off the recognised amounts; and (b) intends to settle the asset and the liability on a net basis.
- An enterprise should **offset deferred tax assets and deferred tax liabilities** if: (a) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and (b) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

## …Continued **Presentation and Disclosure :**

- In the Balance sheet, Disclose under separate heading of Deferred Tax Asset/liabilities, separately from current assets and liabilities.
    - Deferred tax asset – separately after the head 'Investment'
    - Deferred tax liabilities – separately after the head 'Unsecured Loans'
- The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

## Transitional Provision :

- On First implementation of the standard, the net deferred tax balance accumulated prior to adoption of the standard should be adjusted against revenue reserves.

**Case Study:**

1. Let's understand how DTA/DTL created in the books with simple example :

Amount in Lacs

| Particulars | Books | Income Tax | Difference | (DTA)/DTL @ 30% |
|---|---|---|---|---|
| Income | 1000 | 800 | 200 | |
| Opening Bal. of (DTA)/DTL | - | - | - | - |
| Depreciation | 100 | 200 | 100 | 30 |
| Sales Tax payable | 50 | 0 | (50) | (15) |
| Leave Encashment | 200 | 100 | (100) | (30) |
| Closing Bal. of (DTA)/DTL | - | - | - | (15) |

Current Tax on Taxable Income = 800*30% = 240 L
Deferred Tax Asset/income (As above) = (15) L
Net Tax Effect = 225 L

# AS 28: Impairment of Assets

***CA KUSAI GOAWALA***

# AS 28 : Impairment of Assets

- **Applies to all entities**
- **Assets not covered :**
  - Inventories (AS- 2 )
  - Construction Contracts (AS – 7)
  - Deferred Tax Assets (AS – 22)
  - Financial Assets including Investment Property (AS – 13)

# Impairment vs Depreciation

- Depreciation is amortization based on useful life

- Impairment is value based

**If indication of impairment exists :**

- Useful life of the asset need to be re-evaluated
- Depreciation amount to be re-evaluated
  (even though no impairment found)
- Residual value needs to be reviewed

# When to test for impairment

Look for symptoms. Only if symptoms exists – test for impairment

- **Existence of Symptoms - Test for impairment**
  - External Factors
  - Internal Factors
- **External Source of Information**
  - Substantial decline in market value
  - Technological and other changes impacting adversely
  - Interest rates – increased

    need not require testing if :

    (a) Changes in Short Term Loans

    (b) Corresponding increase in cash inflows
  - Carrying Amount is more than market capitalization

# Factors – Test for Impairment Contd…

- **Internal Source of Information**
  - Obsolesce of assets or physical damage of assets
  - Internal plans to re-organize / discontinue operations
  - Economic performance of asset worst than expected

# Impairment Testing – How ?

• Identify Cash Generating Unit (CGU) : Smallest independent source of revenue

(Product of CGU has active market even though consumed internally example tyre tubes)

**Impairment Loss = Carrying Amount – Recoverable Amount**

- First apply to individual asset.
- If RA for individual asset cannot be worked out use CGU.

# Recoverable Amount is :

**Higher of :**

- Fair Value less cost to sell
- Value in Use

Value in Use = Present Value of future cash flows of CGU and on ultimate disposal

Some special machines may not have a Realisable Value – Apply Value in Use.

In case of SMC, VIU can be worked out based on a Reasonable Estimate of the Value.

# Factors for calculating VIU :

- **Cash Flows**

  - Based on Supportable assumptions – greater weightage to external evidence
  - Maximum for five years
  - Cash Flow projections based on recent forecast with steady or declining growth rate
  - Current Conditions - Do not consider future expenditure and its revenue
  - Residual Value
  - No financial activities
  - Before tax impacts
  - Forex – PV as per foreign currency translated on valuation date.
  - Restructuring only if committed.

## Discount Rate – how determined

- Discounting rate – current market rate pre-tax covering risks specific to the asset.
  - Enterprise's Weighted Average Cost of Capital
  - Enterprise's Incremental Borrowing Cost
  - Other Market Borrowing Rates

**Adjust the above :**

- Add specific risks associated with cash flows
- Deduct risks not relevant to cash flows

**Consider :**

- Country Risk
- Currency Risk
- Price Risk
- Cash Flow Risk

# How to identify assets for impairment

First identify individual assets which have independent cash flows

If such assets not available, find cluster of assets (Cash Generating Unit – CGU to which such asset belongs)

**For example –**

One individual machine in a manufacturing line performing only one activity and its cash flow is dependant on the output of the entire production line.

– Entire Production Line is CGU

In some case some of the output may be used internally – example Tyres in Automobile Manufacturing unit

**Treatment of Impairment Loss :**

- Carrying Amount –Recoverable Amount = P&L

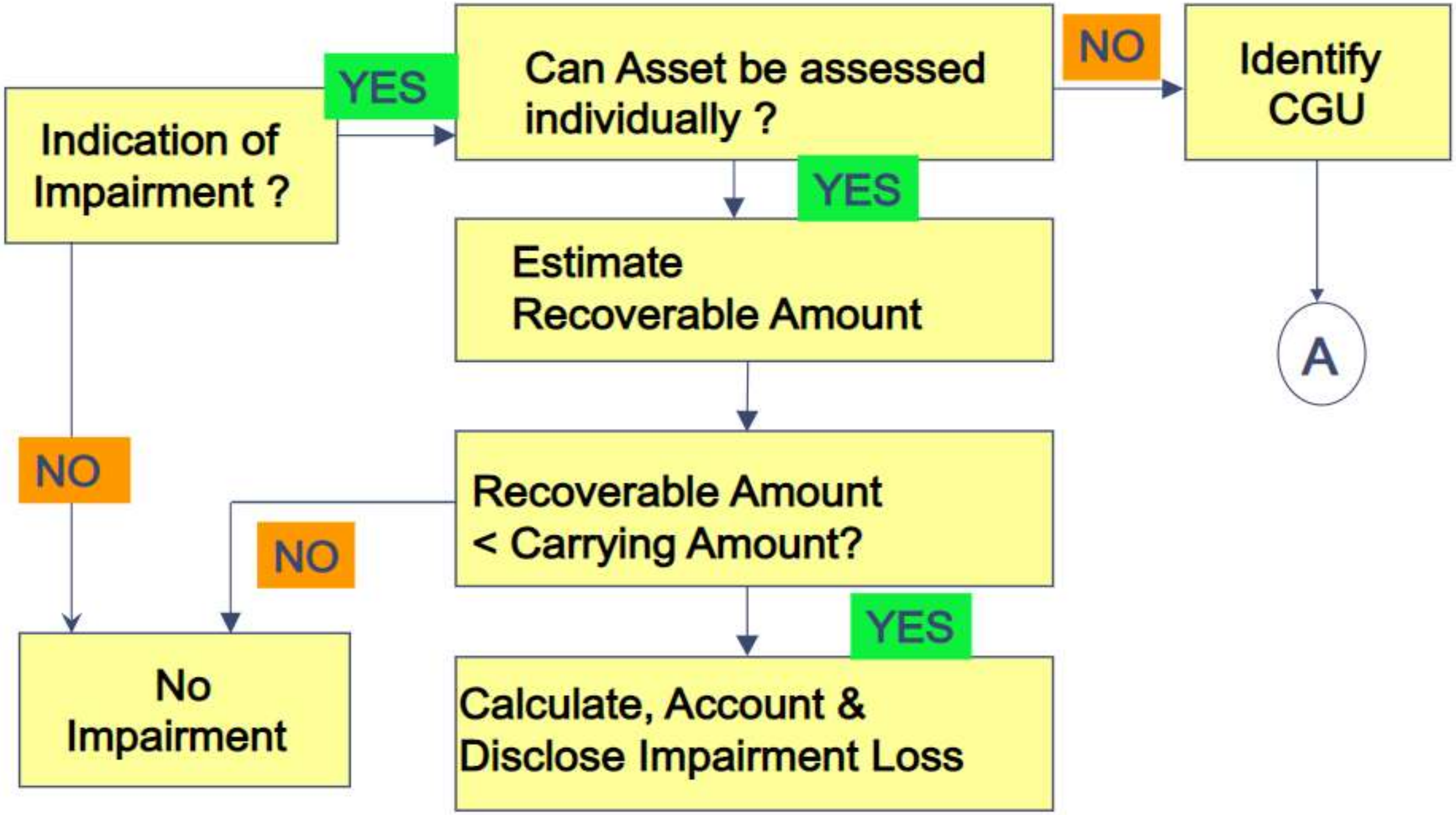
- If Carrying Amount is revalued
  - first reduce Revaluation reserve to that extent and
  - balance to P&L

**If RA is negative = provide a liability if other Standards permit else take Carrying Amount as NIL**

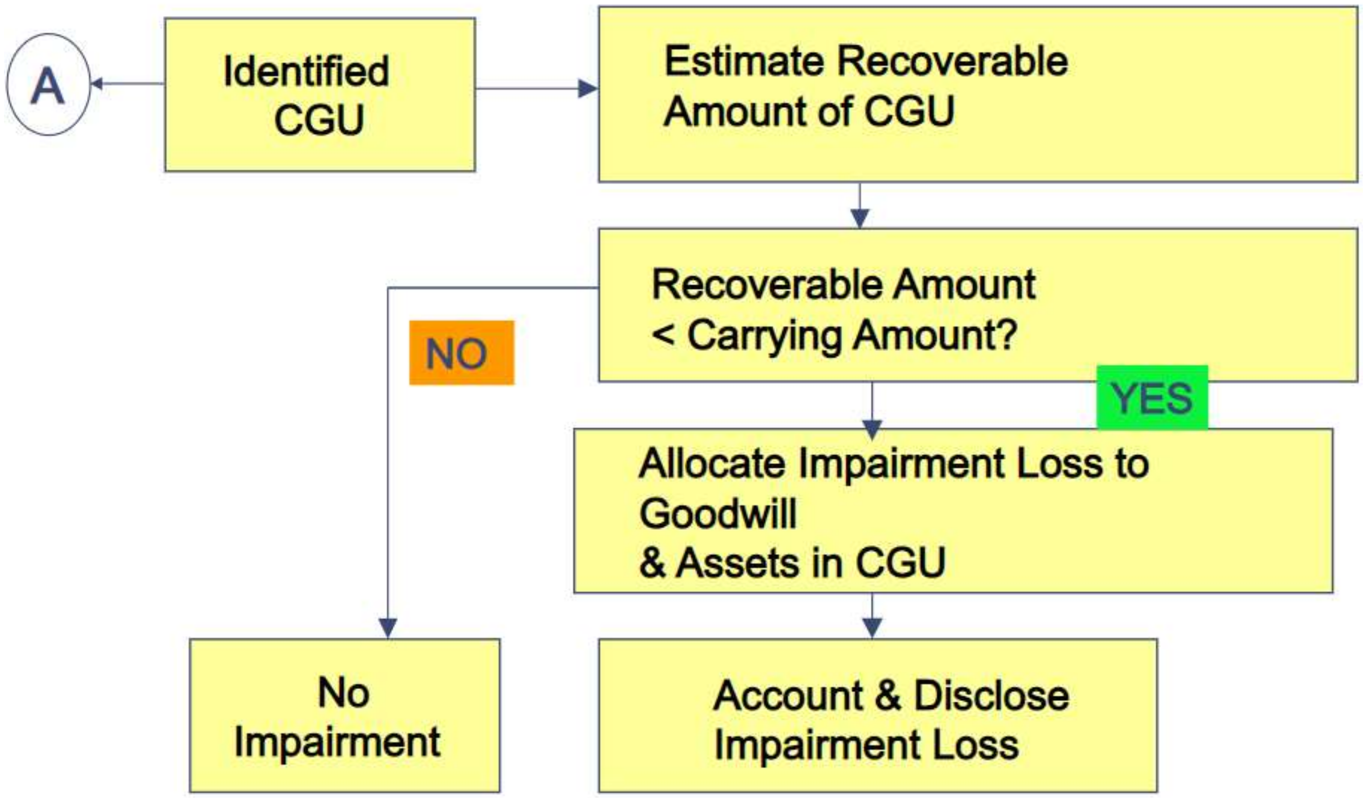
Deferred Tax Impact due to Impairment

Impairment Loss creates timing difference in tax computation as Impairment Loss is not allowable as expense
Hence recognise DTA as per AS22.

## Accounting for Impairment :



# Accounting for Impairment :



# Impact of Impairment on Depreciation

- Depreciation to be provided on the assets' revised carrying amount over its remaining useful life

- Previously recognized impairment loss is increased or decreased depending on the circumstances.

**Bottoms up test.**

**If goodwill relating to CGU being tested exists in the FS**

- Identify whether the carrying amount of the goodwill can be allocated
- Compare the recoverable amount and recognize any impairment loss

If carrying amount of goodwill could not be identified by bottom-up then use **'Top-down' test-**

- Identify smallest unit of CGU where Goodwill can be allocated that is the larger CGU above CGU being tested.
- Compare recoverable amount of the larger CGU and recognize any impairment loss

## Impairment of Goodwill :

| CGU | A | B | C | Total |
|---|---|---|---|---|
| Carrying Amount | 150 | 100 | 35 | 285 |
| Recoverable Amount | 115 | 105 | 40 | 260 |
| Goodwill | | | | 40 |

**First Step : Bottom up Test**

- Test only CGU which is impaired : CGU - A

| CGU | A |
|---|---:|
| Carrying Amount | 150 |
| Recoverable Amount | 115 |
| Impairment Loss | -35 |

## Second Step : Top Down Test -

- Full Company as larger CGU

| CGU | A | B | C | Goodwill | Total |
|---|---|---|---|---|---|
| Carrying Amount | 150 | 100 | 35 | 40 | 325 |
| Impairment loss in Bottomup Test | -35 | | | | -35 |
| Carrying Amount after Bottomup Test | 115 | 100 | 35 | 40 | 290 |
| Recoverable Amount | 115 | 105 | 40 | | 260 |
| Impairment Loss in Top down Test | | | | | -30 |

- **Total Impairment Loss : -65**
  **(Bottomup Test -35 & Topdown Test -30)**

# Impairment Loss in case of CGU with Goodwill

- First impact Goodwill then balance distribute to assets in CGU on pro-rata
- The value cannot reduce below zero

**For example :**

| | |
|---|---|
| Carrying Amount | Rs.100 |
| Goodwill | Rs. 50 |
| Machine | Rs. 50 |
| | |
| Realisable Amount | Rs.40 |
| Impairment Loss | Rs.60 |
| | |
| Carrying Amount after impairment adjustment | |
| Carrying Amount | Rs.40 |
| Goodwill | Rs. 0 |
| Machine | Rs. 40 |

# Corporate Assets

**Assets which are do not directly generate Cash but support activities of CGU**

**- Admin Office**
**- Research Department**
**- EDP**

- If possible to allocate to a CGU – allocate – apply bottoms up test
- If not possible to allocate to a CGU – apply Bottoms Up and Tops Down test both.

# Reversals of Impairment

- If external/internal sources favorable, check for reversals.
- Reversals to be given effect only if there is a change in estimates since last impairment loss.
- Change due to reduction in period of cash flow cannot reverse impairment .
- Cannot exceed Carrying Amount if Impairment loss was not recognized
- Impairment reversals to be taken to P&L except in case of revaluation impact.

# Reversals for goodwill – AS vs IFRS.

- IFRS prohibits reversals of impairment of Goodwill under any circumstances

- AS permits reversals of impairment of Goodwill only under certain circumstances :

    - Impairment was caused by specific external event of exceptional nature

    - This event has now been reversed

- Contradiction between AS26 and AS28

AS 28 para 109 accepts the fact that internally generated goodwill cannot be recognised.
Hence reversal of impairment of goodwill – recognition of internally generated goodwill.

# Discontinuing Operations

- Clear indication of impairment
- Since individual assets are not CGU, apply test on entire division
- Disposal is piecemeal, recoverable amount for individual assets
- If operation is abandon, then recoverable amount for individual assets.

# Disclosures

Impairment loss recognized for each class of asset

- PL, Revaluation Reserve

Impairment loss reversed

- PL, Revaluation Reserve

Segment wise break up of above, if applicable

Events and circumstances requiring

- Impairment
- Reversals

CGU description

Realisable Amount – Net Selling Price or Value in Use

Net Selling price – basis of determining

Value in Use - Discount rate applied for PV

Main Class of Assets impacted due to impairment or reversals

# ANY QUERIES?


*CA KUSAI GOAWALA*