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PAPER – 6E: GLOBAL FINANCIAL REPORTING STANDARDS

*The question paper comprises **five** case study questions. The candidates are required to answer any **four** case study questions out of **five**.*

Case Study - 1

GG Ltd., a listed company, prepares its first IFRS financial statements for the year ending 31st December, 2020. The date of transition is 1st January 2019. The functional & presentation currency is CU. The financial statements as at and for the year ended 31st December, 2020 contain an explicit and unreserved statement of compliance with IFRS. Previously it was using US GAAP as base.

It has already published its first interim results of quarter 1, quarter 2 and quarter 3 of 2020 in accordance with IAS 34 and IFRS 1. The interim financial report included the reconciliations both of total comprehensive income and of equity that are required by IFRS 1.

Since issuing the interim financial report, its management has concluded that one of accounting policy choices applied at the interim should be changed for the full year.

GG Ltd. has elected to apply its business combinations exemptions, but to restate all business combinations occurring after 1st February, 2015.

It undertook a step acquisition of Super Champ Inc. It acquired:

– *18% interest on 31st March, 2013;*

– *17% interest on 31st March, 2015; and ·*

– *29% interest on 15th November, 2015, which was the final step in the acquisition.*

GG Ltd. also operates oil exploration and production facilities. There· is a significant decommissioning obligation in connection with several oil wells, but it's previous GAAP did not require the obligation to be recognized.

On 1st January 2017, GG Ltd. issued 10,000 6% convertible debentures of face value of CU 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31st December 2020 or these may be converted into ordinary shares at the option of the holder. The interest rate for equivalent debentures without conversion rights would have been 11%. The premium payable on redemption was recognized under previous GAAP on straight line basis. Interest is paid annually. Premium is payable on redemption. Under the old GAAP, the instrument was not required to be split between equity & debt component. It was carried entirely as a debt instrument. The present value of CU 1 receivable at the end of each year based on discount rate of 6% and 11% can be taken as under:

End of year	*6%*	*11%*
1	*0.9434*	*0.9009*
2	*0.8900*	*0.8116*
3	*0.8396*	*0.7312*
4	*0.7921*	*0.6587*

GG Ltd. has four assets, each in a different class under property, plant & equipment.

Asset 1 and 2 are revalued under previous GAAP. Assets 3 and 4 are not. Under previous GAAP, at 31st December 2018, immediately prior to the entity's date of transition to IFRS, it Statement of financial position (extract) is as follows:

	Asset 1	*Asset 2*	*Asset 3*	*Asset 4*	*Total*
	Valuation	*Valuation*	*Cost*	*Cost*	
	CU	*CU*	*CU*	*CU*	*CU*
Cost or revaluation	*5,000*	*2,000*	*4,000*	*4,500*	*15,500*
Accumulated deprecation	*(1,000)*	*(500)*	*(2,000)*	*(1,700)*	*(5,200)*
Net book value	*4,000*	*1,500*	*2,000*	*2,800*	*10,300*
Revaluation surplus	*2,500*	*500*	*-*	*-*	*3,000*

On adoption of IFRS, its management decides that, under IFRS, it will:

- *Continue to revalue asset 1. The fair value of asset 1 at the date of transition is not materially different from its carrying value under previous GAAP;*
- *Use the previous valuation of asset 2 as deemed cost, and adopt a policy of cost less depreciation under IFRS;*
- *Adopt a policy of revaluation for asset 3. The fair value of asset 3 at the entity's date of transition is CU 5000;*
- *Continue to use a policy of cost less depreciation for asset 4.*

All depreciation methods are already in accordance with those required by IAS 16.

You are the IFRS consultant to GG Ltd. Advise on the following:

1.1. The carrying value of 6% convertible debentures on the date of transition as per old GAAP:

(A) CU 1,000,000

(B) CU 1,100,000

(C) CU 1,050,000

(D) CU 1,040,000

1.2. The (approx.) equity component of 6% convertible debentures on initial recognition as per IFRS is:

(A) CU 89,300

(B) CU NIL

(C) CU 50,000

(D) CU 90,001

1.3. The (approx.) debt component of 6% convertible debentures on initial recognition as per IFRS is:

(A) CU 1,000,000

(B) CU 910,700

(C) CU 1,050,000

(D) CU 658,700

1.4. The (approx.) debt component of 6% convertible debentures on the date of transition as per IFRS is:

(A) CU 995,743

(B) CU 959,473

(C) CU 995,473

(D) CU 959,743

1.5. The (approx.) effective interest rate amount on 6% convertible debentures in the calendar year 2020 as per IFRS is:

(A) CU 141,947

(B) CU 141,497

(C) CU 114,497

(D) CU 114,947 ***(2 x 5 = 20 Marks)***

1.6. How should GG Ltd. deal with the change in accounting policy under IFRS framework?

(4 Marks)

1.7. Should Super Champ Inc. be restated as per IFRS 3? ***(3 Marks)***

1.8 Discuss the treatment under IFRS of:

a. Decommissioning obligations for GG Ltd.? ***(4 Marks)***

b. Valuation of assets 1, 2, 3 & 4, being part of property, plant & equipment? ***(4 Marks)***

Answer to Case Study 1

1.1 Option (C) : CU 1,050,000

1.2 Option (A) : CU 89,300

1.3 Option (B) : CU 910,700

1.4 Option (C) : CU 995,473

1.5 Option (D) : CU 114,947

1.6 **Applicability of IAS:**

As per para 27 of IFRS 1, IAS 8 does not apply to the changes in accounting policies an entity makes when it adopts IFRS or to changes in those policies until after it presents its first IFRS financial statements. Therefore, requirements of IAS 8 about changes in accounting policies do not apply in an entity's first IFRS financial statements.

Disclosure:

Further para 27A of IFRS 1 states that if during the period covered by its first IFRS financial statements an entity changes its accounting policies or its use of the exemptions contained in this IFRS, it shall explain/disclose the changes between its first IFRS interim financial report and its first IFRS financial statements, by way of disclosure note in accordance with paragraph 23, and it shall update the reconciliations required by paragraph 24(a) and (b) and the disclosure note is likely to include information, similar to what IAS 8 would otherwise require, to help users of the financial statements to understand the changes that have been made.

Analysis of the given case:

Accordingly, entity after presenting its first interim IFRS financial statements but before presenting its first annual IFRS compliant financial statements may change its accounting policies, or its use of exemptions contained in IFRS 1.

If GG Ltd. does so, it should explain the changes between its first IFRS interim financial report and its first annual IFRS financial statements and update the reconciliation of total comprehensive income and of equity presented in the first IFRS financial statements from those included in the interim financial report to reflect the amended accounting policy.

1.7 Business combination:

Business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

Applicability of IFRS and requirement of restatement:

As per para C1 of IFRS 3, **a first-time adopter may elect not to apply IFRS 3 retrospectively to past business combinations** (business combinations that occurred before the date of transition to IFRS). However, if a first-time adopter restates any business combination to comply with IFRS 3, it shall restate all later business combinations and shall also apply IFRS 10 from that same date.

Analysis of the given case:

It is assumed that on obtaining more than 50% of the voting power in Super Champ Inc., that is, on 15th November 2015, control of Super Champ Inc. was obtained by GG Ltd. on acquisition of 29% shares on 15th November, 2015, which falls after 1st February, 2015, the date the entity has decided for restatement of future business combinations.

Hence, GG Ltd. shall apply IFRS 3 for its step acquisition of Super Champ Inc., control of which acquired on 15 November 2015. Any acquisitions occurring between 31st March, 2013 and 1st February, 2015 do not need to be restated.

1.8 (a) De-commissioning Obligation of GG Ltd.

Recognition of decommissioning cost:

Retrospective application of IAS 37 requires management to recognise the provision for decommissioning cost on the opening IFRS Statement of financial position. The provision should reflect the net present value of the management's best estimate of the amount required to settle the obligation.

Accounting Treatment:

The obligation should be capitalised as a separate component of property, plant and equipment, together with the accumulated depreciation from the date when the obligation was incurred to the transition date. The amount to be capitalised as part of the cost of the asset is calculated by discounting the liability back to the date when the obligation initially arose, using the best estimate of historical discount rate. The associated accumulated depreciation is calculated by applying the current estimate of the asset's useful life, using the entity's depreciation policy for the asset.

Any difference between the provision and the related component of the property, plant and equipment is adjusted against the retained earnings.

The entity could elect to apply the deemed cost exemption. Property, plant and equipment would be restated to fair value, with the corresponding adjustment to the retained earnings. Management would need to ensure that the fair value obtained was the gross fair value and not net of the decommissioning obligation. Management would recognise the provision for decommissioning costs in accordance with IAS 37. No cost in respect of provision should be added to property, plant and equipment but such cost should be recognised in the entity's opening retained earnings.

(b) <u>Valuation of PPE:</u>

<u>Measurement basis:</u>

An entity has the following options with respect to measurement of its property, plant and equipment (IAS 16) in the opening IFRS Statement of financial position:

- Measurement basis as per the respective standards applied retrospectively. This measurement option can be applied on an item-by-item basis. For example, Plant A can be measured applying IAS 16 retrospectively and Plant B can be measured applying the "fair value" or "revaluation" options mentioned below.
- Fair value at the date of transition to IFRS. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.
- Previous GAAP revaluation, if such revaluation was, at the date of revaluation, broadly comparable to (a) fair value or (b) cost or depreciated cost in accordance with other IFRS adjusted to reflect changes in general or specific price index. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.

<u>Analysis of given case:</u>

	Asset 1	Asset 2	Asset 3	Asset 4
Basis used in previous GAAP	Revaluation Model	Revaluation Model	Cost Model	Cost Model
Intent of GG Ltd. on transition	To continue with Revaluation model	Use previous valuation as deemed cost	Adopt a policy of revaluation	Continue to use a policy of cost less depreciation
Treatment at the time of transition to IFRS	Since fair value at the transition date is not materially different from its carrying value	An entity may elect to measure an item of property, plant and equipment at the date of	Fair value at the date of transition to IFRS is materially different from its	The entity is not availing any exemption given in IFRS 1. The entity can measure

	under previous GAAP, GG Ltd. can carry forward with revalued carrying value CU 4,000 as per previous GAAP in IFRS books and continue to disclose a revaluation surplus of CU 2,500.	transition to IFRS at its fair value and use that fair value as its deemed cost at that date. In IFRS financial statements, asset will be carryforward at CU 1,500 and previously disclosed revaluation surplus is transferred to retained earnings or another component of equity.	carrying value under previous GAAP. The asset should be revalued and stated at its fair value of CU 5,000 on the date of transition to IFRS. A revaluation surplus of CU 3,000 (5,000 – 2,000) will be transferred to revaluation reserve.	applying IAS 16 retrospectively. It is assumed that measurement bases for cost of asset as per previous GAAP and IFRS are same so asset will be shown in the IFRS financial statements at CU 2,800.

Case Study - 2

M Limited is into the manufacturing and trading of numerous products & services. It prepares its financial statements as per IFRS with presentation and reporting currency being FC. The financial year ends on 31st March 2021.

During the financial year on 30th June 2020, the entity purchased 100 beef cattle at an auction for FC 100,000. Subsequent transportation costs were FC 10,000. The entity would have to incur the same transportation costs if it had sold its cattle in this auction. In addition, there would be 2% auctioneer's fee on the market price of the cattle payable by the seller. The entity also incurred FC 500 on medical & veterinary expenses.

On 31st March 2021, the market value of the cattle in the most relevant market increases to FC 110,000. Transportation costs of FC 9,000 would have to be incurred by the seller to get the cattle to the relevant market. An auctioneers's fee of 2% on the market price of the cattle would be payable by the seller.

The Company during the year had installed a solar power plant. It has a present obligation to dismantle the plant after 35 years of useful life. The Company cannot cancel this obligation or transfer to third party. It has estimated the total cost of dismantling at FC 500,000, the present value of which is FC 300,000. Based on the facts and circumstances, the company considers the risk factor of 7.50% i.e. the risk that the actual outflows would be more from the expected present value.

M Limited was awarded on 1st April 2018, being the commencement of financial year 2018-2019 a 'New Jobs' government grant of FC 30,000 receivable over three years (FC 20,000 in year 1 and FC 7,500 in year 2 and FC 2,500 in year 3), contingent on creating 10 new jobs and maintaining them for three years. The employees are recruited at a total cost of FC 15,000 and the wage bill for the first year is FC 100,000, rising by FC 5,000 in each of the subsequent years. The grant is set up as deferred income.

M Limited had constructed another factory few years ago with the assistance of yet another government grant, 'Innovative Product'. The grant is non-repayable and, following the construction of the factory, cannot be clawed back by the government. There are no further conditions attached to the grant that the Company is required to satisfy. The grant received has been treated as deferred income and is being credited to the income statement over the same period as the factory is being depreciated. Following an adverse change in the demand of the product the factory manufactures, during the year at the reporting date, the directors have concluded that the factory's carrying value is no longer recoverable in full and that a write down for impairment is required. The write down is more than covered by the amortized deferred income balance related to the grant.

M Limited had entered into a contract during financial year 2020-2021 to supply 90,000 CCTV consoles to a retailer. The contract contains specific instructions from the retailer about where the consoles should be delivered. The Company should deliver the consoles in calendar year 2021 at a date to be specified by the retailer. The retailer expects to have sufficient shelf space at the time of delivery.

As at 31st March 2021, M Limited has inventory of 1,15,000 CCTV consoles, including the 90,000 relating to the contract with the retailer. The 90,000 consoles are stored with the other 25,000 consoles, which are all interchangeable products. However, M Ltd. will not deplete its inventory below 100,000 units.

On 1st April 2020, M Limited enters into two leases of retail space A & retail space B. With respect to both the leases:

- *The non-cancellable lease term is 7 years;*
- *The annual lease payment is FC 10,000 in the first year, with a 5% increase in every following year; and*
- *FC 10,000 reflects the market rent at the commencement date;*
- *M Limited has the option to extend the lease term for another five-year period. At the commencement date, it concludes that it is reasonably certain to exercise the extension option.*

However,

- *<u>With respect to lease of retail space A:</u> The revised rent for the extension period will be agreed by the lessor and the lessee at the date when the option is exercised, based on the market rent at that time. The revised rent will, however, be no more than 105% of the rent at the end of the preceding period;*
- *<u>With respect to lease of retail space B:</u> The revised rent for the extension period will also be agreed by the lessor and the lessee at the date when the option is exercised, based on the market rent at that time. There is, however, a cap and a floor such that the revised rent cannot be below 85% or higher than 115% of the rent at the end of the preceding period.*

M Limited had announced in March 2021 that 100 employees would have their employment terminated in May 2021 as part of a restructuring project that the entity is demonstrably committed to carry out.

The Company has given these 100 employees an option to have their pensions settled by a lump sum payment of FC 75,000 per employee, payable at the date of termination in May 2021. Of these, 90 employees made an irrevocable decision to accept the payment in March 2021. The Company expects that the remaining 10 employees will not accept the offer. The Company has a pension liability towards the 90 employees of FC 6,300,000 at 31st March 2021, prior to considering the lump sum settlement offer. The plan is wholly unfunded.

You are the General Manager, Finance & Accounts. You are asked to respond to the following:

2.1. *With respect to purchase of beef cattle, determine the cost at the time of initial recognition:*

(A) *FC 112,000*

(B) *FC 112,500*

(C) *FC 88,000*

(D) *FC 88,500*

2.2. *The subsequent measurement of beef cattle as on the reporting date 31st March, 2021 is:*

(A) *FC 110,000*

(B) *FC 98,800*

(C) *FC 101,000*

(D) *FC 121,200*

2.3. *The Company should at the time of initial recognition measure its dismantling obligation liability of the solar power plant at:*

(A) FC 300,000

(B) FC 322,500

(C) FC 337,500

(D) FC 277,500

2.4. *The balance in deferred income of 'New Jobs' government grant as on 31st March 2019 was:*

(A) FC 9,545 Cr.

(B) FC 20,455 Cr.

(C) FC 455 Cr.

(D) FC 20,000 Cr.

2.5. *During the year ended 31st March 2021, with respect to 'New Jobs' government grant, the Company would be recognizing an income of:*

(A) FC 2,500

(B) FC 7,500

(C) FC 10,000

(D) FC 10,476 ***(2 x 5 = 20 Marks)***

2.6. *Discuss, in the context of IFRS framework and IAS 20, the impairment of the factory for which 'Innovative Product' government grant, has been received. Would your answer be different, if there are further conditions attached to grant beyond construction of factory?*

(3 Marks)

2.7. *Should M Limited recognize the revenue for 90,000 CCTV consoles as per IFRS? Prepare a working note, which can be shared with audit committee.* ***(3 Marks)***

2.8. *Discuss the computation of lease liability at the time of initial measurement of lease of retail space A & retail space B as per IFRS 16.* ***(6 Marks)***

2.9. *Discuss the treatment and amount of expense that M Limited should charge in its statement of financial statements as per IAS 19, Employee Benefits.* ***(3 Marks)***

Answer to Case Study 2

2.1 Option (C) : FC 88,000

2.2 Option (B) : FC 98,800

2.3 Option (B) : FC 3,22,500

2.4 Option (A) : FC 9,545 Cr.

2.5 Option (C) : FC 10,000

2.6 **Accounting treatment for Government Grant:**

Government grants, related to assets, including non-monetary grants at fair value should be presented in the Statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the asset's carrying amount. (Para 24 of IAS 20)

Government grants should be recognised as income over the periods in which the entity recognises as expenses the related costs that they are intended to compensate, on a systematic basis. The outcome should be same in the income statement regardless of whether grants are netted or deferred.

In case the grant had been offset against the acquisition cost of the factory and net carrying value is less than the recoverable amount, then there would be no need for an impairment write-down. The income statement would be charged with annual depreciation on the net acquisition cost

Government grant relating to 'Innovative Product':

To match the same result for the grant 'Innovative Product' which has been shown as deferred income and the factory is initially recorded at its cost, it is reasonable to release an amount of deferred income to the income statement to compensate for the impairment write-down.

Treatment in case of further conditions attached:

If there are further conditions attached to the grant beyond construction of the factory, it may not be appropriate to release an amount of the deferred income to compensate for the impairment write down. An entity would need to assess those further conditions to determine the amount, if any, of deferred income to release.

2.7 **Required criteria for Bill-and-hold transaction:**

M Ltd. should not recognise revenue until the bill-and-hold criteria are met or if it no longer has physical possession and all of other criteria related to the transfer of control have been met.

For compliance of Bill and hold situation, M Ltd. has to meet all the criteria given in para B81 of IFRS 15

(a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement) - The retailer expects to have sufficient shelf space at the time delivery

(b) the product must be identified separately as belonging to the customer – Since the products are interchangeable, they cannot be said as identified separately

(c) the product currently must be ready for physical transfer to the customer – Inventory of M Ltd. on 31st March is 1,15,000 CCTV consoles. Basic inventory limit which M Ltd. maintains as per its policy is 1,00,000 units. This implies that the product is not ready for delivery immediately as it will substantially lead to fall of basic inventory level from 1,00,000 units.

(d) the entity cannot have the ability to use the product or to direct it to another customer – As products are interchangeable, the entity can direct it to some other customers as well.

Decision:

Although the reason for entering into the bill-and-hold transaction is substantive (lack of shelf space), the other criteria are not met, the CCTV consoles produced for the retailer are not separated from other products. Since 3 out of 4 criteria given are not satisfied, M Ltd. cannot recognise the revenue and bill-and-hold criterial is not met. Hence, M Ltd. cannot recognise the revenue for 90,000 CCTV consoles.

2.8 With respect to lease of retail space A:

As given in the question that M Ltd. is reasonably certain to exercise the extension option, the lease term is 12 years. All lease payments within that period are included in the lease liability.

Since both lessor and lessee have to agree to the revised rent for the extension period, it can be assumed that the rent will be the market rent at that time. As per para 27 of IFRS 16, variable lease payments that depend on an index or a rate, such as payments that vary to reflect changes in market rental rates, are initially measured using the index or rate as at the commencement date.

The lease payments for the extension period that are included in the initial measurement of the lease liability are therefore FC 10,000 (market rent at the commencement date) for each year of the renewal period.

	1	2	3	4	5	6	7	8-12
Lease payment (FC)	10,000	10,500	11,025	11,576	12,155	12,763	13,401	10,000

When the entity agrees the amount of the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time.

With respect to lease of retail space B:

The lease payment throughout the extension period will be at least FC 11,391 (FC 13,401 × 0.85)

In this case, the payments throughout the extension period are not fully variable but floored. Since the floor of FC 11,391 is higher than the market rental rate at commencement date (FC 10,000), the amount that is included in the initial measurement of the lease liability for years 8–12 is FC 11,391.

	1	2	3	4	5	6	7	8-12
Lease payment (FC)	10,000	10,500	11,025	11,576	12,155	12,763	13,401	11,391

When the entity agrees the amount for the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time.

2.9 Quantum of employee expenses:

Curtailment has occurred, giving rise to a past service cost in March, 2021 as a result of the restructuring. The future service of the 90 employees who exercised the lump sum option will not earn them any additional benefits, and the plan is curtailed.

M Ltd. entered into a transaction with the 90 employees that changed the pension obligation at the same time. M Ltd. should recognise, in its financial statements for the year ended 31st March, 2021 a liability of FC 75,000 x 90 employees = FC 67,50,000 towards the 90 employees that accepted the offer. This results in the recognition of additional expenses of FC 67,50,000 – FC 63,00,000 = FC 4,50,000.

Accounting treatment:

This liability should be adjusted, as necessary, when final settlement actually occurs, by way of payment.

Case Study-3

P Ltd., a listed company is preparing its financial statements as per IFRS for the quarter ending September 2020 for the purpose of submission to its head office based in UK. The financial year of the company is April to March. Income tax rate applicable to the Company is 25%. Method of depreciation used by the Company is straight line method. The board meeting for *approval of financial statements was held on 10th November, 2020. An error in the accounting software was detected on 31st October, 2020 which resulted in under reporting of income by ₹ 2 crores for the quarter ending September 2020.*

The Company has imported leather from Australia worth ₹ 4,00.000. It paid ₹ 8,000 as import duties and ₹ 2,000 as import taxes (subsequently recoverable from the taxing authorities). Company has taken a loan for this purpose on which it has paid interest of ₹ 4,000. Also, the company has incurred ₹ 12,000 for transportation from Australia and ₹ 10,000 as port handling charges for loading the materials. Selling expenses were ₹ 18,000 and administrative overheads amounted to ₹ 14,000. This material is lying in inventory.

The Company acquired the business of N Ltd., which carried in its books certain assets classified as held for sale at an amount of ₹ 2,11,300. The fair value of these items is ₹ 3,77,000 and costs to sell were estimated at ₹ 18,000. The tax base of these items stood at ₹ 2,99,000.

Company purchased a large equipment for ₹ 55 lacs on 1st April, 2019. The useful life of the equipment is 5 years and the residual value is estimated to be ₹ 5 lacs. On 31st March, 2020 a test of impairment was conducted with the information for fair value less costs to sell to be ₹ 41 lacs, whereas the value in use was ₹ 36 lacs.

Company purchased another special equipment on 1st April, 2017. Some evidence is available from internal reporting that indicates that the economic performance of this equipment is, or will be, worse than expected as on 31st March, 2021. If the Company chooses to proceed with the disposal of the equipment it would have to incur certain legal cost for ₹ 2,000, finance cost of ₹ 800, cost of removing the equipment would be ₹ 20,000, certain termination benefits will have to be paid for ₹ 1,000, transaction cost ₹ 500 and resultant income tax expense would be for ₹ 1,500.

P Ltd. has a foreign subsidiary named G Ltd. The functional currency of P Ltd. is ₹ and G Ltd. is USD. Both the entities follow financial year ended 31st March as accounting year; G Ltd. uses US GAAP for reporting. The presentation currency for P Ltd.'s separate as well as consolidated financial statements is ₹. G Ltd. has given a loan to P Ltd. (denominated in ₹) some years back that stand at ₹ 140 million as at 31st March, 2020. The loan is the net investment of P Ltd. in the foreign operation i.e. G Ltd. The exchange rate as on 31st March, 2020 and 31st March, 2021 were USD 1 = ₹ 70 and ₹ 80 respectively. However, the average exchange rate for financial year 2020-2021 was ₹ 74. The loan liability outstanding in the books of G Ltd. as on 31st March, 2020 is USD 2 million (USD 140 million divided by ₹ 70).*

In January 2021, P Ltd. contracts with a US supplier (with the USD as its functional currency) to purchase an item of machinery it intends to use in its business. The machine will be

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* **PS:** Read the sentence as "P Ltd. has given a loan to G Ltd...."

delivered at the start of July 2021 and the contracted price, payable on delivery, is USD 1,000. P Ltd. has no appetite to take on foreign currency exchange risk in relation to ₹/USD exchange rates and so contracts with a bank to purchase USD 1,000 at the start of July in exchange for ₹ 60,000 (six-month forward exchange rate is USD 1: ₹ 60). In other words, P Ltd. has effectively fixed the price it will pay for the machine (in ₹ terms) at ₹ 60,000. If the fair value of the forward contract at the end of March 2021 (P Ltd.'s year-end) is ₹ 3,000 positive to P Ltd, on delivery is ₹ 5,000 positive to P Ltd. (spot exchange rate is USD 1: ₹ 65). P Ltd. has chosen to treat all hedges of foreign currency risk associated with firm commitments as fair value hedges.

The Company issued share-based option to one of its CFO which can be exercised either in cash or equity and it has following features:

- *Option 1 has 74,000 options which are cash settled shares with a service condition of 3 years.*
- *Option 2 has 90,000 options which are equity settled shares with a service condition of 3 years and a restriction to sell for 2 years.*

Following is the summary of Fair Values

Fair Value	*₹*
Equity price with restriction of sale for 2 years	*115*
Fair value as on grant date	*135*
Fair value as on 31st March 2020	*138*
Fair value as on 31st March 2021	*140*
Fair value as on 31st March 2022	*147*

Questions:

3.1 What will be the treatment of the error identified in the accounting software on the results for the quarter ending September 2020?

(A) Rectification of error in the period in which the error was detected

(B) Rectification of error in the period in which the error pertained to

(C) Disclosure of error in the quarterly financial statements because those are unaudited

(D) No affect in quarterly financial statements because those are unaudited

3.2. What will be the cost of inventories for the material imported from Australia as per IFRS?

(A) ₹ 4,30,000

(B) ₹ 4,34,000

(C) ₹ 4,48,000

(D) ₹ 4,36,000

3.3 What would be the deferred tax impact on the transaction for acquisition of N Ltd. in the books of accounts of P Ltd. under IFRS?

(A) DTL ₹ 15,000

(B) DTL ₹ 21,925

(C) DTA ₹ 26,425

(D) DTA ₹ 15,000

3.4 Compute the impairment loss to be recognized in case of large equipment for the year ended 31st March, 2020 and the depreciation charge for the year ending 31st March, 2021?

(A) Impairment loss is ₹ 4 lacs and depreciation is ₹ 8 lacs

(B) Impairment loss is ₹ 5 lacs and depreciation is ₹ 10 lacs

(C) Impairment loss is ₹ 4 lacs and depreciation is ₹ 9 lacs

(D) Impairment loss is ₹ 5 lacs and depreciation is ₹ 9 lacs

3.5 Please advise the CFO regarding disposal cost to be taken for impairment testing of special equipment.

(A) ₹ 23,500

(B) ₹ 22,500

(C) ₹ 24,800

(D) ₹ 25,800

3.6 What would be the treatment of exchange rate difference in the separate financial statements of P Ltd. and G Ltd. and the consolidated financial statements of P Ltd. for the financial year 2020-2021 as per IFRS?

3.7 In case of P Ltd.'s purchase of machinery from the US supplier and the purchase of forward contract to settle the liability, assuming the hedge is perfectly effective and meets all the requirements for hedge accounting, pass the journal entries to record this hedging relationship.

3.8 Pass the Journal entries under IFRS framework for the share-based payment plan of P Ltd. for the year ended 31st March 2020, 2021 and 2022.

Answer to Case Study 3

3.1 Option (B) : Rectification of error in the period in which the error pertained to

3.2 Option (A) : ₹ 4,30,000

3.3 Option (A) : DTL ₹ 15,000

3.4 Option (C) : Impairment loss is ₹ 4 lacs and depreciation is ₹ 9 lacs

3.5 Option (B) : ₹ 22,500

3.6 **<u>In the books of P Ltd:</u>**

In the given case, the loan is denominated in ₹. As it is denominated in the functional currency of the reporting entity, there would be no exchange difference from loan in the separate financial statements of P Ltd.

<u>In the books of G Ltd:</u>

In the given case, the loan is denominated in ₹. As it is denominated in the functional currency of the reporting entity, the exchange difference from loan would arise in the foreign operation's individual financial statements.

Accordingly, the treatment for exchange difference in G Ltd.'s books would be as follows:

The loan balance is a monetary item so it is translated at the rate of exchange at the reporting date.

The closing loan balance in USD is ₹ 140 million / 80 = 1.75 million USD.

The exchange gain to G Ltd. shall be recognised in profit or loss of G Ltd.'s individual financial statements = USD 2 million – USD 1.75 million = USD 0.25 million

<u>In consolidated financial statements:</u>

On consolidation at 31st March, 2021, the receivable and payable (in respect of Intra-group receivable and payable) will be eliminated. However, an exchange gain equivalent to USD 0.25 million for the year ended 31st March, 2021 will remain on consolidation. This is appropriate because G Ltd. will need to obtain Rupees in order to repay the liability. Therefore, the group has a foreign currency exposure. The exchange gain will be taken to other comprehensive income at the time of consolidation since the loan forms part of P Ltd.'s net investment in G Ltd.

Amount of gain would be USD 0.25 million x ₹ 74 = ₹ 18.5 million

3.7 Journal Entries in the books of P Ltd.

Date	Particulars	Dr. (₹)	Cr. (₹)
January 2021	No entry as initial fair value is zero		
March 2021	Forward Contract A/c Dr.	3,000	
	To Profit or Loss A/c		3,000
	(Being change in fair value of the forward contract transferred to Profit or Loss)		
	Profit or Loss A/c Dr.	3,000	
	To Firm commitment		3,000
	(Being recognition of change in the fair value of unrecognised firm commitment in respect of changes in forward exchange rates)		
July 2021	Forward Contract A/c Dr.	2,000	
	To Profit or Loss A/c		2,000
	(Being change in fair value of the forward contract transferred to Profit or Loss)		
	Profit or Loss A/c Dr.	2,000	
	To Firm commitment		2,000
	(Being recognition of change in the fair value of unrecognised firm commitment in respect of changes in forward exchange rates)		
	Cash / Bank A/c Dr.	5,000	
	To Forward Contract A/c		5,000
	(Being forward contract settled at its fair value)		
July 2021	Machinery A/c Dr.	65,000	
	To Cash/Bank A/c		65,000
	(Being payment done to supplier for purchase of machinery at the contracted price of USD 1,000 at the spot rate of USD 1 : INR 65)		
July 2021	Firm commitment Dr.	5,000	
	To Machinery A/c		5,000
	(Being removal of the carrying amount of firm commitment from the statement of financial position and adjust the initial carrying amount of the machinery resulting from the firm commitment)		

3.8

Fair value of Equity option components:		
Fair value of a share with restrictive clause		₹ 115
Number of shares		90,000
Fair value (90,000 x 115)	A	₹ 1,03,50,000
Fair value of a share at the date of grant		₹ 135
Number of cash settled shares		74,000
Fair value (74,000 x 135)	B	₹ 99,90,000
Fair value of equity component in compound instrument (A-B)		₹ 3,60,000

Journal Entries

31/3/2020	₹	₹
Employee benefit expenses Dr.	35,24,000	
To Share based payment reserve (equity) (3,60,000/3)		1,20,000
To Share based payment liability (138 x 74,000) / 3		34,04,000
(Recognition of equity option and cash settlement option)		
31/3/2021		
Employee benefits expenses Dr.	36,22,667	
To Share based payment reserve (equity) (3,60,000/3)		1,20,000
To Share based payment liability [{(140x74,000)x2/3} - 34,04,000]		35,02,667
(Recognition of equity option and cash settlement option)		
31/3/2022		
Employee benefits expenses Dr.	40,91,333	
To Share based payment reserve (equity) (3,60,000/3)		1,20,000
To Share based payment liability [(147 x 74,000) - (34,04,000 + 35,02,667)]		39,71,333
(Recognition of equity option and cash settlement option)		
Share based payment liability (147 x 74,000) Dr.	1,08,78,000	
To Bank/ Cash		1,08,78,000
(Being settlement made in cash)		
Share based payment reserve (equity) Dr.	3,60,000	
To Retained Earnings		3,60,000
(Being transfer of equity from one account to another one)		

Share based payment liability Dr.	1,08,78,000	
To Share Capital (90,000 x 100*)		90,00,000
To Securities Premium		18,78,000
(Being settlement made in equity)		
Share based payment reserve (equity) Dr.	3,60,000	
To Retained Earnings		3,60,000
(Being transfer of equity from one account to another one)		

***Note:** The face value of a share is assumed as ₹ 100 each in the above solution.

Case Study - 4

A Limited ("the Company") is in the business of manufacturing of customized modern engineering equipment and heavy machinery. It prepares accounts as per IFRS. The finance controller of the Company is in need of your help and wants to know the accounting treatment and related disclosures for certain transactions undertaken by the Company. You have been provided with the following information:

– *The Company provides various employee benefits like bonus, gratuity and provident fund which had been agreed by the Company with employees as part of employment contract Besides this, although not agreed as part of employment contract, the Company had a practice to bear the entire cost of medical expenses of employees after their retirement if an employee works at least for 5 years with the Company. The retired employees of the Company do not have any legal claim to take this benefit. However, the past practice of the Company had generated a valid expectation among the employees that the Company will continue such practice of bearing medical cost after retirement.*

  To meet the future cash outflow arising on account of such medical expenses, the Company contributes a fixed amount each year into a fund which is managed by an insurance company. This fund is utilized to pay the medical expenses of retired employees as and when it arises. The Company reviews the balance of amount accumulated in the fund in each three years and make additional contribution if needed based on expected payment of medical expenses.

– *The Company has implemented a share-based employee payment scheme (ESPS) with effect from 1st April 2020 when the market price of the Company is ₹ 75 per equity share. As per the scheme, each employee of the Company is granted an option to buy an equity share of the Company at a price of ₹ 60 per share if the employee remains in employment with the Company for a continuous period of 3 years and the market price of the Company's equity share achieves at least ₹ 100 per share or more at the end of 3 years i.e. by 31st March 2023. Once the options are vested, the employee can exercise the option within one year from vesting date i.e. by 31st March 2024.*

The Company has granted such options to 200 employees as at 1st April 2020 with 100 options to each employee. At the end of the financial year 2020-2021 (by 31st March 2021), 10 employees had already left the Company. However, the Company does not expect to leave any more employees till 31st March 2023. The Company determined the fair value of each option at ₹ 23 using the Black Scholes model of option pricing, as at grant date.

Due to slowdown in economic activities on account of pandemic, there is a steep fall in the share price of the Company and current market price of the Company's share falls to ₹ 25 per share. The management of the Company considers that the share price will be unable to recover for next 3 years and therefore the ESPS will not be attractive for employees. Hence, the management cancels all the options as at 31st March 2021.

– *During the year ended 31st March 2021, the Company had acquired a business from P Ltd. at a purchase consideration of ₹ 25 lacs. The Company had recorded assets at its fair value as against their carrying value as follows:* *(Amount in ₹)*

Particulars	***Fair value recorded by the Company***	***Carrying value in the books of P Ltd.***
Plant & equipment	*9,00,000*	*5,00,000*
Land	*18,00,000*	*(at cost) 2,00,000*
Liabilities	*6,00,000*	*6,00,000*
Contingent Liability (Disclosure)	*-*	*1,00,000*

For the purpose of Income tax calculation, the Company is eligible to take depreciation on plant & equipment to the extent the carrying value of plant & equipment in the books of acquiree. No depreciation will be allowed on land, however, an indexed cost of acquisition will be deducted from sale proceeds of the land while calculating capital gains on sale of land in the year of sale. Tax base of liabilities assumed in business combination is the same as its book value. The Company is eligible for equal deduction in 5 years for Goodwill while calculating taxable profit of the Company. The land acquired in business combination is vacant land and the Company has planned to monetize the land by selling the same by next financial year. The indexation for financial year 2020-2021 is 301 and indexation of the year in which land is purchased is 105. Income tax is payable on the capital gain at the rate of 20% however 30% tax rate is applicable in case of business profits.

– *The Company grants 30 paid leaves to each of its employee in a year. However, if an employee does not utilize all 30 leaves then the unutilized leaves will be accumulated and carried forward to next years which can be utilized anytime. However, one can accumulate maximum 30 leaves. The Company recognizes the liability towards paid leave using actuarial valuation based on the projected unit credit method.*

- *During the year ended 31st March 2021, the Company had sold certain machinery for ₹ 5,00,000 to S Limited in ordinary course of business. One of the key managerial personnel of the Company has a significant influence over S Limited.*
- *After amendment in corporate tax rates in July 2019, the Company has option to pay income tax either at the rate of 30% on taxable income after availing certain deductions or at the rate of 25% without taking benefits of certain deductions on taxable income. In earlier year, the Company had paid Minimum Alternate Tax (MAT) at the rate of 18% on book profit. Since the Company has a credit on account of MAT therefore the Company will pay tax using tax rate of 30% for financial year ended 31st March 2021 and utilize the MAT credit. However, from next financial year onwards, the Company is planning to pay the income tax at the rate of 25%.*

Questions:

4.1 While recognizing the expenses for paid leave, how should the Company recognize re-measurement of liability comprising the actuarial gain/loss?

(A) In the statement of profit or loss;

(B) In other comprehensive income as item to be reclassified to profit or loss;

(C) In other comprehensive income as item not to be reclassified to profit or loss;

(D) Directly in equity.

4.2 While accounting for a defined benefit obligation, there is net interest to be recognized in profit or loss. Based on the prevailing accounting practices, which of the following statement is true?

(A) Net interest cost shall be recognized as 'employee benefit expenses' in the statement of profit or loss.

(B) Net interest cost shall be recognized as 'finance cost' in the statement of profit or loss.

(C) Net interest cost shall be recognized as 'other expenses' in the statement of profit or loss.

(D) The Company has an accounting policy choice of recognizing net interest cost either in 'employee benefit expenses' or 'finance cost'.

4.3 What is the disclosure requirement under IFRS regarding S Limited while preparing financial statements of the Company for the year ended 31 March 2021?

(A) The Company shall classify S Limited as 'associate' and the details of transaction shall be disclosed in related party clubbed with transactions with other associates;

(B) The Company shall classify S Limited as 'associate' and the details of transaction shall be disclosed in separately in related party disclosure;

(C) S Limited is not a related party in accordance with IAS 24 therefore no disclosure required in related party;

(D) The Company shall classify S Limited as 'associate' however transaction is not required to be disclosed since the transaction is concluded in ordinary course of business.

4.4 Which of the following rate shall be used for calculation of deferred tax asset/ (liability) as at 31 March 2021?

(A) 30%

(B) 25%

(C) 27.5% (average of 30% & 25%)

(D) 18% (MAT rate)

4.5. On acquisition of P Ltd., how much goodwill should be accounted for by the company as per IFRS? (before adjustment of deferred tax)

(A) ₹ 4,00,000

(B) ₹ 16,00,000

(C) ₹ 3,00,000

(D) ₹ 5,00,000 ***(2 x 5 = 20 Marks)***

4.6 Using the information provided, you are required to analyse whether the Company shall have to recognise any liability towards medical expenses of its retired employees? Draft an accounting policy explaining the accounting treatment and highlight disclosures required in annual financial statements. ***(6 Marks)***

4.7 Calculate the amount of expenses under the ESPS scheme to be charged in the statement of profit or loss in relation to for the year ended 31st March 2021 along with the relevant provisions under IFRS. ***(5 Marks)***

4.8 Calculate the amount of deferred tax asset/(liability) to be recognized while accounting for business combination. Also calculate the amount of Goodwill to be recognized after deferred tax adjustment as per IFRS. ***(4 Marks)***

Answer to Case Study 4

4.1 Option (A) : In the statement of profit or loss

4.2 Option (D) : The company has an accounting policy choice of recognizing net interest cost either in 'employee benefit expense' or 'finance cost'.

4.3 Option (C) : S Limited is not a related party in accordance with IAS 24 therefore no disclosure required in related party.

4.4 Option (B) : 25%

4.5 Option (A) : ₹ 4,00,000

4.6 **Requirement of IAS:**

Para 4 of IAS 19 states that IAS 19 applies to those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits.

Further as per para 61 of IAS 19, an entity shall account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices.

Analysis of the given case:

In the given case, although there is no employment contract between the company and employees to bear the cost of medical expenses of retired employees, yet the company has generated a valid expectation among those retired employees that the company will continue such practice of bearing medical cost after retirement. Furthermore, the company has not expressly denied such liability.

Accordingly, the company has constructive obligation to recognize the liability towards medical expenses of its retired employees in line with the provision. Hence, it must recognise the liability/ provision for post-retirement medical expenses as at 31st March, 2021

Accounting policy to be stated in annual financial statements:

The company takes care of medical expenses of its employees after their retirement for those employees who are in continuous employment for at least 5 year at the time pf retirement. The company contributes a fixed amount in a fund managed by the insurance company which is used to settle the liability under this plan. The company recognises and measures the liability under the plan as post-employment defined benefit plan.

The expense under the plan is determined based on an actuarial valuation, using the projected unit credit method, as at the date of the statement of financial position. Current service cost, past service cost as well as gains and losses on curtailments and settlements are recognised in the statement of profit or loss as employee cost. Net ineptest expense on defined benefit liability is recognised in the statement of profit or loss as employee cost.

Remeasurements, comprising of actuarial gains and losses, the effect of the asset ceiling and the return on plan assets (excluding interest cost considered in net defined benefit liability) are recognised immediately in the statement of financial position with charge or credit recognised in other comprehensive income. Remeasurements are not reclassified to profit or loss in subsequent periods.

The amount recognised in the Statement of financial position is the discounted value of defined benefit obligation netted off with the fair value of plan assets.

Disclosures in Annual financial statements:

Following are the major disclosure requirements for a post-employment defined benefit plan:

(a) Information about the characteristics of the plan;

(b) Reconciliation from opening balance to closing balance of:

  (i) plan assets;

  (ii) present value of defined benefit obligation; and

  (iii) asset ceiling mentioning the current service cost, interest expenses / income, remeasurement of defined benefit liability;

(c) Past service cost;

(d) Contribution to the plan;

(e) Composition of plan assets;

(f) Significant actuarial assumption and their sensitivity analysis;

(g) Expected contribution for next financial year;

(h) Maturity profile of defined benefit obligation.

4.7 Provisions under IFRS relating to cancellation of grant:

As per para 28(a) of IFRS 2, if a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), the entity shall account for the cancellation or settlement as an acceleration of vesting and shall therefore recognise immediately the amount that otherwise would have been recognized for services received over the remainder of the vesting period.

Analysis of the given case:

The case given in the question is not a case of forfeiture since failure to meet either market or non-vesting conditions are not forfeitures as they are already taken into account when determining the grant date fair value.

Further, question does not specify any payment made to the employee on the cancellation of the grant. Hence only para 28 (a) will be applied accordingly.

Calculation of expense for the year

Particulars	**Year 2020-2021**
Number of employees	200
Employee left	(10)
Expected to leave	(0)
Net employees (A)	190
Options per employee (B)	100
Fair value of the option (C)	23
Expense for the year [(A) x (B) x (C)] - Full, as it is cancelled	4,37,000

4.8 Calculation of Deferred Tax Asset / Liability on Business Combination

Item	**Fair Value / Book base**	**Tax Base**	**Temporary Difference**	**Tax rate**	**Deferred Tax Liability / (Asset)**
Plant and Equipment	9,00,000	5,00,000	4,00,000	30%	1,20,000
Land	18,00,000	5,73,333 (2,00,000 x 301/105)	12,26,667	20%	2,45,333
Liabilities	6,00,000	6,00,000	-	30%	NIL
Deferred tax liability (₹ 1,20,000 + ₹ 2,45,333)					3,65,333

Defer tax liability of ₹ 3,65,333 shall be recognised with corresponding increase in goodwill.

Although deduction for amortization of goodwill is allowed for tax purposes, no deferred tax should be recognised on goodwill at the time of business combination. (Para 15 of IAS 12)

Calculation of Goodwill

Particulars	Amount
Plant and Equipment	9,00,000
Land	18,00,000
	27,00,000
Liabilities	(6,00,000)
Deferred tax liability	(3,65,333)
Net assets (A)	17,34,667
Consideration paid (B)	25,00,000
Goodwill (B) – (A)	7,65,333

In other words, revised goodwill after considering deferred tax liability would be ₹ 4,00,000 + ₹ 3,65,333 = ₹ 7,65,333.

Note: In later part of the question, income tax rates have been given and also it was mentioned that the company is planning to apply 25% rate of tax from next years. In such a situation, defer tax on acquisition of assets and liabilities may also be calculated by applying the tax rate of 25%. Hence, there is a possibility of alternative answer as follows:

Calculation of Deferred Tax Asset / Liability on Business Combination

Item	Fair Value / Book base	Tax Base	Temporary Difference	Tax rate	Deferred Tax Liability/(Asset)
Plant and Equipment	9,00,000	5,00,000	4,00,000	25%	1,00,000
Land	18,00,000	5,73,333 [2,00,000 x (301/105)]	12,26,667	20%	2,45,333
Liabilities	6,00,000	6,00,000	-	25%	NIL
Deferred tax liability (₹ 1,00,000 + ₹ 2,45,333).					3,45,333

Defer tax liability of ₹ 3,45,333 shall be recognised with corresponding increase in goodwill.

Although a deduction for amortization of goodwill is allowed for tax purposes, no deferred tax is to be recognised on goodwill at the time of business combination. (Para 15 of IAS 12)

Calculation of Goodwill

Particulars	Amount
Plant and Equipment	9,00,000
Land	18,00,000
	27,00,000
Liabilities	(6,00,000)
Deferred tax liability	(3,45,333)
Net assets (A)	17,54,667
Consideration paid (B)	25,00,000
Goodwill (B) – (A)	7,45,333

In other words, revised goodwill after considering deferred tax liability would be ₹ 4,00,000 + ₹ 3,45,333 = ₹ 7,45,333.

Case Study - 5

XYZ Ltd. offers a six-month warranty on its small to medium sized equipment, which can be put to use by the customer with no installation support. The warranty comes with the equipment and the customer cannot purchase it separately. This equipment are typically sold at a gross margin of 40%. XYZ Ltd. has made a provision of ₹ 30,000 during the year ended 31st March 2021, which is approximately 1% of its gross margin on the sale of these equipment. Based on past experience, it is expected that 1% of equipment sold have been returned as faulty within the warranty period. Faulty equipment returned to XYZ Ltd. during the warranty period are scrapped and the sale value is fully refunded to the customer.

– *During 2020-2021, XYZ Ltd. completed a large contract to supply a customized equipment for one customer for a total consideration of ₹ 5,00,000 received fully in cash. As a special arrangement and in order to procure the customer's order, XYZ Ltd agreed to maintain the equipment for three years from the date of installation. Had there been no maintenance requirement, the sale would have been for an amount of ₹ 4,85,500. If maintenance alone was required, it would have cost the customer ₹ 12,500 per annum.*

– *XYZ Ltd is a keen proponent of 'Make in India'. The company acquired an asset from a local manufacturer at a cost of ₹ 3,00,000. This carrying amount was after an impairment write down of ₹ 60,000 and cumulative depreciation of ₹ 100,000. Depreciation rate for accounting and tax laws is equal. Impairment loss is not deductible for tax purposes. Tax rate applicable to XYZ is 30%.*

– *XYZ Ltd has a subsidiary company PQR Ltd, which is carrying a business of supplying cabs for hire. Passengers would hail their cabs typically using an app on a smartphone, or from airports, railway stations etc. During the Covid-19 pandemic, PQR Ltd. operations came to a complete standstill during the months of April to June 2020. Although their* *services resumed in July 2020, the capacity utilized was only 20% - 30% until December, 2020, by when the utilization reached almost 60%. All cabs are fully owned by PQR Ltd. and depreciated using the Straight Line Method (SLM) over a period of three years.*

Given the decreased revenue in financial year 2020-2021, management of PQR Ltd is keen to identify ways to reduce the overall impact on profit and loss. A consultant has suggested that they could explore changing the basis of depreciation from SLM to hours-in-use but not entirely sure if this is permitted. Annual depreciation charge for financial year 2020-2021 would be ₹ 25 lacs using SLM and ₹ 7 lacs using new method. This difference is significant for PQR Ltd.'s financial statements.

– *In order to attract customers to use their cabs, PQR Ltd. produces a music application (app) that can be downloaded by customers. The app is free for all customers. PQR Ltd. incurred a cost, of ₹ 200,000 to develop the app in house.*

– *XYZ Ltd has another subsidiary T Ltd that operates cabs for long hire between various cities. On account of the Covid-19 pandemic, there have been several restrictions on movement and the government authorities have cancelled all cab permits to travel between cities. Accordingly, T Ltd is unable to operate from 1st April 2021.*

XYZ prepares its financial statements under IFRS framework. As CFO, you are supposed to take some decisions. Please answer following questions.

Questions:

5.1 What is the deferred tax on asset to be recognised as per IFRS for the asset bought from the local manufacturer?

(A) Deferred tax asset ₹ 18,000

(B) Deferred tax liability ₹ 18,000

(C) Deferred tax asset ₹ 30,000

(D) Deferred tax liability ₹ 30,000

5.2 How should PQR Ltd. account for the cost of the in-house app production?

(A) The cost of developing the app is charged to profit and loss.

(B) The app is a component of the cab, and cost of ₹ 200,000 is capitalized in accordance with IsAS 16

(C) The app is an intangible asset, the cost of ₹ 200,000 must be capitalized and amortised over its useful life

(D) The app is an intangible asset with indefinite useful life, the cost of ₹ 200,000 must be capitalized and tested for impairment every year.

5.3 How should the cancellation of permits be reflected in the financial statements of T Ltd as at 31st March 2021?

(A) Make adequate disclosures about the cancelled permits in the notes to accounts

(B) Disclose in the notes that the company will be unable to operate from 1st April 2021

(C) Disclose in the Director's report that the company will be unable to operate from 1st April 2021

(D) Prepare the financial statements after considering and giving impact of going concern assumption.

5.4 XYZ Ltd has been valuing inventory on a First-in-first-out basis but in line with methods used by industry peers, the company has decided to move to weighted average method. What is your advice with regard to the disclosure of the change under IFRS?

(A) Reasons for change in accounting policy must be disclosed and comparative information for prior period must be restated.

(B) Reasons for change must be disclosed, the amount of adjustments must be presented but comparative information for prior period must not be restated.

(C) Reasons for change need not be disclosed, the amount of adjustments must be presented and comparative information for prior period must be restated.

(D) Reasons for change must be disclosed, the amount of adjustments must be presented and comparative information for prior period must be restated.

5.5 As part of future expansion plans, some board members of PQR Ltd. are keen to understand how toll roads within the city are operated and how accounting is done under IFRS. Which of the following statements is correct?

(A) The operator shall recognize an intangible asset to the extent that it receives a right (a licence) to charge users of the toll road

(B) The operator shall recognize a financial asset to the extent that it receives a right (a licence) to charge users of the toll road

(C) The operator shall recognize an intangible asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from the grantor

(D) The operator shall recognize an intangible asset to the extent that it has an unconditional contractual right to receive cash from the users of the toll road.

(2 x 5 = 20 Marks)

5.6 Assuming that sales occurred evenly during the year, how should XYZ Ltd. evaluate whether any additional warranty provision is required on equipment sold in the past as at 31st March 2021? Had the warranty period been 2 years instead of six months, what additional criteria would XYZ Ltd. need to consider? ***(5 Marks)***

5.7 Explain the requirements of IFRS in relation to the XYZ Ltd.'s supply of customized contract and the maintenance that has been agreed to be provided to the customer. Calculate the amounts to be recognized in the financial statements as at 31st March 2021. ***(5 Marks)***

5.8 What are the considerations in determining whether a change in depreciation methodology is appropriate, and how should this change be accounted for? Given the risk of charging lower depreciation per annum and the possibility that the asset will be depreciated over a period longer than it would otherwise be (under SLM basis), what other safeguards do you suggest, in order to ensure compliance with relevant standards in IFRS and its framework?

(5 Marks)

Answer to Case Study 5

5.1 Option (A) : Deferred tax asset ₹ 18,000

5.2 Option (C) : The app is an intangible asset, the cost of ₹ 2,00,000 must be capitalized and amortised over its useful life.

5.3 Option (D) – Prepare the financial statements after considering and giving impact of going concern assumption.

5.4 Option (D) : Reasons for change must be disclosed, the amount of adjustments must be presented and comparative information for prior period must be restated.

5.5 Option (A) – The operator shall recognize an intangible asset to the extent that it receives a right (a license) to charge users of the toll road.

5.6 **<u>Calculation of additional warranty provisions:</u>**

Warranty claim covers 1% of gross margin, whereas customers are refunded the full selling price. As the goods are scrapped it is assumed XYZ Ltd has no potential for re-imbursement from its supplier regarding the faulty goods.

A calculation of warranty provision is set out below:

1% of annual gross margin is ₹ 30,000 therefore 100% of annual gross margin must be ₹ 30,00,000

	% age	Annual sales	Product under warranty at 31 March 2021	Percentage expected to be returned	Warranty provision
		₹	₹	₹	₹
Gross margin	40%	30,00,000			
Selling price	100%	75,00,000	37,50,000	1%	37,500

The warranty provision should therefore be increased by ₹ 7,500 (₹ 37,500 – ₹ 30,000). As the provision is expected to be used in the next 6 months no discounting is required.

If the warranty period is 2 years:

Since the outstanding period of warranties is 6 months (i.e. less than a year), no discounting is required. However, if a longer warranty period is to be given, the entity will have to take into account the effect of the time value of money. The amount of provision shall be the present value of the expenditures expected to be required to settle the warranty obligation. (Para 45 of Ind AS 37).

The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The discount rate shall not reflect risks for which future cash flow estimates have been adjusted.

	% age	Annual sales	Product under warranty at 31 March 2021	Percentage expected to be returned	Warranty provision
		₹	₹	₹	₹
Gross margin	40%	30,00,000			
Selling price	100%	75,00,000	75,00,000	1%	75,000

The warranty provision should therefore be increased by ₹ 45,000 (₹ 75,000 – ₹ 30,000). Further discounting of provision would be required.

5.7 Requirement of IFRS:

As per para 81 of IFRS 15

- a customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract.
- except when an entity has observable evidence in accordance with paragraph 82 that the entire discount relates to only one or more, but not all, performance obligations in

a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract.

- the proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of the underlying distinct goods or services.

Amount to be recognised:

In this case, there are two separately identifiable performance obligations one being sale of the equipment and second being maintenance contract for three years.

For recognition of revenue, relative stand-alone selling price of the individual components may be taken and the consideration allocated in proportion of relative fair values, i.e. 4,85,500 : 37,500* (i.e. 12,500 x 3). Hence, the sale of equipment should be recognised at ₹ 4,64,149 [₹ 5,00,000 x {4,85,500 / (4,85,500 + 37,500)}] when all other conditions for sale of the equipment are fulfilled and the revenue from maintenance services of ₹ 35,851 [₹ 5,00,000 x {37,500 / (4,85,500 + 37,500)}] should be the service revenue recognised over a period of three years as per its stage of completion.

***Note:** Discounting factor have been ignored in the above solution as it is not mentioned in the question.

5.8 As illustrated in per para 32 of IAS 8, Change in method of depreciation is a change in accounting estimates.

Considerations in determining whether the change in depreciation methodology is appropriate:

Paragraphs 60 and 61 of IAS 16, Property, Plant and Equipment, state that the depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern.

Accounting procedure:

Such a change is accounted for as a change in an accounting estimate in accordance with IAS 8.

Depreciation is a function of several factors, with extent of usage and efflux of time being its primary determinants. The hours-in-use method relates the amount of periodic depreciation charge only to one of the above two factors, namely, the extent of usage as reflected by the number of hours. This method may therefore be said to be appropriate as per para 62 of IAS 16.

Determination of depreciation method involves an accounting estimate; depreciation method is not a matter of an accounting policy. Accordingly, as per IAS 8 and IAS 16, a change in depreciation method shall be accounted for as a change in accounting estimate, i.e; prospectively.

However, given the possibility that the asset will be depreciated over a period longer than it would be under SLM basis, the company will need to assess if there are any impairment triggers and carry out impairment testing as required under Ind AS 36.