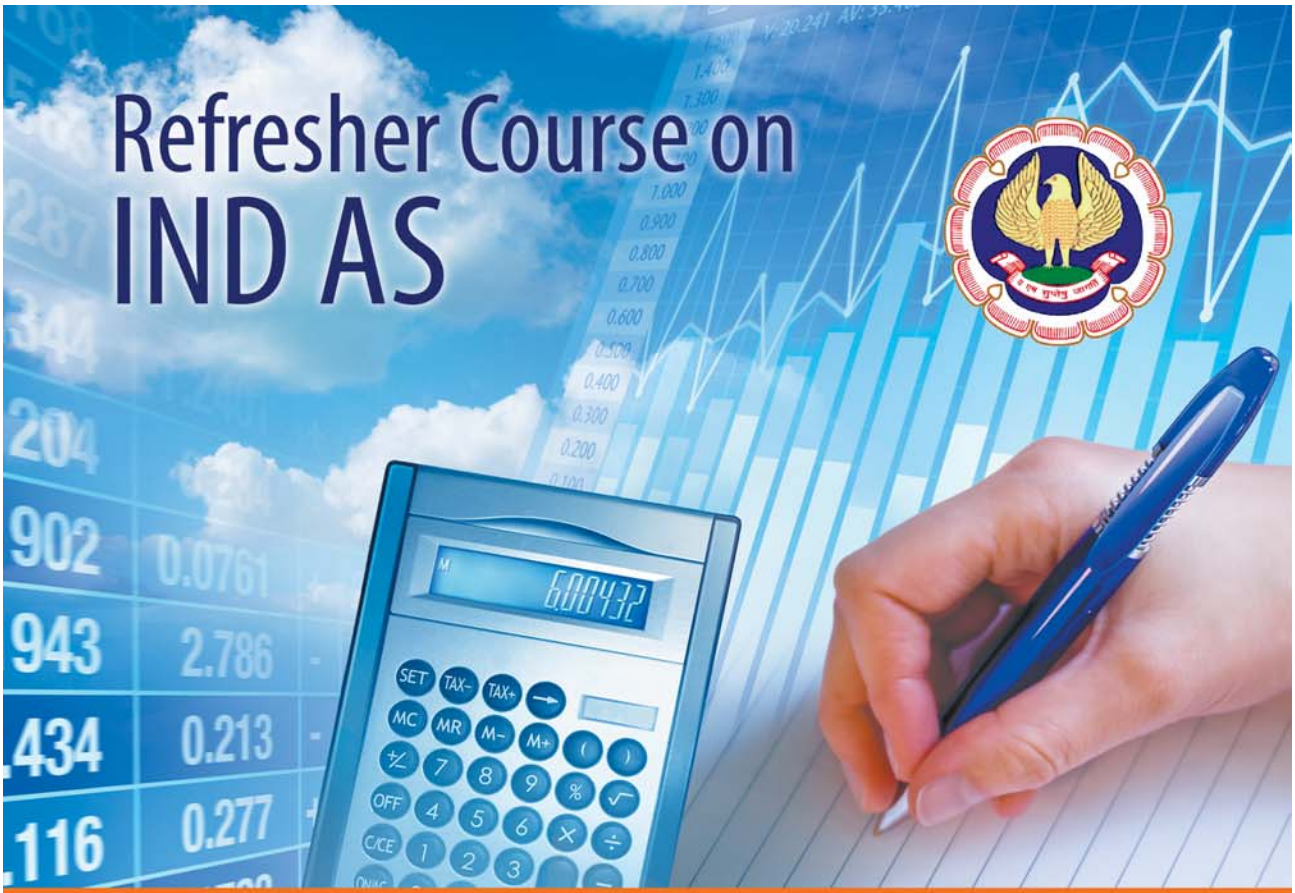
Refresher Course on IND AS



IND AS

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Eastern India Regional Council

The Institute of Chartered Accountants of India

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ABOUT THE ICAI

The Institute of Chartered Accountants of India is a statutory body established by an Act of Parliament viz., The Chartered Accountants Act, 1949 in the year 1949 for regulating the profession of Chartered Accountancy in the country. The Institute, which functions under the administrative control of Ministry of Corporate Affairs, Government of India, has five Regional Councils at Mumbai, Chennai, Kanpur, Kolkata and New Delhi. It presently has 155 Branches covering the length and breadth of the country, 22 Chapters outside India and an overseas office in Dubai.

Founded 66 years ago with just seventeen hundred members, the Institute has grown to cross mark of 2,46,000 members and 9,35,000 students as of now. A significant majority of our membership is in practice and a good deal of specialisation in traditional areas of direct/indirect taxes and in emergent specialism's inter-alia, in financial services, information technology, insurance sector, joint ventures, mutual funds, exchange risk management, risk and assurance service environment/energy/quality audits, investment counseling, corporate structuring and foreign collaborations. The other half was/is in employment, many occupying senior positions such as CMDs in Banks/Financial Institutions, CEOs in leading and reputed public/private sector companies etc.

One of the important elements of the developmental role of the Institute is to make contributions to Government authorities and Regulations viz., the Ministry of Corporate Affairs, Trade Policy Division of the Ministry of Commerce, CBDT, RBI, IRDA, C&AG, SEBI etc. to name a few, on relevant matters of importance to the economy and profession.

On International front, the Institute, a permanent member of International and Regional Accounting bodies, like International Federation of Accountants(IFAC), International Accounting Standards Board(IASB), Confederation of Asian and Pacific Accountants(CAPA) and South Asian Federation of Accountants(SAFA) has made its presence felt through its effective and sustained contribution Professional bodies like American Institute of Certified Public Accountants(AICPA) in U.S.A. The Institute of Chartered Accountants in England and Wales(ICAEW) in U.K. and a host of similar bodies in many other countries have signed MOUs with our Institute for professional collaboration in areas such as education, examination, training etc. and on issues confronting the accounting profession worldwide.

The Institute, being a statutory body, is administered by a Council which is the highest policy making body of the chartered accountancy profession. The Council is comprised of 40 members of whom 32 are elected from among its members spread all over the country. The remaining eight members are nominated by the Central Government representing such authorities as the Comptroller and Auditor General of India, Ministry of Finance, Ministry of Corporate Affairs and persons of eminence from the fields of law, banking, economic, business, finance, industry, management, public affairs etc.

ABOUT EIRC

In 1952, Eastern India Regional Council (EIRC of ICAI) was constituted with its jurisdiction on West Bengal, Orissa, Assam, Tripura, Sikkim, Arunachal Pradesh, Mehalaya, Nagaland, Manipur, Mizoram and the Union Territory of Andaman & Nicobar Islands. The founder Chairman was Mr. Molay Deb and the office of EIRC was located in the 2nd Floor of 7, Hastings Street(Now renamed as Kiron Shankar Roy Road).

On 10th December, 1975, the foundation stone of the present EIRC Building at 7, Russell Street (Now renamed as Anandilal Poddar Sarani) was led by the then Chief Justice, Calcutta High Court, Hon'ble Justice Shankar Prasad Mitra. On 14th April, 1977, the building was inaugurated by the then Hon'ble Governor of West Bengal, His Excellency Shri A.L. Dias.

On 17th January, 2014, the Second State of Art Building at 382/A, Prantik Pally, Rajdanga, Kasba, Kolkata-700107 has been inaugurated and the same is in operation to cater its dedicated service to its more than 23,005 Members and 83,690 Students.

EIRC has 13 Branches, 18 Study Circles, 5 Study Circles for Members in Industry, 8 CPE Chapters and 9 Study Groups.

EIRC has the privilege and pride in presenting 10 Presidents to ICAI and each one of them has enriched and empowered the profession through their visionary leadership and innovative dynamism.

The cherished dream of EIRC is to kindle the spark within the fraternity and to make the members world class professionals as well as good human beings – to contribute as an active partner in the nation building exercise.

CHAIRMAN'S MESSAGE

With a view to empower all our Members of all the latest developments, we have organised this Refresher Course on Ind AS from 5th to 17th November, 2016, and have also come up with a Background Material on Ind AS giving insights on the various Ind AS.

Consistent, comparable and understandable financial reporting is essential for every economy. This Refresher Course on Ind AS will cover the various Ind AS in a nutshell and provide a high-level of understanding of the same. We have covered a wide gamut of topics in the background material which would be further deliberated upon by the eminent speakers in this 10 days' workshop. I trust the participants would make good use of this opportunity and would be immensely benefited.

I express my sincere gratitude to all my colleagues in the Regional Council & Central Council for giving their all-out support in bringing out this background material on Ind AS. I would like to extend my sincere appreciation for CA Nitesh Kumar More, Chairman, Research Committee of EIRC for coming out with an out of box idea of organising this workshop. I would like to thank the contributors without whose support this material would not have been possible.

I wish the programme a resounding success and a great learning experience to all.

Let's touch base…today, tomorrow and forever!!!

Date : 5th November 2016
Place : Kolkata

CA Anirban Datta
Chairman, EIRC

CHAIRMAN - RESEARCH COMMITTEE'S MESSAGE

Dear Professional Colleagues,

It gives me immense pleasure to present before you Background Material on IndAS.

Standardised accounting language across the globe is very important. Reliable and consistent financial statements are important as good corporate practices. They improve the credibility of the businesses in the eyes of the investors. It is thus necessary that we are updated with all the latest changes so as to provide the best services to our clients. In view of the same we have come out with this background material on Ind AS.

I would like express my gratitude to CA Anirban Datta, Chairman, EIRC for his constant support in all the endeavours. I would like to thank my central council and other regional council members for their cooperation and guidance. I acknowledge the sincere efforts of Prof (Dr.) Amitabha Mukherjee for preparing the basic draft of this background material.

I sincerely believe that this background material will be of great help in understanding the various Ind AS covered in this material. I earnestly request the readers to send their suggestions at eirc.material@icai.in

Date : 5th November, 2016
Place : Kolkata

CA Nitesh Kumar More
Member, EIRC
Chairman, Research Committee, EIRC

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We are thankful to all for the tireless efforts in earnestly contributing for this **Background Material on Ind AS**

Prof. (Dr.) Amitabha Mukherjee

Mr. Aparup Mukherjee

Conceptual Framework for Financial Reporting

Introduction

Conceptual framework is a statement of theoretical principles that provide guidance for financial reporting. It is the foundation, because the criteria or basic ideas of the conceptual framework underlie the entire IFRS.

This framework is not an International Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. In a limited number of cases, there may be a conflict between the conceptual framework and an International Accounting Standard. In those cases, the requirements of the International Accounting Standard will prevail over those of the conceptual framework.

General purpose financial statements

The framework addresses general purpose financial statements that a business entity prepares and presents at least annually to meet the common information needs of a wide range of users external to the entity. It does not necessarily apply to special purpose financial reports such as reports to governmental regulatory authorities, eg – income tax returns.

Users and their need for information

The users of financial statements consist of several explicit groups, as under :

- **Investors** to decide about –
  - making investments;
  - quantum of investment; and
  - holding on to the equities they own.
- **Lenders** to know with reasonable assurance as to the –
  - payment of interest; and
  - repayment of principal.
- **Suppliers** to decide about the credibility of the entity.
- **Customers** are a composite group, consisting of –
  - producers at every stage of processing – they must be assured of the input which they obtain from the entity.
  - wholesalers and retailers – they must be sure about the uninterrupted supply of materials
  - final consumer – they should be sure about the availability of the product.
- **Government and other agencies** in order to –
  - regulate the activities of the entities;
  - determine taxation policies; and
  - use as the basis for national income and similar statistics.
- **Employees** in order to –
  - know about the stability and profitability of the entity;
  - assess the ability of the entity to provide remuneration, retirement benefit and employment opportunities.
- **Public** is concerned about –
  - financial information for employment opportunities;
  - general growth in the individual entity and the economy as a whole.

The objective of financial statements

The objective of financial statements is to provide information about the –

- financial position (provided in a Balance Sheet);
- performance (provided in an income statement); and
- changes in financial position (provided in a cash flow statement)

Though the above statements are independent, there is a direct relationship among them – known as articulation of financial statements.

The financial statements also contain notes and supplementary schedules, which may include disclosures about the –

- risks and uncertainties affecting the entity;
- resources and obligations not recognised in the balance sheet;
- geographical and industry segments;
- effect on the entity of changing prices.

Underlying Assumptions

Underlying assumptions are broad concepts and have been developed from common accounting practices. These assumptions are the rules of the game which provide –

- a unifying theoretical structure; and
- internal logic of accounting.

These assumptions help financial reporting to become comparable leading to better analysis and comparison of performances.

Accrual basis

This is also known as the matching principle. The purpose of this assumption is to make sure that all revenues and costs are recorded in the appropriate statement at the appropriate time. According to this concept, the expenses for a reporting period are matched against related incomes, rather than comparing cash received and cash payments. The result of this matching is the net profit or net loss. Thus, when a profit and loss statement is compiled, the cost of goods sold relevant to those sales should be recorded accurately and in full in that statement. In effect, there should be proper allocation of costs into different reporting periods so that relevant incomes and expenses are matched. Costs concerning a future period must be carried forward as a prepayment for that period and not charged in the current profit and loss statement. For example, payments made in advance such as the prepayment of rent would be treated in this way. Likewise, expenses paid in arrears must, even though paid after the period to which they relate, should also be shown in the current reporting period's profit and loss statement.

Financial statements prepared under accrual basis provide the following information :

- Past events involving the receipts and payments of cash; and
- Resources that represent cash to be received in the future, and future obligations to pay cash.

Going concern

Generally, for most of the entities, the assumption that the business is a going concern may not always be clear-cut, because they continue to experience complicated economic scenarios. This directs accountants to prepare financial statements on the assumption that the business is not about to go broke or be liquidated. Therefore, unless there is significant evidence to the contrary, accountants will base valuations and their reporting of financial data on the assumption that the business will remain in existence for the foreseeable future to carry out its objectives and commitments. As this is purely a judgmental decision, reporting practices differ. In effect, it is necessary for the management to make careful judgments to ensure that it is reasonable for them to conclude that it is appropriate to prepare the annual and interim financial statements on a going concern basis. Therefore, management should make :

- and document the process which should be –
  - proportionate in nature and depth depending upon the size; and
  - level of financial risk and complexity on the business and its operations.
- careful observation of all available information to cover a period of at least 12 months from the end of the reporting period.
- balanced, proportionate and clear disclosures for the financial statements to give a true and fair view.

The board of directors should be responsible for the sustainability and top executive incentives should be a function of sustainability metrics. Moreover, they should organise procedures for stakeholder engagement, to be more long-term oriented, and to exhibit better measurement and disclosure of non-financial information.

Qualitative characteristics of useful financial information

Fundamental qualitative characteristics

Relevance

Relevance refers to whether the information makes a difference to the decision maker to make predictions about the outcome of past, present and future events or to confirm and correct prior expectations, eg, report of bank balance that is essential to determine how much to borrow.

To be relevant, information must have confirmatory value, predictive value or both.

Confirmatory value is the exchange value, ie, the value of one thing in terms of another at any place or time, eg, the expected selling price of a non-current asset less costs to sell.

Predictive value is the ability of accounting numbers to provide information that is useful in predicting future accounting numbers, eg, present value of expected future cash flows (known as value in use).

The confirmatory value and predictive value of financial information are interrelated. Information that has predictive value often also has confirmatory value.

Materiality

Materiality is the basis for recognising a transaction in the financial reporting process. It is the extent to which financial information is material. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Therefore, information is considered material if its omission could influence the decision making of the users.

Though materiality guideline allows an entity to violate the accrual concept on the justification that no one would consider it misleading, this assumption –

- does not apply while recording cash transactions; and
- cannot be used as a defence for not correcting errors.

Faithful representation

Faithful representation is the correspondence between accounting figures and descriptions and the resources or events that these figures and descriptions represent. Information must faithfully represent the effects of transactions and other events.

To be a perfectly faithful representation, a depiction would have the following three characteristics –

- Complete A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.
- Neutral A neutral depiction is without bias in the selection or presentation of financial information, which does not mean information with no purpose or no influence on behavior.
- Free from error It means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

A faithful representation, by itself does not necessarily result in useful information, eg, reporting an asset acquired through a government grant at nominal value.

Applying the fundamental qualitative characteristics

The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the effects of enhancing characteristics and the cost constraint):

First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information.

Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented.

Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

Enhancing qualitative characteristics

The qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented are –

Comparability

It is a characteristic of values which makes it legitimate to draw comparisons between them. It requires consistent accounting treatments of items in the financial statements of different entities at the same point of time so as to enable valid comparison. Two sets of financial statements would have comparability if they had been prepared on the same basis and include similar type of value.

Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items (vertical consistency), either from period to period within a reporting entity (horizontal consistency) or in a single period across entities (third dimensional consistency).

Comparability is not uniformity. Uniformity is one which is universally applicable by operators of law and no alternatives are available to choose from. Consistency, on the other hand, is an option available to the entity which can be chosen and has to be applied over a period of time.

Verifiability

It means that the measure made by one measurer will be confirmed by another. It exists when there is a high degree of consensus among independent measurers, i.e., independent accountants using the same measurement process arrived substantially at same results. Verifiability may be applied to the procedures used to make the measurement as to the attribute being measured. In accounting, the problem is to obtain agreement on the measure of the attribute as also the measurement process. Verifiability is possible if an agreement can be reached on the attribute and the measurement process.

Verification can be –

- direct (verifying an amount or other representation through direct observation; eg, by counting cash); or
- indirect (checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology, eg, using FIFO method)

Timeliness

It is necessary to balance the relative merits of timely reporting, and the provision of reliable information. If reporting is delayed until all aspects are known, the information may be reliable, but of little use to those who have had to make decisions in the interim.

Understandability

Information should be presented in a way that is readily understandable by users who have a reasonable knowledge of business, economic activities and accounting and who are willing to study the information diligently.

Applying the enhancing qualitative characteristics

Enhancing qualitative characteristics cannot make information useful if that information is irrelevant or not faithfully represented. Therefore, they should be maximised, either individually or as a group, to the extent possible.

Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished or maximise another qualitative characteristic, eg, there may be a conflict between understandability and relevance. The most relevant information may be difficult to understand, or information that is easy to understand may not be relevant. The following are some cross-cutting issues –

- The relevant information may be difficult to verify.
- There may be a conflict between prudence and materiality.
- Comparability may not be as important as relevance and reliability.
- Faithful representation may not be separated from verifiability.

The cost constraint on useful financial reporting

It is a pervasive constraint on the information that can be provided by financial reporting. It should be remembered that the benefits from information should exceed the cost of providing it. There are several types of costs and benefits to consider. Therefore, it is a judgemental process to evaluate costs and related benefits derived.

Time and fair view/fair presentation

Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity.

Despite its importance, this framework does not deal directly with such concepts. It is generally assumed that the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

The elements of financial statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are expressed as elements of financial statements, which are concerned about the measurement of –

- financial position (assets, liabilities and equity)
- financial performance (income and expenses);
- the changes in financial position (inflow and outflow of cash).

Assets

An asset is a resource controlled by an entity as a result of past transactions or events and from which it is considered probable that economic benefits will flow to the entity beyond the current reporting period and the asset has a cost or value that can be measured reliably.

The future economic benefits embodied in an asset have the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity in a number of ways. For example, an asset may be –

- used singly or in combination with other assets in the production of goods or services;
- exchanged for other assets;
- used to settle a liability;
- distributed to the owners of the equity

Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available, eg, when some degree of non-payment of receivables is normally probable, an expense representing the anticipated reduction in economic benefits is recognised.

An asset may or may not have a physical form (property, plant and equipment or trademarks) and does not require –

- legal right of ownership (know-how obtained from a development activity); and
- physical possession (bill and hold, or consignment transactions) for its existence

The assets of an entity result from past –

- transactions (obtained assets by purchasing or producing them); or
- events (government grants or discovery of mineral resources).

Though closely related, there may not be any nexus between incurring expenditure and generating assets, eg –

- An asset can be acquired without incurring an expenditure, eg, government grants;
- An expenditure may not generate an asset, eg, expenditure on research phase of a project.

Assets are classified as –

- Financial assets are held by other parties as liabilities. They arise from contracts and are settled in fixed or determinable amounts. The entity's contractual right to receive cash is matched by the other party's corresponding obligation to pay cash. Examples are trade receivables, notes receivable, loans receivable and bonds receivable.
- Non-financial assets do not arise from contracts and, therefore, do not give rise to a present right to receive cash or another financial asset. Examples are property, plant and equipment, intangible assets, leased asset and deferred tax asset.

Liabilities

A liability is a present obligation of the entity arising from past transactions (trade payables) or other past events (future rebates based on annual purchases), the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits in order to satisfy the claim of the other party.

A liability may arise from –

- legally enforceable as a consequence of a binding contract or statutory requirement (trade payables); or
- normal business practice, custom and a desire to maintain good business relations or act in an equitable manner (rectify faults after the warranty period has expired).

A liability is recognised at the amount at which the settlement of a present obligation will take place can be measured reliably – even by using a substantial degree of estimation (provisions for payments to be made under existing warranties).

At initial measurement, an entity shall measure a liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation, which is the lowest of the :

- present value of the resources required to fulfill the obligation estimated by taking into account –
  - the expected outflows of resources and the time value of money; and
  - the risk that the actual outflows of resources might ultimately differ from those expected.

Examples are –

- payment of cash;
- transfer of other assets;
- provision of services;
- replacement of that obligation with another obligation; or
- conversion of the obligation to equity.

- amount that the entity would have to pay for the obligation to –
  - cancel (creditors waiving or forfeiting its rights); and
  - transfer to a third party (financial guaranteecontract).

Liabilities are classified as –

- Financial liabilities are held by other parties as assets. They arise from contracts that are settled in fixed or determinable amounts. The entity's contractual obligation to pay cash is matched by the other party's contractual right to receive cash. Examples are trade payables, noted payable, loans payable and bonds payable.
- Non-financial liabilities arise from contracts that represent delivery of future goods or services (eg, deferred revenue or warranty obligations). Otherwise, they are not contractual (eg, constructive obligation or deferred tax liability).

Contingent rights and obligations

A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Examples are –

- Financial guarantee contract – does not appear;
- Performance bonds – appears;
- Forward contracts – no initial recognition.

Equity

Equity is the residual interest in the assets of the entity after deducting all its liabilities, which may be subclassified as:

- funds contributed by shareholders;
- retained earnings;
- reserves representing –
  - appropriations of retained earnings (required by state or other law); and
  - capital maintenance adjustments (physical or financial)

The aggregate amount of equity is dependant on the measurement of assets and liabilities, which only be coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of either the –

- net assets on a piece meal basis; or
- entity as a whole as a going concern.

Income

Income is simultaneous increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity (which can be measured reliably), other than those relating to contributions from equity participants.

Income is taken to be a measure of –

- the success of an activity;
- the criterion of taxable capacity; and
- what may prudently be distributed.

The definition of income encompasses both –

- revenue (arises in the course of ordinary activities); and
- gains (irregular or non-recurring nature), which can be classified as –

- realised (displayed separately in the income statement, eg, disposal of non-current assets); or
- unrealised (displayed separately in Statement of Profit and Loss and/or Balance Sheet, eg, increases in the carrying amount of non-current asets).

Expenses

Expenses are simultaneous decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity (which can be measured reliably), other than those relating to distributions to equity participants.

Expenses arise –

- in the course of ordinary activities of the entity (eg, cost of sales, wages and depreciation); and
- from losses which can be classified as –
  - realised (displayed separately in Statement of Profit and Loss and/or Balance Sheet, eg, disposal of non-current assets); or
  - unrealised (displayed separately in Statement of Profit and Loss and/or Balance Sheet, eg, decreases in the carrying amount of non-current assets)

Applying the matching concept, expenses are recognised on the basis of a direct association between the costs incurred and the earning of specific items of income (sometimes on the basis of systematic and rational procedures).

An expense is recognised –

- immediately when it produces no future economic benefits eg, research costs; and
- when a liability is incurred without the recognition of an asset eg, warranty obligations.

Concept of capital and capital maintenance

Capital maintenance is a principle of accounting which states that a profit is the residual revenue of a period after the initial value of the capital of the business has been restored. The common sense view of income of a company is the increase in its wealth during a period, which is the amount that could be paid out to shareholders at the end of the period, while still leaving the company as well off as it was at the beginning of the reporting period.

The owners expect a return on the capital as well as a return of the capital. Therefore, the company first measures the resources required to maintain invested capital at its original level. Any profit above and beyond this level of maintained capital is income.

There are two concepts of capital maintenance –

- Financial capital maintenance Under this concept, income is equal to the change in the money amount of net assets. Using historical cost accounting, if the net assets of a company are the same at the end of a period as they were at the beginning, the financial capital has been maintained. If they are higher at the end, a profit has been made. Conversely, if they are lower at the end, a loss is to be recognised. But, this concept needs to be applied in a manner that recognises the impact of inflation. It is possible to re-state the historical cost profit using a unit of “constant purchasing power,” which means the figures are adjusted by some factor, such as a rate of inflation.
- Physical capital maintenance Under this concept, the emphasis is on the ability of a company to maintain its physical capacity and to continue operating at the same level. Therefore, physical capital is maintained only if the physical productive capacity of the company at the end of the period is the same as the physical productive capacity at the beginning of the period.

Fair Value Measurement (Ind AS 113)

(This chapter deals with non-financial aspects of assets and liabilities only)

Introduction

Non-financial assets do not arise from contracts and, therefore, do not give rise to a present right to receive cash or another financial asset. Example are property, plant and equipment, intangible assets, leased assets and deferred tax assets.

Non-financial liabilities arise from contracts that represent delivery of future goods or services (eg, deferred revenue, warranty obligations and decommissioning liability). Otherwise, they are not contractual (eg, constructive obligation and deferred tax liabilities).

Entities do not necessarily –

- sell assets at the price paid to acquire them; and
- fulfill/cancel/transfer liabilities at the prices received to assume them.

Fair value

The definition of fair value focuses on assets and liabilities, because income and expenses recognised in Statement of Profit and Loss are based on the amount of the assets and liabilities recognised in Balance Sheet. For example, depreciation expense is based on the cost or fair value of the related asset.

Fair value is the price that would be received to sell an asset or paid to fulfill/cancel/transfer a liability in an orderly transaction in the principal (or most advantageous) market between market participants at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

- Orderly transaction

  A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are useful and customary for transactions involving such assets or liabilities; it is not a forced transaction (eg, forced liquidation or distressed sale).

  Circumstances that may indicate that a transaction is not orderly include the following :

- There was –
  - not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.
  - a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
- The seller –
  - is in or near bankruptcy or receivership (ie, the seller is distressed).
  - was required to sell to meet regulatory or legal requirements (ie, the seller was forced).
  - The transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability.

If a transaction is not orderly, the transaction price (the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties, eg, sales taxes) might not represent the fair value of an asset or a liability at initial recognition if the transaction:

- is between related parties; or

- is for a different unit of account; or
- takes place –
  - under duress; or
  - in a different market.
- Principal market

  The market with the greatest volume and level of activity for the asset or liability.
- Most advantageous market

  The market that minimises the amount that would be received to sell the asset or minimises the amount that would be paid to fulfill/cancel/transfer the liability, after taking into account :
  - Transaction costs The costs to sell an asset or fulfill/cancel/transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or fulfill/cancel/transfer of the liability and meet both of the following criteria –
    - They represent directly from and are essential to that transaction.
    - They would not have been incurred by the entity had the decision to sell the asset or fulfill/cancel/ transfer the liability not been made (similar to costs to sell, as defined in Ind AS 105)
  - Transport costs The costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.
- Market participants

  Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all the following characteristics –

  They are –
  - independent of each other, ie, they are not related parties, although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into at market terms.
  - knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence that are usual and customary.
  - able to enter into a transaction for the asset or liability.
  - willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.

  Market participants buyers are generally representative of both –
  - strategic buyers (eg, competitors); and
  - financial buyers (eg, private equity or venture capital).
- Exit price

  The price that would be received to sell an asset or paid to fulfill/cancel/transfer a liability.
- Entry price

  The price paid to acquire an asset or receive to assume a liability in an exchange transaction.
- Valuation technique

  An entity shall use valuation techniques that are appropriate in the circumstances are for which sufficient data are available to measure fair value maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

- Observable inputs are those that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

- Unobservable inputs are those for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

3 widely used valuation techniques are –

- Market approach uses prices and other relevant information generated by market transactions involving identical or comparable (ie, similar) assets, liabilities or a group of assets and liabilities, such as a business.

- Cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

- Income approach converts the future amounts (eg, cash flows or income and expenses) to a single current (ie, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

Measurement

A fair value measurement requires an entity to determine all the following :

- The particular asset or liability that is the subject of the measurement consistently with its unit of account – which is the level at which an asset or a liability is aggregated or disaggregated in an Ind AS for recognition purposes . The asset or liability measured at fair value might be either of the following –

  - a stand-alone asset or liability (eg, a financial instrument or a non-financial asset); or

  - a group of assets, a group of liabilities or a group of assets and liabilities (eg, cash generating unit or a business).

- For a non-financial asset, the valuation premise that is appropriate for the measurement consistently with its highest and best use – which is the use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (eg, a business)within which the asset would be used. The highest and best use of a non-financial asset takes into account the use of the asset that is :

  - physically possible ,ie, the physical characteristics of the asset that market participants would take into account when pricing the asset. Such characteristics include, for example, the following –

    - the condition and location of the asset; and

    - restriction, if any, on the sale or use of the asset.

  - legally permissible ,ie, any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg, zoning regulations applicable to a property).

  - financially feasible ,ie, whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

- The principal (or most advantageous) market for the asset or liability. A fair value measurement assumes that the transaction to sell an asset or fulfill/cancel/transfer a liability takes place either in the –

  - principal market for the asset or liability; or

  - in the absence of a principal market, in the most advantageous market for the asset or liability.

  The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs shall be accounted for in accordance with other Ind AS. Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.

Transaction costs do not include transport costs. If location is a characteristic of the asset (as might be the case, eg, for a commodity),the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

- The valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability.

Appurtenances of measuring liabilities

At initial measurement, an entity shall measure a liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation which is the lowest of the :

- present value of resources to **fulfill** the obligation estimated by taking into account the –
  - expected outflows of resources and the time value of money; and
  - risk that the actual outflows of resources might ultimately differ from those expected. Examples are –
    - payment of cash;
    - transfer of other assets;
    - provision of services;
    - replacement of that obligation with another obligation; or
    - conversion of the obligation to equity.
- amount that the entity would have to pay for the obligation to –
  - cancel (creditor waiving or forfeiting its rights); and
  - transfer to a third party (financial guarantee contract).

A fair value measurement of a liability assumes that the liability is transferred to a market participant at the measurement date (ie, the liability would remain outstanding and the market participant transferee would be required to fulfill the obligation; it would not be settled with the counterparty or otherwise extinguished on the measurement date).

The fair value of a liability reflects the effect of non-performance risk. It is the risk that an entity will not fulfill the obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk (the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge the obligation).

When measuring the fair value of a liability, an entity shall take into account the effect of its credit risk (credit standing), and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. That effect may differ depending on the liability, for example:

- whether the liability is an obligation to deliver –
  - cash; or
  - goods or services.
- the terms of the credit enhancements related to the liability, if any

Example 1

An entity owns a group of assets comprises Assets A, B and C. Asset C is used in conjunction with Assets A and B (the related assets).

As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups.

- Strategic buyer asset group The entity determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (synergies). Those assets include a substitute asset for Asset C and, therefore, Asset C would not be used for its full remaining life. The indicated fair values are :

  A 36 B 26 C 3 Cash-generating unit 65

- Financial buyer asset group The financial buyers do not have substitute assets that would enhance the value of the group within which the assets would be used. The indicated fair values are :

  A 30 B 20 C 10 Cash-generating unit 60

The fair value of Assets A, B and C would be determined on the basis of the use of the assets as a group within the strategic buyer group, (36,26 and 3), which maximises the fair value of the asset as a group (65)

Example 2

An entity currently develops a plot of land for industrial use, which is presumed to be its HBU (highest and best use). The entity determines that market participants would also take into account the potential to develop the site for residential use when pricing the land.

The HBU of the land would be determined on the basis of the higher of the value of the land as –

- currently developed for industrial use.
- a vacant site for residential use, taking into account the costs of demolishing the factory and other costs necessary to convert the land to a vacant site.

Example 3

An entity has a R&D project which it does not intend to complete to prevent its competitors from obtaining access to the technology. If completed, the project would compete with one of its project (to provide the next generation of the entity's commercialised technology). Locking up the project is expected to improve the prospects for the entity's own competing technology. To measure the fair value of the project at initial recognition, the highest and best use (HBU) of the project would be determined on the basis of its use by market participants (MPs). For example:

The HBU of the project would be to–	That might be the case if MPs –	The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used (locked up, when closed) with its complementary assets and the associated liabilities and those assets and liabilities would be available to MPs.
continue developments if MPs would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used.	do not have similar technology, either in development or commercialised.	
cease development if, for competitive reasons, MPs would lock up the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used.	have technology in a more advanced stage of development that would compete with the project if completed and the project would be expected to improve the prospects for their own competing technology if locked up.	

Example 4

An entity acquires a machine which was originally purchased from an outside vendor and, was customised by the entity for use in its operations. However, the customisation of the machine was not extensive. The acquiring entity determines that the asset would provide maximum value to market participants through its use in combination with other assets or with other assets and liabilities (as installed or otherwise configured for use). There is no evidence to suggest that the current use of the machine is not its highest and best use. Therefore, the highest and best use of the machine is its current use in combination with other assets or with other assets and liabilities.

The entity determines that sufficient data are available to apply the cost approach and, because the customisation of the machine was not extensive, the market approach. The income approach is not used because the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows. Furthermore, information about short-term and intermediate-term lease rates for similar used machinery that otherwise could be used to project an income stream (ie, lease payments over remaining service lives) is not available. The market and cost approaches are applied as follows –

- The market approach is applied using quoted prices for similar machines adjusted for differences between the machine (as customised) and the similar machines. The measurement reflects the price that would be received for the machine in its current condition (used) and location (installed and configured for use). The fair value indicated by that approach ranges from 40 to 48.

  The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business. For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement.

- The cost approach is applied by estimating the amount that would be required currently to construct a substitute (customised) machine of comparable utility. The estimate takes into account the condition of the machine and the environment in which it operates, including physical wear and tear (ie, physical deterioration), improvements in technology (ie, functional obsolescence), conditions external to the condition of the machine such as a decline in the market demand for similar machines (ie, economic obsolescence) and installation costs. The fair value indicated by that approach ranges from 40 to 52.

  The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because, a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives). In many cases, the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.

The entity determines that the higher end of the range indicated by the market approach is most representative of fair value and, therefore, ascribes more weight to the results of the market approach. That determination is made on the basis of the relative subjectivity of the inputs, taking into account the degree of comparability between the machine and the similar machines.In particular –

- the inputs used in the market approach (quoted prices for similar machines) require fewer and less subjective adjustments than the inputs used in the cost approach.

- the range indicated by the market approach overlaps with, but is narrower than, the range indicated by the cost approach.

- there are no known unexplained differences (between the machine and the similar machines) within that range.

Accordingly, the entity determines that the fair value of the machine is 48.

If customisation of the machine was extensive or if there were not sufficient data available to apply the market approach (eg, because market data reflect transactions for machines used on a stand-alone basis, such as a scrap value for specialised assets, rather than machines used in combination with other assets or with other assets and liabilities), the entity would apply the cost approach. When an asset is used in combination with other assets or with other assets and liabilities, the cost approach assumes the sale of the machine to a market participant buyer with the complementary assets and the associated liabilities. The price received for the sale of the machine (ie, an exit price) would not be more than either of the following –

- the cost that a market participant buyer would incur to acquire or construct a substitute machine of comparable utility; or

- the economic benefit that a market participant buyer would derive from the use of the machine.

Example 5

An entity acquires a group of assets. The asset group includes an income-producing software asset internally developed for licensing to customers and its complementary assets (including a related database with which the software asset is used) and the associated liabilities. To allocate the cost of the group to the individual assets acquired, the entity measures the fair value of the software asset. The entity determines that the software asset would provide maximum value to market participants through its use in combination with other assets or with other assets and liabilities (ie, its complementary assets and the associated liabilities). There is no evidence to suggest that the current use of the software asset is not its highest and best use. Therefore, the highest and best use of the software asset is its current use. (In this case, the licensing of the software asset, in and of itself, does not indicate that the fair value of the asset would be maximised through its use by market participants on a stand-alone basis.)

The entity determines that, in addition to the income approach, sufficient data might be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available. The income and cost approaches are applied as follows –

- The income approach is applied using a present value technique. The cash flows used in that technique reflect the income stream expected to result from the software asset (licence fees from customers) over its economic life. The fair value indicated by that approach is 15.

  The income approach converts future amounts (eg, cash flows or income and expenses) to a single current (ie, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

- The cost approach is applied by estimating the amount that currently would be required to construct a substitute software asset of comparable utility (ie, taking into account functional and economic obsolescence). The fair value indicated by that approach is 10.

Through its application of the cost approach, the entity determines that market participants would not be able to construct a substitute software asset of comparable utility. Some characteristics of the software asset are unique, having been developed using proprietary information, and cannot be readily replicated. The entity determines that the fair value of the software asset is 15, as indicated by the income approach.

Example 6

An asset is sold in 2 different active markets (a market in which transaction for the asset or liability takes place with sufficient frequency and volume to provide pricing information on an ongoing basis) at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. In Market A, the price that would be received is 26, transaction costs in that market are 3 and the costs to transport the asset to that market are 2 (ie, the net amount that would be received is 21). In Market B, the price that would be received is 25, transaction costs in that market are 1 and the costs to transport the asset to that market are 2 (ie, the net amount that would be received in Market B is 22).

If Market A is the principal market for the asset (ie, the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (24).

If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (ie, the net amount that would be received in the respective markets).

Because the entity would maximise the net amount that would be received for the asset in Market B (22), the fair value of the asset would be measured using the price in that market (25), less transport costs (2), resulting in a fair value measurement of 23. Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

Example 7

A donor contributes land in an otherwise developed residential area to a not-for-profit neighbourhood association. The land is currently used as a playground. The donor specifies that the land must continue to be used by the association as a playground in perpetuity. Upon review of relevant documentation (eg, legal and other), the association determines that the fiduciary responsibility to meet the donor's restriction would not be transferred to

market participants if the association sold the asset, ie, the donor restriction on the use of the land is specific to the association. Furthermore, the association is not restricted from selling the land. Without the restriction on the use of the land by the association, the land could be used as a site for residential development. In addition, the land is subject to an easement (ie, a legal right that enables a utility to run power lines across the land). Following is an analysis of the effect on the fair value measurement of the land arising from the restriction and the easement –

- Donor restriction on use of land Because in this situation the donor restriction on the use of the land is specific to the association, the restriction would not be transferred to market participants. Therefore, the fair value of the land would be the higher of its fair value used as a playground (ie, the fair value of the asset would be maximised through its use by market participants in combination with other assets or with other assets and liabilities) and its fair value as a site for residential development (ie, the fair value of the asset would be maximised through its use by market participants on a stand-alone basis), regardless of the restriction on the use of the land by the association.
- Easement for utility lines Because the easement for utility lines is specific to (ie, a characteristic of) the land, it would be transferred to market participants with the land. Therefore, the fair value measurement of the land would take into account the effect of the easement, regardless of whether the highest and best use is as a playground or as a site for residential development.

Example 8

An entity uses the expected present value technique to measure the fair value of a decommissioning liability to dismantle and remove an offshore oil platform at the end of 10 years, which the entity was contractually allowed to transfer to a market participant.

When estimating the price, a market participant would use all the following probability-weighted inputs :

- labour costs;
- allocation of overhead costs (80% of expected labour costs);
- compensation for undertaking the activity and for assuming risk associated to fulfill the obligation includes the following –
  - profit on labour and overhead cost (20% mark-up); and
  - the risk that the actual cash outflows might differ from those expected (5% including the effect of inflation);
- effects of inflation on estimated costs and profits (4% for 10 years);
- time value of money, represented by the risk-free rate (5%)
- non-performance risk relating to the risk that the entity will not fulfill the obligation, including the entity's own credit risk (3.5%).

The entity measures the fair value of the decommissioning liability as under :

Cash flow estimate	Probability assessment	Expected cash flows
100,000	25%	25,000
125,000	50%	62,500
175,000	25%	43,750
Expected labour costs		131,250
Allocated overheads (80% of 131,250)		105,000
Total cost		236,250
Mark-up (20%)		47,250
	283,500	
Inflation factor (4% for 10 years = 1.4802)		
Expected cash flow adjusted for inflation (283,500 x 1.4802)		419,637
Market risk premium (5%)		20,982
Expected cash flow adjusted for market risk		440,619
Expected present value using discount rate (5% + 3.5% = 8.5%) for 10 years		194,879

Income Taxes (Ind AS 12)

Introduction

Accounting for business and accounting for taxation are two different things. Accounting profit is the profit or loss for a period before deducting tax expense. Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

When we prepare accounting for business, we ascertain profit for the reporting period by applying Ind AS recognition criteria, for determining the return on capital. This is done when tax expense is deducted from accounting profit. Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax. Therefore, tax expense (tax income) comprises current tax expense (current tax income) and deferred tax expense (deferred tax income). Likewise, when we prepare accounting for taxation, we ascertain taxable profit (loss) on which income tax is payable (recoverable). Therefore, the preparation of taxable profit is similar to, but not identical with the preparation of accounting profit. As a result, differences can arise between taxable profit (tax loss) on which income tax is payable (recoverable), and the profit (loss) for the reporting period. As the Ind AS recognition criteria are different from those which are normally set out in tax law, certain income (expenses) in the financial statements will not be taxable (deductible) for taxation purposes, thus causing **temporary differences.**

The objective of Ind AS is to provide useful information to decision makers about a business unit. Therefore, accounting for income taxes should be on an accrual basis – to recognise the consequences of a transaction in the same year that transaction is recognised in financial statements.

Thus, for transactions and other events recognised –

- in profit and loss, any related tax effects are also recognised in profit and loss.
- outside profit and loss (either in other comprehensive income or directly in equity), any related tax effects are also recognised outside profit and loss (either in other comprehensive income or directly in equity, respectively).

Inter-period tax allocation is applied to all temporary differences between taxable profit (loss) and accounting profit (loss), regardless of the period in which taxes are paid.

The tax base of an asset or liability is the amount attributable to that asset or liability for tax purposes. For example, the tax base of –

- an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of revenue that will not be taxable in future periods.

Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either –

- taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or
- deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Current Tax

Current tax liability (asset) is a balance sheet expression to describe the estimated taxes payable (recoverable) on the current year's tax return, which is similar to an account payable (receivable) but relates to income taxes payable (recoverable).

A current tax liability (asset) is recognised as an expense (income) in the statement of profit and loss for the period, which is based on the tax rates enacted or substantially enacted by the end of the reporting period.

Current taxes payable (recoverable) are based on the tax returns for the current period. If the tax return shows a tax due (recoverable), a payable (receivable) is recorded as a current tax liability (asset), similar to other payables (receivables).

Deferred tax liability

Deferred tax liability is a balance sheet expression used to describe an estimated future tax liability due to taxable temporary differences. It arises when the carrying amount of –

- an asset is more than its tax base.
- a liability is less than its tax base.

A deferred tax liability represents the application of financial capital maintenance – some tax penalty the entity believes it is exposed to down the line. Without the creation of a deferred tax liability, the earnings per share will show higher than what it actually is. As a result, there is a risk that dividends might be higher than the entity could afford.

Deferred tax asset

Deferred tax asset is a balance sheet expression used to describe an estimated future tax benefit due to temporary differences and carry forwards, which is likely to materialise. It arises when the carrying amount of–

- an asset is less than its tax base.
- a liability is more than its tax base.

A deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits, but only to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Sufficient taxable profit can arise –

- from existing taxable differences, which should reverse in the same reporting period as the reversal of the deductible temporary difference, or in the period in which a tax loss is expected to be used.
- if there are insufficient taxable temporary differences, and the entity may recognise the deferred tax asset where it feels that there will be future taxable profits, other than that arising from taxable differences.
- when the entity may be able to create tax planning opportunities whereby the deductible temporary differences can be utilised.

The point to note is that the existence of current tax losses is probably the evidence that future taxable profit will not be available.

A deferred tax asset represents some tax advantage the entity will benefit from in the future. Therefore, without the creation of a deferred tax asset, the earnings per share will show lower than what it actually is. As a result, there is a possibility that dividends might be lower than what the entity could afford.

Deferred tax assets (liabilities) are to be treated as non-current assets (liabilities). They should not be discounted because it is difficult to accurately predict the timing of the reversal of each temporary difference.

Example 1

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%.

Statement of Profit and Loss

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		20		20		20		20		20
Accounting Profit		80		80		80		80		80
Tax expense –										
Current tax	30		30		30		30		40	
Deferred tax expense / (liability)	2	32	2	32	2	32	2	32	(8)	32
Profit for the Period		48		48		48		48		48

Workings	**Current Tax**	
Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	2	4	6	8
Created	2	2	2	2	–
Reversed	–	–	–	–	(8)
Closing balance	2	4	6	8	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated depreciation	20	40	60	80	100
Carrying Amount	80	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 2

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%.

Statement of Profit and Loss

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		25		25		25		25		–
Accounting Profit		75		75		75		75		100
Tax expense –										
Current tax	32		32		32		32		32	
Deferred tax (income) / asset	(2)	30	(2)	30	(2)	30	(2)	30	8	40
Profit for the Period		45		45		45		45		60

Workings	**Current Tax**
Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current tax @ 40%	32

Deferred Tax Asset

Year	1	2	3	4	5
Opening balance	–	2	4	6	8
Created	2	2	2	2	–
Reversed	–	–	–	–	(8)
Closing balance	2	4	6	8	–

Carrying Amount of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Accumulated depreciation	25	50	75	100
Carrying Amount	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 3

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Life increased by 1 year at the end of year 2.

Statement of Profit and Loss

Year		1		2		3		4		5		6
Profit before depreciation		100		100		100		100		100		100
Depreciation		20		20		15		15		15		15
Accounting Profit		80		80		85		85		85		85
Tax expense –												
Current tax	30		30		30		30		40		40	
Deferred tax expense/(liability)	2	32	2	32	4	34	4	34	(6)	34	(6)	34
Profit for the Period		48		48		51		51		51		51

Workings **Current Tax**

Year	1 to 4	5 and 6
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5	6
Opening balance	–	2	4	8	12	6
Created	2	2	4	4	–	–
Reversed	–	–	–	–	(6)	(6)
Closing balance	2	4	8	12	6	–

Carrying Amount of the Asset

Year	1	2	3	4	5	6
Gross block	100	100	100	100	100	100
Accumulated depreciation	20	40	55	70	85	100
Carrying Amount	80	60	45	30	15	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 4

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%. Life increased by 2 years at the end of year 1.

Statement of Profit and Loss

Year		1		2		3		4		5		6
Profit before depreciation		100		100		100		100		100		100
Depreciation		25		15		15		15		15		15
Accounting Profit		75		85		85		85		85		85
Tax expense –												
Current tax	32		32		32		32		32		40	
Deferred tax (income) / asset	(2)		2		–		–		–		–	
Deferred tax expense/(liability)	–	30	–	34	2	34	2	34	2	34	(6)	34
Profit for the Period		45		51		51		51		51		51

Workings **Current Tax**

Year	1 to 5	6
Profit before depreciation	100	100
Depreciation allowed	20	–
Taxable Profit	80	100
Current tax @ 40%	32	40

Deferred Tax Asset / Liability

Year		1		2		3		4		5		6
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	2	–	–	–	–	2	–	4	–	6
Created	2	–	–	–	–	2	–	2	–	2	–	–
Reversed	–	–	(2)	–	–	–	–	–	–	–	–	(6)
Closing Balance	2	–	–	–	–	2	–	4	–	6	–	–

Carrying Amount of the Asset

Year	1	2	3	4	5	6
Gross block	100	100	100	100	100	100
Accumulated depreciation	25	40	55	70	85	100
Carrying Amount	75	60	45	30	15	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 5

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%. Life reduced to 3 years at the end of year 2.

Statement of Profit and Loss

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		25		25		50		–		–
Accounting Profit		75		75		50		100		100
Tax expense –										
Current tax	32		32		32		32		32	
Deferred tax (income) / asset	(2)	30	(2)	30	(12)	20	8	40	8	40
Profit for the Period		45		45		30		60		60

Workings	**Current Tax**
Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current tax @ 40%	32

Deferred Tax Asset

Year	1	2	3	4	5
Opening balance	–	2	4	16	8
Created	2	2	12	–	–
Reversed	–	–	–	(8)	(8)
Closing balance	2	4	16	8	–

Carrying Amount of the Asset

Year	1	2	3
Gross block	100	100	100
Accumulated depreciation	25	50	100
Carrying Amount	75	50	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 6

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%.

Scenario 1 : Life reduced to 3 years at the end of year 2.

Scenario 2 : Life reduced to 4 years at the end of year 2.

Scenario 1	**Statement of Profit and Loss**							
Year		1		2		3		4
Profit before depreciation		100		100		100		100
Depreciation		20		20		60		–
Accounting Profit		80		80		40		100
Tax expense –								
Current tax	30		30		30		30	
Deferred tax expense/(liability)	2		2		(4)		–	
Deferred tax (income) / asset	–	32	–	32	(10)	16	10	40
Profit for the Period		48		48		24		60

Workings	**Current Tax**
Year	1 to 4
Profit before depreciation	100
Depreciation allowed	25
Taxable Profit	75
Current tax @ 40%	30

Deferred Tax Liability / Asset

Year		1		2		3		4
Deferred tax	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset
Opening balance	–	–	2	–	4	–	–	10
Created	2	–	2	–	–	10	–	–
Reversed	–	–	–	–	(4)	–	–	(10)
Closing Balance	2	–	4	–	–	10	–	–

Carrying Amount of the Asset

Year	1	2	3
Gross block	100	100	100
Accumulated depreciation	20	40	100
Carrying Amount	80	60	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Scenario 2 **Statement of Profit and Loss**

Year		1		2		3		4
Profit before depreciation		100		100		100		100
Depreciation		20		20		30		30
Accounting Profit		80		80		70		70
Tax expense –								
Current tax	30		30		30		30	
Deferred tax expense / (liability)	2	32	2	32	(2)	28	(2)	28
Profit for the Period		48		48		42		42

Workings **Current Tax**

Year	1 to 4
Profit before depreciation	100
Depreciation allowed	25
Taxable Profit	75
Current tax @ 40%	30

Deferred Tax Liability

Year	1	2	3	4
Opening balance	–	2	4	2
Created	2	2	–	–
Reversed	–	–	(2)	(2)
Closing balance	2	4	2	–

Carrying Amount of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Accumulated depreciation	20	40	70	100
Carrying Amount	80	60	30	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 7

On 1.1.20x1 an entity enters into a contract to sell a real estate for 200. Payment : 1.1.20x1 – 100 and 1.1.20x2 – 100. Cost of sales 75% of contract price. Incremental borrowing rate 10% p.a. Income tax rate 40%. Date of delivery 31.12.20x2.

Contract Liability

Date	Heads of Account	Dr	Cr	Balance
20x1				
Jan 1	Cash		100	100
Dec 31	Interest expense (10% on 100)		10	110
20x2				
Jan 1	Cash		100	210
Dec 31	Interest expense (10% on 210)		21	231
Dec 31	Revenue	200		31
Dec 31	Interest income	31		–

Revenue

Date	Heads of Account	Dr	Cr	Balance
20x2				
Dec 31	Contract liability		200	200
Dec 31	Profit and loss	200		–

Deferred Tax Asset

Date	Heads of Account	Dr	Cr	Balance
20x1				
Dec 31	Deferred tax income (40% of 10)	4		4
20x2				
Dec 31	Deferred tax income (40% of 21)	8		12
Dec 31	Tax expense		12	–

Statement of Profit and Loss (Year 2)

Revenue		200
Cost of Sales (75% of 200)		(150)
Gross Profit		50
Interest expense		(21)
		29
Interest income		31
Accounting Profit		60
Tax expense –		
Current tax	20	
Deferred tax income	(8)	
Deferred tax asset	12	24
Profit for the Period		36

Workings **Current Tax**

Revenue	200
Cost of sales (75% of 200)	150
Taxable Profit	50
Current tax @ 40%	20

Deferred Tax Asset

	31.12.20x1	31.12.20x2
Opening balance	–	4
Created	4	8
Reversed	–	(12)
Closing balance	4	–

Carrying Amount of the Asset

	31.12.20x1	31.12.20x2
Closing balance	110	231

Tax Base of the Asset

	31.12.20x1	31.12.20x2
Closing balance	100	200

Example 8

An entity enters into a contract with a customer to sell a product in a calendar year, under the following terms : Purchases < 100 units, price 10 per unit; Purchases > 100 units, price 9 per unit. Income tax rate 40%.

Quarter	Expected Annual Sales (Units)	Quarterly Sales (units)	Price	Revenue	Deferred Revenue	Deferred Tax Asset
1	100	20	10	200	–	–
2	115	30	10	300	50	20
3	110	30	10	300	30	12
4	100	20	10	200	(80)	(32)
		100		1,000	–	–

Revenue

Quarter	Heads of Account	Dr	Cr	Balance
1	Cash		200	200
2	Cash		300	500
	Deferred revenue	50		450
3	Cash		300	750
	Deferred revenue	30		720
4	Cash		200	920
	Deferred revenue		80	1,000
	Profit and loss	1,000		–

Deferred Revenue

Quarter	Heads of Account	Dr	Cr	Balance
2	Revenue		50	50
3	Revenue		30	80
4	Revenue	80		–

Deferred Tax Asset

Quarter	Heads of Account	Dr	Cr	Balance
2	Deferred tax income	20		20
3	Deferred tax income	12		32
4	Tax expense		32	–

Example 9

Custom of trade – Unsold products can be returned within 30 days against full refund. Costs of recovering the products are immaterial and returned products can be resold at a profit. The entity sells 100 products for 100 each. Cost 60 per product. The entity estimates that 3 products will be returned. Income tax rate 40%.

Statement of Profit and Loss		
Revenue (97 x 100)		9,700
Cost of Sales (97 x 60)		5,820
Accounting Profit		3,880
Tax expense –		
Current tax	1,600	
Deferred tax (income)	(48)	1,552
Profit for the Period		2,328

Workings **Current Tax**	
Revenue (100 x 100)	10,000
Cost of sales (100 x 60)	6,000
Taxable Profit	4,000
Current tax @ 40%	1,600

Carrying Amount of Refund Liability	
Closing balance	300

Tax Base of Refund Liability	
Carrying Amount	300
Amount that will be deductible (3 x 40)	120
Tax base	180

Deferred Tax Asset = (Carrying amount – Tax base)Income tax rate = (300 – 180)x40% = 48.

Example 10

Year 1 Revenue 100 includes revenue received in advance 10 for service to be performed in year 2.

2 Revenue 180 does not include any revenue received in advance for service to be performed in future

Cost of sales – Product 50%; Service 40%. Income tax rate 40%. Revenue is taxable in the year of receipt less cost of sales.

Statement of Profit and Loss				
Year		1		2
Revenue (product)		100		180
Deferred revenue (service)		(10)		10
		90		190
Cost of sales –				
Product (50%)	45		90	
Service (40%)	–	45	4	94
Accounting Profit		45		96
Tax expense –				
Current tax	22		34	
Deferred tax (income) / asset	(4)	18	4	38
Profit for the Period		27		58

Workings **Current Tax**				
Year		1		2
Revenue		100		180
Cost of sales –				
Product	*45		90	
Service	–	45	**4	94
Taxable Profit		55		86
Current tax @ 40%		22		34

*50% of 90 ** 40% of 10

Deferred Tax Asset		
Year	1	2
Opening balance	–	4
Created	4	–
Reversed	–	(4)
Closing balance	4	–
Carrying Amount of Deferred Revenue		
Year	1	2
Closing balance	10	–
Tax Base of Deferred Revenue		
Year	1	2
Closing balance	–	–

Example 11

Sales : Year 1 – 60; 2 – 100; 3 – 140. Cost of sales 50% of revenue. Instalment sales : Year 1 – 60 receivable 20 per year for 3 years. Instalment sales are taxable on receipt basis.

Income tax rate 40%.

Statement of Profit and Loss						
Year		1		2		3
Revenue from –						
Sales		60		100		140
Instalment sales		60		–		–
		120		100		140
Cost of sales		60		50		70
Accounting Profit		60		50		70
Tax expense –						
Current tax	16		24		32	
Deferred tax expense/(liability)	8	24	(4)	20	(4)	28
Profit for the Period		36		30		42

Workings **Current Tax**			
Year	1	2	3
Revenue from –			
Sales	60	100	140
Instalment sales	20	20	20
	80	120	160
Cost of sales	40	60	80
Taxable Profit	40	60	80
Current tax @ 40%	16	24	32
Deferred Tax Liability			
Year	1	2	3
Opening balance	–	8	4
Created	8	–	–
Reversed	–	(4)	(4)
Closing balance	8	4	–
Carrying Amount of Receivables			
Year	1	2	3
Closing balance	40	20	–

Tax Base of Receivables

Year	1	2	3
Closing balance of receivables less amount deductible	20	10	–

Example 12

Revenue 20 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%.

Statement of Profit and Loss

Year		1		2		3		4		5
Revenue		20		20		20		20		20
Depreciation		20		20		20		20		20
Accounting Profit		–		–		–		–		–
Tax expense –										
Current tax (income) / asset	(2)		(2)		(2)		(2)		8	
Deferred tax expense / (liability)	2	–	2	–	2	–	2	–	(8)	–
Profit for the Period		–		–		–		–		–

Workings **Current Tax**

Year	1 to 4	5
Revenue	20	20
Depreciation allowed	25	–
Taxable Profit / (Loss)	(5)	20
Current tax @ 40%	(2)	8

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	2	4	6	8
Created	2	2	2	2	–
Reversed	–	–	–	–	(8)
Closing balance	2	4	6	8	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated depreciation	20	40	60	80	100
Carrying Amount	80	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 13

Revenue 20 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) : Financial 25%, Tax 20

Statement of Profit and Loss

Year		1		2		3		4		5
Revenue		20		20		20		20		20
Depreciation		25		25		25		25		–
Accounting Profit / (Loss)		(5)		(5)		(5)		(5)		20
Tax expense –										
Current tax	0		0		0		0		0	
Deferred tax (income) / asset	(2)	2	(2)	2	(2)	2	(2)	2	8	8
Profit / (Loss) for the Period		(3)		(3)		(3)		(3)		12

Workings	**Current Tax**
Year	1 to 5
Revenue	20
Depreciation allowed	20
Taxable Profit	0
Current tax @ 40%	0

Deferred Tax Asset

Year	1	2	3	4	5
Opening balance	–	2	4	6	8
Created	2	2	2	2	–
Reversed	–	–	–	–	(8)
Closing balance	2	4	6	8	–

Carrying Amount of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Accumulated depreciation	25	50	75	100
Carrying Amount	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 14

Bond value 1,000. Transaction cost 50. Interest (simple) 10%. Tenure 3 years. Profit before finance cost 200 per year. Income tax rate 40%.

At initial recognition, transaction costs are to be deducted from the fair value of the bond. Since bonds are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit and loss over the life of the bond.

Journal

(1) Cash	1,000	(2) Transaction Cost	50	(3) Bond	50
Bond	1,000	Cash	50	Transaction Cost	50

Amortisation Schedule of Transaction Cost

Year	Transaction Cost Amortised	Amortisation Schedule
1	16*	950 + 16 = 966
2	16*	966 + 16 = 982
3	18*	982 + 18 = 1,000

* At an effective interest rate of 1.7%

Statement of Profit and Loss

Year		1		2		3
Profit before finance cost		200		200		200
Finance cost		116		116		118
Accounting Profit		84		84		82
Tax expense –						
Current tax	20		40		40	
Deferred tax expense / (liability)	14	34	(7)	33	(7)	33
Profit for the Period		50		51		49

Workings **(1) Current Tax**

Year		1		2		3
Profit before finance cost		200		200		200
Finance cost –						
Interest	100		100		100	
Transaction	50	150	–	100	–	100
Taxable Profit		50		100		100
Current tax @ 40%		20		40		40

(2) Deferred Tax Liability

Year	Heads of Account	Dr	Cr	Balance
1	Deferred tax expense	–	14	14
2	Tax expense	7	–	7
3	Tax expense	7	–	–

Example 15

Zero-coupon bonds 1,000 issued at 751. Transaction cost 50. Tenure 3 years. Effective interest rate 10%. Profit 300 per year. Income tax rate 40%.

At initial recognition, transaction costs are to be deducted from the fair value of zero-coupon bonds. Since zero-coupon bonds are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the *effective interest method* and, in effect, amortised through profit and loss over the life of the zero-coupon bonds.

Zero-coupon Bonds

Year	Heads of Account	Dr	Cr	Balance
0	Cash		751	751
	Transaction cost	50		701
1	Finance cost		87[1]	788
2	Finance cost		99[1]	887
3	Finance cost		113[1]	1,000
	Cash	1,000		–

[1]At an effective interest rate of 12.5%

Statement of Profit and Loss

Year		1		2		3
Profit before finance cost		300		300		300
Finance cost		87		99		113
Accounting Profit		213		201		187
Tax expense –						
Current tax expense	100		120		20	
Deferred tax (income) / asset	(15)	85	(40)	80	55	75
Profit for the Period		127		121		112

Workings **(1) Current Tax**

Year		1		2		3
Profit		300		300		300
Finance cost –						
Discount	–		–		249	
Transaction	50	50	–	–		–249
Taxable Profit		250		300		51
Current tax @ 40%		100		120		20

(2) Deferred Tax Asset

Year	Heads of Account	Dr	Cr	Balance
1	Deferred tax income	15		15
2	Deferred tax income	40		55
3	Tax expense		55	–

Example 16

Zero-coupon convertible bonds 1,000. Transaction cost 50. Tenure 3 years. Effective interest rate 10%. Profit 300 per year. Income tax rate 40%.

Unwinding of Discount

Year	Closing Value	Opening Value at Effective Interest Rate of 10%	Finance cost at Effective Interest Rate of 12.5%*
3	1,000	1,000 x 0.909 = 909	887 x .125 = 113
2	909	1,000 x 0.826 = 826	788 x .125 = 99
1	826	1,000 x 0.751 = 751	701 x .125 = 87

*The impact of transaction cost increases the effective interest rate to 12.5%

Zero-coupon Convertible Bonds

Year	Heads of Account	Dr	Cr	Balance
0	Cash		1,000	1,000
	Transaction cost	50		950
	Equity component of convertible bonds	149[1]		801
	Deferred tax liability	100[2]		701
1	Finance cost		87[3]	788
2	Finance cost		99[3]	887
3	Finance cost		113[3]	1,000
	Share capital	1,000		–

[1]60% of (950 – 701) [2]40% of (950 – 701)[3]At an effective interest rate of 12.5%

Statement of Profit and Loss

Year		1		2		3
Profit before finance cost		300		300		300
Finance cost		87		99		113
Accounting Profit		213		201		187
Tax expense –						
Current tax	100		120		120	
Deferred tax liability	(15)	85	(40)	80	(45)	75
Profit for the Period		128		121		112

Statement of Changes in Equity

Year	1	2	3
Equity component of bond			
Opening balance	149	106	56
Transferred to retained earnings	43*	50**	56***
Closing balance	106	56	–

* [60% of (87 – 16)] ** [60% of (99 – 16)]*** [60% of (113 – 18)]

Workings **(1) Current Tax**

Year		1		2		3
Profit		300		300		300
Finance cost –						
Discount	–		–		–	
Transaction	50	50	–	–	–	–
Taxable Profit		250		300		300
Current tax @ 40%		100		120		120

(2) Deferred Tax Liability

Year	Heads of Account	Dr	Cr	Balance
0	Zero-coupon convertible bonds		100	100
1	Tax expense	15		85
2	Tax expense	40		45
3	Tax expense	45		–

Example 17

5% convertible bonds 1,000. Transaction cost 50. Tenure 3 years. Interest rate without the conversion feature 10%. Profit before finance cost 200 per year. Income tax rate 40%.

The issuer of a convertible bond, (ie, convertible into ordinary shares) to present the liability component and equity component of the convertible bond separately in the Balance Sheet. The fair value of the liability component in the present value of the contractually determined stream of future cash flows discounted at the effective interest rate.

At initial recognition, transaction costs are to be deducted from the fair value of the bond. Since bonds are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit and loss over the life of the bond.

Present Value of 5% Convertible Bond

Year	Particulars	Cash Outflow	Effective Interest Rate @ 10%	Present Value
0	Transaction cost	(50)		(50)
1	Interest	50	0.909	45
2	Interest	50	0.826	41
3	Interest and repayment	1,050	0.751	789
Present value of 5% convertible bond				825

5% Convertible Bonds

Year	Heads of Account	Dr	Cr	Balance
0	Cash		1,000	1,000
	Transaction cost	50		950
	Equity component of convertible bonds	75[1]		875
	Deferred tax liability	50[2]		825
1	Finance cost		101[3]	926
	Cash	50		876
2	Finance cost		108[4]	984
	Cash	50		934
3	Finance cost		116[5]	1,050
	Cash	50		1,000
	Share capital	1,000		–

[1]60% of (950 – 825)[2]40% of (950 – 825) [3]12.2% of 825 [4]12.2% of 876[5]12.2% of 934

Statement of Profit and Loss

Year		1		2		3
Profit before finance cost		200		200		200
Finance cost		101		108		116
Accounting Profit		99		92		84
Tax expense –						
Current tax	40		60		60	
Deferred tax liability	–	40	(23)	37	(27)	33
Profit for the Period		59		55		51

Statement of Changes in Equity

Year	1	2	3
Equity component of bond			
Opening balance	75	54	29
Transferred to retained earnings	21*	25**	29***
Closing balance	54	29	–

* [60% of (51 – 16)] ** [60% of (58 – 16)]*** [60% of (66 – 18)]

Workings **(1) Current Tax**

Year		1		2		3
Profit before finance cost		200		200		200
Finance cost –						
Interest	50		50		50	
Transaction	50	100	–	50	–	50
Taxable Profit		100		150		150
Current tax @ 40%		40		60		60

(2) Deferred Tax Liability

Year	Heads of Account	Dr	Cr	Balance
0	5% Convertible bonds		50	50
1				50
2	Tax expense	23		27
3	Tax expense	27		–

Example 18

At the beginning of year 1, an entity grants 1 share option to each of its 50 employees, which will vest at the end of year 3 and have a life of 6 years. The exercise price and the entity's share price at the date of grant is 60. Income tax rate 40%. Profit for year 1 : 100; 2 : 200; 3 to 6 : 1,000 per year.

End of year	Employees (Nos.)		At year end			Options exercised (Nos.)
	Left	Likely to leave	Share price	Increase in share price	Intrinsic value	
1	2	8	63	3	–	–
2	2	1	65	5	–	–
3	1	–	75	15	–	–
4	–	–	88	13	28	25
5	–	–	100	12	40	10
6	–	–	90	(10)	30	10

End of year	Calculation	Expenses			Deferred Tax Asset		
		Created	Transferred	Balance	Created	Reversed	Balance
1	40 x 3 x 1/3	40	–	40	16	–	16
2	(45 x 5 x 2/3) – 40	110	–	150	44	–	60
3	(45 x 15) – 150	525	–	675	210	–	270
4	(25 x 13) + (20 x 13)	585	700	560	234	280	224
5	(10 x 12) + (10 x 12)	240	400	400	96	160	160
6	10 x (–10)	(100)	300	–	–	160	–

Statement of Profit and Loss

Year		1		2		3		4		5		6
Profit (before remuneration expense)		100		200		1,000		1,000		1,000		1,000
Remuneration expense		(40)		(110)		(525)		(585)		(240)		100
Accounting Profit		60		90		475		415		760		1,100
Tax expense –												
Current tax	40		80		400		120		240		280	
Deferred tax (income) / asset	(16)	24	(44)	36	(210)	190	46	166	64	304	160	440
Profit for the Period		36		54		285		249		456		660

Workings **Current Tax**

Year	1	2	3	4	5	6
Profit (before remuneration expense)	100	200	1,000	1,000	1,000	1,000
Remuneration expense allowed	–	–	–	700	400	300
Taxable Profit	100	200	1,000	300	600	700
Current tax @ 40%	40	80	400	120	240	280

Example 19

Profit before remuneration expense : year 1 – 4 : 200 per year; year 5 : 1,000. Income tax rate 40%.

Year	Remuneration expense		Options at year-	Intrinsic value	Total value
	For period	Cumulative	end (Nos)	per option	of option
1	110	110	50	6	300
2	115	225	45	7	315
3 **Vested**	125	350	40	8	320
4	–	–	40	9	360
5 **Exercised**	–	–	40	10	400

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Year 1				
(1)	Remuneration expense	110		
	Liability for options		110	
(2)	Profit and loss	110		
	Remuneration expense		110	
(3)	Deferred tax asset	40		(300 x 1/3 x 0.4)
	Deferred tax income		40	
(4)	Deferred tax income	40		
	Tax expense		40	
Year 2				
(1)	Remuneration expense	115		
	Liability for options		115	
(2)	Profit and loss	115		
	Remuneration expense		115	

(3)	Deferred tax asset	44		[(315 x 2/3 x 0.4) – 40]
	Deferred tax income		44	
(4)	Deferred tax income	44		
	Tax expense		44	
Year 3				
(1)	Remuneration expense	125		
	Liability for options		125	
(2)	Profit and loss	125		
	Remuneration expense		125	
(3)	Deferred tax asset	44		[(320 x 0.4) – 40 + 44)]
	Deferred tax income		44	
(4)	Deferred tax income	44		
	Tax expense		44	
Year 4				
(1)	Retained earnings	6		[(360 – 350) x 0.6]
	Liability for options		6	
(2)	Deferred tax asset	16		[(360 x 0.4) – (40 + 44 + 44)]
	Deferred tax income		12	[(350 – 320) x 0.4]
	Deferred tax equity		4	[(360 – 350) x 0.4]
(3)	Deferred tax income	12		
	Tax expense		12	
Year 5				
(1)	Retained earnings	24		[(400 – 360) x 0.6]
	Liability for options		24	
(2)	Current tax asset	16		
	Current tax equity		16	
(3)	Tax expense	160		
	Deferred tax asset		144	
	Current tax asset		16	
(4)	Liability for options	380		(110 + 115 + 125 + 6 + 24)
	Deferred tax equity	4		
	Current tax equity	16		
	Equity		400	

Statement of Profit and Loss

Year		1		2		3		4		5
Profit		200		200		200		200		1,000
Remuneration expense		110		115		125		–		–
Accounting Profit		90		85		75		200		1,000
Tax expense –										
Current tax	80		80		80		80		240	
Deferred tax (income) / asset	(40)		(44)		(44)		(12)		144	
Current tax asset	–	40	–	36	–	36	–	68	16	400
Profit for the Period		50		49		39		132		600

Workings **Current Tax**

Year	1	2	3	4	5
Profit	200	200	200	200	1,000
Remuneration expense allowed	–	–	–	–	400
Taxable Profit	200	200	200	200	600
Current tax @ 40%	80	80	80	80	240

Carrying Amount of Liability for Options

Year	1	2	3	4	5
Opening balance	–	110	225	350	356
Created from –					
Profit and loss	110	115	125	–	–
Retained earnings	–	–	–	6	24
Transferred to equity	–	–	–	–	(380)
Closing balance	110	225	350	356	–

Tax Base of Liability for Options

Year	1	2	3	4	5
Opening balance	–	10	15	30	–
Created from –					
Profit and loss	110	115	125	–	–
Retained earnings	–	–	–	6	24
Deductible in future / current period(s)	(100)	(110)	(110)	(36)	(24)
Closing balance	10	15	30	–	–

Deferred Tax Asset

Year	1	2	3	4	5
Opening balance	–	40	84	128	144
Created from –					
Deferred tax income	40	44	44	12	–
Deferred tax equity	–	–	–	4	–
Transferred to profit and loss	–	–	–	–	(144)
Closing balance	40	84	128	144	–

Current Tax Asset

Year	5
Created from current tax equity	16
Transferred to profit and loss	(16)
Closing balance	–

Deferred Tax Equity

Year	4	5
Opening balance	–	4
Created outside profit and loss	4	–
Transferred to equity	–	(4)
Closing balance	4	–

Current Tax Equity

Year	5
Created outside profit and loss	16
Transferred to profit and loss	(16)
	–

Example 20

Profit (before fair value determination of investment property) 100 per year. Investment property acquired at the beginning of year 1 : 100. Year-end fair value of investment property: Year 1 – 110; 2 – 120; 3 – 110; 4 – 140. Disposal of investment property : Year 5 - 150. Depreciation rate for income tax (SLM) 25%. Unrealised changes in the fair value of investment property do not affect taxable profit. If the property is sold for more than cost, the reversal of the accumulated tax depreciation will be included in taxable profit and taxed at an ordinary tax rate of 30%. For sale proceeds in excess of cost, tax law specifies a tax rate of 40% for assets held for more than 3 years.

Statement of Profit and Loss (Fair Value Model)

Year		1		2		3		4		5
Profit		100		100		100		100		100
Fair value increase / (decrease)		10		10		(10)		30		10
Accounting Profit		110		110		90		130		110
Tax expense –										
Current tax	22.5		22.5		22.5		22.5		80	
Deferred tax expense / (liability)	11.5	34	11.5	34	3.5	26	19.5	42	(46)	34
Profit for the Period		76		76		64		88		76

Statement of Profit and Loss (Cost Model)

Year		1		2		3		4		5
Profit		100		100		100		100		100
Profit on disposal		–		–		–		–		50
Accounting Profit		100		100		100		100		150
Tax expense –										
Current tax	22.5		22.5		22.5		22.5		80	
Deferred tax expense / (liability)	7.5	30	7.5	30	7.5	30	7.5	30	(30)	50
Profit for the Period		70		70		70		70		100

Workings **Current Tax**

Year	1	2	3	4	5
Profit	100	100	100	100	100
Depreciation (allowed) / reversed	(25)	(25)	(25)	(25)	100
	75	75	75	75	200
Profit on disposal	–	–	–	–	50
Taxable Profit	75	75	75	75	250
Current tax	22.5	22.5	22.5	22.5	80

Tax Base of the Investment Property

Year	1	2	3	4	5
Gross block	100	100	100	100	–
Depreciation (allowed) / reversed	(25)	(50)	(75)	(100)	100
	75	50	25	–	100
Profit on disposal	–	–	–	–	50
Tax base	75	50	25	–	150

Carrying Amount of the Investment Property (Fair value model)

Year	1	2	3	4	5
Gross block	100	110	120	110	140
Fair value increase / (decrease)	10	10	(10)	30	10
Carrying amount	110	120	110	140	150

Carrying Amount of the Investment Property (Cost model)

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Profit on disposal	–	–	–	–	50
Carrying amount	100	100	100	100	150

Example 21

Profit (before amortisation) 100 per year. Development costs were deducted for income tax purposes in the period in which they were incurred. Income tax rate 40%..

Development Costs

Year	1	2	3	4	5	6
Capitalised	30	30	40	–	–	–
Amortised	–	–	25	25	25	25

Statement of Profit and Loss

Year		1		2		3		4		5		6
Profit before amortisation		100		100		100		100		100		100
Amortisation		–		–		25		25		25		25
Accounting Profit		100		100		75		75		75		75
Tax expense –												
Current tax	28		28		24		40		40		40	
Deferred tax expense/(liability)	12	40	12	40	6	30	(10)	30	(10)	30	(10)	30
Profit for the Period		60		60		45		45		45		45

Workings **Current Tax**

Year	1 and 2	3	4 to 6
Profit	100	100	100
Development costs allowed	30	40	–
Taxable profit	70	60	100
Current tax @ 40%	28	24	40

Deferred Tax Liability

Year	1	2	3	4	5	6
Opening balance	–	12	24	30	20	10
Created	12	12	6	–	–	–
Reversed	–	–	–	(10)	(10)	(10)
Closing balance	12	24	30	20	10	–

Carrying Amount of Development Costs

Year	1	2	3	4	5	6
Opening balance	–	30	60	75	50	25
Capitalised	30	30	40	–	–	–
Amortised	–	–	(25)	(25)	(25)	(25)
Closing balance	30	60	75	50	25	–

Tax Base of Development Costs

Year	1	2	3
Opening balance	–	–	–
Capitalised	30	30	40
Amortisation allowed	(30)	(30)	(40)
Closing balance	–	–	–

Example 22

Profit (before development costs) 100 per year. Development costs in relation to development of a new product were deducted for income tax purposes in year 4. Income tax rate 40%.

Year	**1**	**2**	**3**	**4**
Development Costs expensed	10	20	30	40

Statement of Profit and Loss

Year		1		2		3		4
Profit before development costs		100		100		100		100
Development costs		10		20		30		40
Accounting Profit		90		80		70		60
Tax expense –								
Current tax	40		40		40		–	
Deferred / current tax income	(4)		(8)		(12)		(16)	
Deferred tax asset	–	36	–	32	–	28	40	24
Profit for the Period		54		48		42		36

Workings **Current Tax**

Year	1 to 3	4
Profit	100	100
Development costs allowed	–	100
Taxable profit	100	–
Current tax @ 40%	40	–

Deferred Tax Asset

Year	1	2	3	4
Opening balance	–	4	12	24
Created from deferred / current tax income	4	8	12	16
Reversed	–	–	–	(40)
Closing balance	4	12	24	–

Carrying Amount of Development Costs

The carrying amount is Nil, since not recognised as assets in Balance Sheet.

Tax Base of Development Costs

Year	1	2	3	4
Opening balance	–	10	30	60
Incurred	10	20	30	40
Allowed for income tax purposes	–	–	–	(100)
Closing balance	10	30	60	–

Example 23

Profit (before amortisation) 100 per year. Development costs in relation to the development of a new product were deducted for income tax purposes in year 3. Income tax rate 40%.

Development Costs

Year	1	2	3	4	5	6
Capitalised	30	30	40	–	–	–
Amortised	–	–	25	25	25	25

Statement of Profit and Loss

Year		1		2		3		4		5		6
Profit before amortisation		100		100		100		100		100		100
Amortisation		–		–		25		25		25		25
Accounting Profit		100		100		75		75		75		75
Tax expense –												
Current tax expense/Deferred tax asset	40		40		40		40		40		40	
Deferred tax equity	–	40	–	40	(10)	30	(10)	30	(10)	30	(10)	30
Profit for the Period		60		60		45		45		45		45

Workings **Current Tax**

Year	1 and 2	3	4 to 6
Profit	100	100	100
Amortisation allowed	–	100	–
Taxable Profit	100	–	100
Current tax @ 40%	40	0	40

Deferred Tax Asset

Year	1	2	3
Opening balance	–	12	24
Created through equity	12	12	16
Reversed through profit and loss	–	–	(40)
Closing balance	12	24	–

Deferred Tax Equity

Year	1	2	3	4	5	6
Opening balance	–	12	24	30	20	10
Created through equity	12	12	16	–	–	–
Reversed through profit and loss	–	–	(10)	(10)	(10)	(10)
Closing balance	12	24	30	20	10	–

Carrying Amount of Development Costs

Year	1	2	3	4	5	6
Opening balance	–	30	60	75	50	25
Capitalised	30	30	40	–	–	–
Amortised	–	–	(25)	(25)	(25)	(25)
Closing balance	30	60	75	50	25	–

Tax Base of Development Costs

Year	1	2	3
Opening balance	–	30	60
Capitalised	30	30	40
Amortisation allowed	–	'–	(100)
Closing balance	30	60	–

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Year 1 and 2

(1)	Tax expense	40		
	Current tax		40	
(2)	Deferred tax asset	12		(40% of 30)
	Deferred tax equity		12	

Year 3

(1)	Deferred tax asset	16		(40% of 40)
	Deferred tax equity		16	
(2)	Tax expense	40		(12 + 12 + 16)
	Deferred tax asset		40	
(3)	Deferred tax equity	10		(40% of 25)
	Tax expense		10	

Year 4, 5 and 6

(1)	Tax expense	40		
	Current tax		40	
(2)	Deferred tax equity	10		(40% of 25)
	Tax expense		10	

Example 24

Profit before depreciation 105 per year. Asset 100. Income tax rate : year 1 and 2 – 30%; year 3 – 35%; year 4 and 5 – 40%. Depreciation (SLM) – Financial 20%; Tax 25%.

Statement of Profit and Loss

Year		1		2		3		4		5
Profit before depreciation		105		105		105		105		105
Depreciation		20		20		20		20		20
Accounting Profit		85		85		85		85		85
Tax expense –										
Current tax	24		24		28		32		42	
Deferred tax expense / (liability)	1.5	25.5	2	26	2.5	30.5	2	34	(8)	34
Profit for the Period		59.5		59		54.5		51		51

Workings **Current Tax**

Year	1 and 2	3	4	5
Profit before depreciation	105	105	105	105
Depreciation allowed	25	25	25	–
Taxable Profit	80	80	80	105
Current tax	24	28	32	42

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	1.5	3.5	6	8
Created	1.5	2	2.5	2	–
Reversed	–	–	–	–	(8)
Closing balance	1.5	3.5	6	8	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated depreciation	20	40	60	80	100
Carrying amount	80	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax base	75	50	25	–

Example 25

Profit before depreciation 105 per year. Asset 100. Income tax rate : year 1 and 2 – 30%; year 3 – 35%; year 4 and 5 – 40%. Depreciation (SLM) – Financial 20%; Tax 25%. Fair value 75 at the end of year 2.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3		4		5
Profit before depreciation		105		105		105		105		105
Depreciation		20		20		25		25		25
Accounting Profit		85		85		80		80		80
Tax expense –										
Current tax	24		24		28		32		42	
Deferred tax expense / (liability)	1.5	25.5	2	26	0.5	28.5	–	32	(10)	32
Profit for the Period		59.5		59		51.5		48		48
Other comprehensive income										
Revaluation surplus (net of tax)		–		9.75		(0.75)		–		–
Total comprehensive income		59.5		68.75		50.75		48		48

Statement of Changes in Equity

Year	2	3	4	5
Revaluation surplus				
Opening balance	–	9.75	6	3
Created	9.75	–	–	–
Reversed	–	(0.75)	–	–
Transferred to retained earnings	–	(3)	(3)	(3)
Closing balance	9.75	6	3	–

Workings **Current Tax**

Year	1 and 2	3	4	5
Profit before depreciation	105	105	105	105
Depreciation allowed	25	25	25	–
Taxable Profit	80	80	80	105
Current tax	24	28	32	42

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	1.5	8.75	10	10
Created through –					
Profit and loss	1.5	2	0.5	–	–
Other comprehensive income	–	5.25	0.75	–	–
Reversed through profit and loss	–	–	–	–	(10)
Closing balance	1.5	8.75	10	10	–

Carrying Amount of the Asset

Restated proportionately

Year	1	2		3	4	5
			Revaluation increase			
Gross block	100	100	125	125	125	125
Accumulated depreciation	20	40	50	75	100	125
Carrying Amount	80	60	75	50	25	–

Eliminated against gross carrying amount

Year	1	2		3	4	5
			Revaluation increase			
Gross block	100	100	75	75	75	75
Accumulated depreciation	20	40	–	25	50	75
Carrying Amount	80	60	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 26

Profit before depreciation 100 per year. Building 100. Deprecitaion (SLM) – Financial 20%; Tax 25%. At the beginning of year 4, there is a change in use leading to a transfer from owner-occupied property to investment property. Fair value at the end of year 2 – 75; year 4 – 60; Year 5 – 80. Disposal of investment property in year 6 – 110. If the property is sold for more than cost, the reversal of the accumulated tax depreciation is included in taxable profit and taxed at an ordinary tax rate of 30%. For sale proceeds in excess of cost, tax law specifies a tax rate of 40%.

Statement of Comprehensive Income

Year		1		2		3		4		5		6
Profit		100		100		100		100		100		100
(Depreciation) / Fair value increase		(20)		(20)		(25)		10		20		30
Accounting Profit		80		80		75		110		120		130
Tax expense –												
Current tax	22.5		22.5		22.5		22.5		30		64	
Deferred tax expense/(liability)	1.5	24	1.5	24	–	22.5	10.5	33	6	36	(24)	40
Profit for the Period		56		56		52.5		77		84		90
Other comprehensive income												
Revaluation surplus (net of tax)		–		10.5		–		–		–		–
Total comprehensive income		56		66.5		52.5		77		84		90

Statement of Changes in Equity

Year	2	3
Opening balance	–	10.5
Created	10.5	–
Transferred to retained earnings	–	(10.5)
Closing balance	10.5	–

Workings **Current Tax**

Year	1	2	3	4	5	6
Profit	100	100	100	100	100	100
Depreciation (allowed) / reversed	(25)	(25)	(25)	(25)	–	100
	75	75	75	75	100	200
Profit on disposal	–	–	–	–	–	10
Taxable profit	75	75	75	75	100	210
Current tax	22.5	22.5	22.5	22.5	30	64

Deferred Tax Liability

Year	1	2	3	4	5	6
Opening balance	–	1.5	7.5	7.5	18	24
Created from –						
Profit and loss	1.5	1.5	–	10.5	6	–
Other comprehensive income	–	4.5	–	–	–	–
Reversed through profit and loss	–	–	–	–	–	(24)
Closing balance	1.5	7.5	7.5	18	24	–

Carrying Amount of the Building

Owner-occupied property					Investmentproperty			
Year	1		2	3	Year	4	5	6
Gross block	100	100	125	125	Opening balance	50	60	80
Accumulated depreciation	20	40	50	75	Fair value increase	10	20	30
Carrying Amount	80	60	75	50	Closing balance	60	80	110

Tax Base of the Building

Year	1	2	3	4	5	6
Gross block	100	100	100	100	–	–
Depreciation (allowed) / reversed	(25)	(50)	(75)	(100)	–	100
	75	50	25	–	–	100
Profit on disposal	–	–	–	–	–	10
Tax Base	75	50	25	–	–	110

Example 27

Profit (loss) before depreciation year 1 – (100); year 2 – (200); year 3 – 100; year 4 – 200; year 5 – 300. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%; Tax 25

Statement of Profit and Loss

Year		1		2		3		4		5
Profit / (loss) before depreciation		(100)		(200)		100		200		300
Depreciation		(20)		(20)		(20)		(20)		(20)
Accounting Profit / (loss)		(120)		(220)		80		180		280
Tax income / expense –										
Current tax income/ expense	50		90		–		–		80	
Current tax asset	–		–		30		70		40	
Deferred tax expense / liability	(2)	48	(2)	88	2	32	2	72	(8)	112
Profit for the Period		(72)		(132)		48		108		168

Workings **Current Tax**

Year	1	2	3	4	5
Profit / (loss)	(100)	(200)	100	200	300
Depreciation allowed	(25)	(25)	(25)	(25)	–
Taxable profit / (loss) before set-off of taxable loss	(125)	(225)	75	175	300
Set-off of taxable loss	–	–	(75)	(175)	(100)
Taxable profit	–	–	–	–	200
Current tax income / expense @ 40%	50	90	–	–	80

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	2	4	6	8
Created	2	2	2	2	–
Reversed	–	–	–	–	(8)
Closing balance	2	4	6	8	–

Current Tax Asset

Year	1	2	3	4	5
Opening balance	–	50	140	110	40
Created	50	90	–	–	–
Reversed	–	–	(30)	(70)	(40)
Closing balance	50	140	110	40	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated depreciation	20	40	60	80	100
Carrying Amount	80	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 28

On 1 January 20x1, an entity issues 100, 10% redeemable preference shares of 10 each. Each preference share is mandatorily redeemable on 31 December 20x3. Profit before finance cost 300 per year. Income tax rate 40%. Transaction cost 50.

A preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. This is because, the issuer has an obligation to transfer financial assets to the holder of the preference shares.

At initial recognition, transaction costs are to be deducted from the fair value of redeemable preference shares. Since, redeemable preference shares are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the *effective interest method* and, in effect, amortised through profit and loss over the life of the preference shares. Because interest payments are fixed and will be paid in perpetuity, the amortised cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period.

Statement of Profit and Loss

Year		20x1		20x2		20x3
Profit before finance cost		300		300		300
Finance cost		116		117		117
Accounting Profit		184		183		183
Tax expense –						
Current tax	100		120		120	
Deferred tax expense / (liability)	14	114	(7)	113	(7)	113
Profit for the Period		70		70		70

Workings : (1) 10% Redeemable Preference Shares

Year	Heads of Account	Dr	Cr	Balance
0	Cash		1,000	1,000
	Transaction cost	50		950
1	Finance cost		116[1]	1,066
	Cash	100		966
2	Finance cost		117[1]	1,083
	Cash	100		983
3	Finance cost		117[1]	1,100
	Cash	1,100		–

[1]At an effective interest rate of 12.22%

(2) Current Tax

Year	20x1	20x2	20x3
Profit	300	300	300
Transaction cost allowed	50	–	–
Taxable profit	250	250	250
Current tax @ 40%	100	120	120

(3) Deferred Tax Liability

Year	Heads of Account	Dr	Cr	Balance
1	Deferred tax expense		14	14
2	Tax expense	7		7
3	Tax expense	7		–

Presentation of Financial Statements (Ind AS 1)

Introduction

This standard prescribes the basis for presentation of general purpose financial statements (those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs) to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. Therefore, financial statements are a structured representation of the financial position and financial performance of an entity.

The objective of financial statements is to provide fair information about the –

- Financial position (assets, liabilities and equity);
- Financial performance (income and expenses, including gains and losses);
- Contributions by and distributions to owners (holders of instruments classified as equity) in their capacity as owners; and
- Cash flows

This information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

A complete set of financial statements comprises –

- a balance sheet at the end of the period;
- a statement of profit and loss and other comprehensive income (statement of comprehensive income) for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period;
- notes, comprising a summary of significant accounting policies and their explanatory information; and
- a balance sheet as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.

An entity may present –

- a single statement of profit and loss and other comprehensive income, with profit and loss and other comprehensive income presented in two sections. The sections shall be presented together, with the section presented first followed directly by the other comprehensive income section; or
- the profit or loss section in a separate statement of profit and loss. If so, the separate statement of profit and loss shall immediately precede the statement presenting comparative income, which shall begin with profit and loss.

General features

Fair presentation and compliance with Ind ASs

Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Conceptual framework for financial reporting.

The application of Ind ASs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

An entity whose financial statements comply with Ind ASs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with Ind ASs unless they comply with all the requirements of Ind ASs.

In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable Ind ASs. A fair presentation also requires an entity to –

- select and apply accounting policies in accordance with Ind AS 8.
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.
- provide additional disclosures when compliance with the specific requirements in Ind ASs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

Example 1

An entity sells goods with a 1-year warranty. It is not adequately enough for the entity to just reveal this in the notes. A provision has to be created for the warranty in the financial statements.

Sometimes, it might happen, that for an entity compliance with a specific requirement of an Ind AS would be so misleading that it leads to a direct conflict with the purpose of financial statements specified in the Conceptual framework. In such circumstances, the entity should give *Conceptual framework for financial reporting* the priority, depart from the specific requirement and provide the following disclosures –

- that management has concluded, that the financial statements are fairly presented;
- that it has complied with all Ind ASs except a particular requirement in a specific Ind AS;
- the details of the Ind AS from which the entity has departed – title of the Standard, nature of non-conformity, the reason for it being misleading, the treatment specified and the treatment actually adopted; and
- for each period presented the financial effect of the non-conformity with the Ind AS requirement.

In some cases, the departure from a certain requirement in an Ind AS might be prohibited. In that case, an entity should reduce the apparent misleading aspect to the maximum level by further disclosing (in addition to the above points) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to realise fair presentation.

Going concern

When preparing financial statements, management should make an assessment of an entity's ability to carry on as a going concern by taking into consideration all information about the future. An entity should prepare financial statements on a going concern basis unless the management either intends to shut down the entity or stop trading, or has no reasonable alternative to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity should disclose those uncertainties.

Example 2

Almost 90% of the production of ABC Ltd is purchased by XYZ Ltd. If XYZ Ltd shuts down operations, ABC Ltd will automatically have to face major consequences. Therefore, ABC Ltd should disclose this uncertainty in its notes.

Therefore, if the entity does not prepare its financial statements on a going concern basis, it should disclose that information, together with the basis on which it has prepared its financial statements and also the reason why it is not regarded as a going concern.

Accrual basis of accounting

An entity should prepare its financial statements using accrual basis of accounting, ie, matching revenues to expenses at the time during which the transaction occurs in the reporting period rather than when payment is made or received. This is, however, not followed for cash flow information, which is more of a cash basis of accounting, ie, transactions reported when money is paid or received.

Example 3

XYZ Ltd sold goods worth 100 on credit in March 2012. The company received cash from the sale in April 2012. Thus, the sale was recorded in March as revenue and not when cash was received.

Materiality and Aggregation

The question that first arises is what materiality is and how to judge what is material and what is not. Thus, omissions or misstatements of items are material if they could individually or collectively influence the economic decisions that users make on the basis of the financial statements. Materiality also depends on size and nature of the omission or misstatement. The size or nature of the item, or a combination of both, could be the determining factor.

Financial statements result after processing large number of transactions that are aggregated into classes based on their similarity in terms of nature or function. If a line item is not individually material, it is aggregated with other items either in those statements or in notes.

If certain information is not material, it is not required to give separate disclosure for them.

Offsetting

An entity cannot offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.

Measuring assets net of valuation allowances is not offsetting.

Example 4

Provision for doubtful debts shown as a deduction from receivables is not offsetting.

It often happens that a transaction is incidental to another main transaction, and then the substance of the transaction can be better reflected by netting the related income (or expense) with related expenses (or incomes) arising out of the same transaction.

Example 5

ABC Ltd has created a provision of 100 for product refund due to defect in its product and added it to the cost of goods sold (related expense). Later, a supplier agreed to reimburse 50 of that expense (due to defective product) and the reimbursement was deducted from cost of goods sold. Thus, ABC Ltd off-set the product refund expense (provision created) as well as the reimbursement from a third party (incidental to the main transaction) against the cost of goods sold (related expense).

Frequency of Reporting

An entity should present a complete set of financial statements (including the comparative statements) at least annually (one year period or 52-week period).

It might happen that an entity changes its financial reporting period and, therefore, presents the financial statements for, either a longer or shorter period. In such cases, the entity must disclose the reason for the longer or shorter period as well as the fact that the amounts are not appropriately comparable.

Example 6

XYZ Ltd has been acquired by ABC Ltd in February and ABC Ltd's reporting period is from January to December, whereas for XYZ Ltd, it is April to March. XYZ Ltd's first set of financial statements, after the acquisition, will be for a 10-month period. XYZ Ltd should also disclose the fact that this set of financial statements may not be correctly comparable with prior or next period(s).

Comparative Information

Except when Ind ASs permit or require otherwise, an entity shall disclose comparative information in respect of the previous period for all amounts reported in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

An entity disclosing comparative information shall present, as a minimum, two balance sheets, two of each of the other statements, and related notes. When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or when it reclassifies items in its financial statements, it shall present, as a minimum, 3 balance sheets, 2 of each of the other statements, and related notes. An entity presents balance sheets as at the –

- end of the current period,
- end of the previous period (which is the same as the beginning of the current period), and
- beginning of the earliest comparative period.

In some cases, narrative information provided in the financial statements for the previous period(s) continues to be relevant in the current period. An entity, eg, discloses in the current period details of a legal dispute whose outcome was uncertain at the end of the immediately preceding reporting period and that is yet to be resolved. Users benefit from information that the uncertainty existed at the end of the immediately preceding reporting period, and about the steps that have been taken during the period to resolve the uncertainty.

When the entity changes the presentation or classification of items in its financial statements, the entity shall reclassify comparative amounts unless reclassification is impracticable. When the entity reclassifies comparative amounts, the entity shall disclose the –

- nature of the reclassification;
- amount of each item or class of items that is reclassified; and
- reason for the reclassification.

When it is impracticable to reclassify comparative amounts, an entity shall disclose the –

- reason for not reclassifying the amounts, and
- nature of the adjustments that would have been made if the amounts had been reclassified.

Enhancing the inter-period comparability of information assists users in making economic decisions, especially by allowing the assessment of trends in financial information for predictive purposes. In some circumstances, it is impracticable to reclassify comparative information for a particular prior period to achieve comparability with the current period. For example, an entity may not have collected data in the prior period(s) in a way that allows reclassification, and it may be impracticable to recreate the information.

Ind AS 8 sets out the adjustments to comparative information required when an entity changes an accounting policy or corrects an error.

Consistency of Information

An entity should maintain consistency in the presentation and classification of items in the financial statements from one period to the next, unless –

- it is evident, from a significant change in the nature of the entity's operations or an assessment of its financial statements, that another presentation or classification would provide more relevant and reliable information;

Example 7

ABC Ltd uses cost model to measure its property, plant and equipment. However, the company feels that using the revaluation model for subsequent measurement of Property, plant and equipment would be a better alternative. In such a case, ABC Ltd can change its policy.

- an Ind AS requires a change in presentation.

Structure and Contents

An entity should clearly identify the entire set of financial statements and notes and differentiate them from other information that is also to be provided to the users in the same published document. The reason for doing so is that the financial statements should be prepared as per the Ind AS requirement, but other information such as reports or management reviews are not subject to those requirements.

An entity should also disclose the following information prominently and repeat when necessary for the information presented to be understandable :

1.	The name of the reporting entity or other means of identification, and any change in that information from the end of the preceding reporting period;	**XYZ Ltd.**
2.	Whether the financial statements are of an individual entity or a group of entities;	**Consolidated Balance Sheet**
3.	The date of the end of the reporting period covered by the set of financial statements or notes;	**as on 31 March 2012 / for the period ended 31 March 2012**
4.	The presentation currency, as defined in Ind AS 21 The Effects of Changes in Foreign Exchange Rates; and	**$**
5.	The level of rounding used in presenting amounts in the financial statements.	**in millions**

Balance Sheet

Current and Non-current Distinction

An entity should present :

- current and non-current assets; and
- current and non-current liabilities

as separate classifications in its Balance Sheet.

Example 8

XYZ Ltd supplies goods within a clearly identifiable operating cycle. Its net assets are continuously circulated as working capital for the business. For XYZ Ltd, it would clearly provide separate classification of current and non-current assets and liabilities in its Balance Sheet.

However, if the entity (eg, financial institutions) believes that the liquidity basis of presentation will reveal more relevant and reliable information, then the entity can present the assets and liabilities in order of their liquidity.

Example 9

ABC Ltd is a bank and XYZ Ltd is a manufacturing concern. The requirements of the users of both the companies are different and, therefore, their basis of presentation is also different. XYZ Ltd presents the financial position by classifying assets and liabilities into current and non-current, whereas ABC Ltd uses the liquidity form of presenting the assets and liabilities in its Balance Sheet, ie, from increasing or decreasing order of liquidity.

An entity is also allowed to present some of its assets and liabilities using a current/non-current classification and others in order of liquidity. This might be preferred by those entities that have diverse operations.

Irrespective of the basis of presentation the entity has adopted, an entity needs to disclose the amount that is expected to be recovered or settled for each asset and liability –

- no more than 12 months after the reporting period (current); and
- more than 12 months after the reporting period (non-current).

Current and non-current assets

An asset that satisfies any of the following criteria can be classified as a current asset –

- realise or consume within normal operating cycle;
- holds assets primarily for trading;
- unrestricted cash and cash equivalents;
- realise the asset within 12 months after the reporting period.

For all other assets, an entity should classify them as non-current.

The operating cycle of an entity is the time between acquisition of assets for processing and their realisation into cash or cash equivalents.

Example 10

ABC Ltd is a ship manufacturing company. Its reporting period is from April to March (12 months). It takes 15 months to build and deliver a ship. Therefore, its normal operating cycle is 15 months. ABC Ltd should classify receivables and inventories as current assets as it expects to sale, consume or realise in the normal course of its 15 month operating cycle.

Sometimes, it also happens that the normal operating cycle of an entity is not clearly identifiable. In such a case, it is assumed to be 12 months.

Current assets also include financial assets that are meant for the sole purpose of trading, such as investments in equity instruments to make short term gains.

The current portion of non-current financial assets is also current asset.

Example 11

ABC Ltd has two types of financial assets.

The company is an active player in the stock market and is a regular buyer and seller of shares of other companies for making short-term gains. These shares are financial assets held for trading and, therefore, are classified as current assets.

ABC Ltd has also given loans to its employees worth 100 for a 10 year period. The company would recover 20 from the employees as loan repayment each year, after the 5th year. Therefore, though the loan to employees is a non-current asset (to be recovered after 12 months), the current portion of the loan repayment (20 loan repayment each year, after the 5th year) is a current asset.

Cash and cash equivalents are current assets until and unless they are restricted from being exchanged or used to settle a liability for at least 12 months.

Example 12

An entity may pledge deposits with banks. In such a case, the entity cannot use that cash for its operating requirements and use it freely. The entity should disclose the amount of cash and cash equivalents that is not available for use.

Current and Non-current Liabilities

An entity should classify a liability as current when –

- it expects to settle the liability in its normal operating cycle;
- it holds the liability primarily for trading;
- the liability due to be settled within 12 months after reporting period;
- it does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period.

All other liabilities are classified as non-current.

The same normal operating cycle concept applies here too, ie, liabilities like trade payables are classified as current liabilities even if they are to be settled after 12 months provided, they are settled within the normal operating cycle. However, if an entity cannot clearly identify its normal operating period, then it is assumed to be 12 months.

Some liabilities are due to be settled within 12 months such as dividends payable, income taxes, the current portion of non-current financial liabilities (borrowings) and other non-trade payables.

Long term financing and the ones which are not to be settled within 12 months after the reporting period are non-current liabilities.

Example 13

Regarding provision for product warranty, the categorisation depends on the terms of product warranty. Warranties which will be utilised within 12-month period are categorised as current liabilities, whereas warranties that can be claimed for an extended period are classified as non-current liabilities.

An entity classifies its financial liabilities as current when they are due to be settled within 12 months after the reporting period, even if –

- the original term was of a period longer than 12 months; and
- an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.

Example 14

ABC Ltd has a long term loan in its books. The loan has to be paid back within 12 months after the reporting date. The reporting date of the company is 31 December 2011. ABC Ltd goes for refinancing the loan in January 2012 and financial statements are authorised for issue on 25 February 2012. The long-term loan is shown as a current liability because it was not refinanced at the end of the reporting period, ie, 31 December 2011.

If an entity has the right to refinance or roll over an obligation which is due within the next 12 months, then it classifies the liability as non-current. However, if this right is not available to an entity, then the entity cannot refinance the obligation and, therefore, classifies it as current.

Example 15

ABC Ltd has a long-term loan, with unconditional refinancing right, in its books. The loan has to be paid back within 12 months of the reporting date. The reporting date of the company is 31 December 2011. ABC Ltd goes for refinancing the loan in January 2012 and the financial statements are authorised for issue on 25 February 2012. The long-term loan is shown as a non-current liability even though it was not refinanced at the end of the reporting period, since the entity had the unconditional right to refinance, enabling it to classify the obligation as a non-current one.

Example 16

ABC Ltd has a loan to be payable after 8 years. At the end of the 5th year, ABC Ltd violates the terms of the loan and, therefore, as per the contract the loan becomes payable on demand. The reporting period of ABC Ltd is 31 March 2012. The lender, on 25 April agrees not to demand payment on the breach of loan agreement and on 15 May the financial statements were authorised for issue. Though the lender did not demand payment, the loan is classified as a current liability because on 31 March due to violation of the loan contract, the loan had become payable.

In respect of loans classified as current liabilities, if the following events occur between the end of the reporting period and the date of financial statements are authorised for issue, those events are disclosed as non-adjusting events in accordance with Ind AS 10 Events After the Reporting Period –

- refinancing on a long-term basis;
- rectification of a breach of a long-term loan arrangement; and
- the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least 12 months after the reporting period.

Structure

This standard has clearly provided the minimum line items that must be included in Balance Sheet. An entity can present additional line items, headings and subtotals in Balance Sheet, provided such presentation will give more relevant and reliable information to the users for their understanding of the entity's financial position.

Deferred tax assets and deferred tax liabilities are outside the purview of current and non-current classification and an entity should always present them as non-current.

The Standard has not specified any order or format by which an entity needs to present the line items.

An entity uses judgment, whether to present additional line items separately on the basis of the –

- nature and the liquidity of assets;
- function of the assets within the entity; and
- amounts, nature and timing of liabilities.

If different measurement bases are used for different classes of assets due to their function or nature, the entity needs to present them as separate line items.

Example 17

ABC Ltd follows cost model for plant and machinery and revaluation model for its buildings. Since both the classes of assets are carried on different measurement bases, ABC Ltd should, therefore, present them as separate line items.

Example 18

The minimum line items provided in this standard have been included in this typical structure of a Balance Sheet.

ABC Ltd.

Balance Sheet as on 31 March

Particulars	2016 (in millions)	2015 (in millions)
Assets		
Non-current Assets		
Property, Plant and Equipment		
Investment Property		
Intangible Assets		
Financial Assets		
Biological Assets		
Deferred Tax Assets		
Current Assets		
Inventories		
Trade Receivables		
Other Current Assets		
Cash and Cash Equivalents		
Non-current Assets Held for Sale, in Disposal		
Group and in Discontinued Operations		
Total Assets		
Equity and Liabilities		
Equity Attributable to Owners of the Parent		
Share Capital		
Retained Earnings		
Other Components of Equity (Reserves)		
Non-controlling Interests		

Total Equity		
Non-current Liabilities		
Long-term Borrowings		
Deferred Tax Liability		
Financial Liabilities		
Current Liabilities		
Trade and Other Payables		
Short-term Borrowings		
Provisions		
Current Portion of Long-term Borrowings		
Current Tax Payable		
Liabilities Associated with Disposal Group classified as held for sale		
Total Liabilities		
Total Equity and Liabilities		

The line items – non-current assets held for sale, in disposal group and in discontinued operations and liabilities associated with disposal group and in discontinued operations will be classified in accordance with Ind AS 105.

An entity needs to provide further sub-classifications of the line items presented, either in Balance Sheet or in the notes. The sub classifications, however, depend on the requirements of Ind ASs and on the size, nature and function of the amounts involved.

Line Items	Standards	Further Sub-classifications
Property, Plant and Equipment	Ind AS 16	● Land
		● Land and buildings
		● Machinery
		● Motor vehicles
		● Furniture and fixtures
		● Office Equipment
Receivables	Ind AS 32	● Amounts receivable from trade customers
		● Receivables from related parties
		● Prepayments
Inventories	Ind AS 2	● Merchandise
		● Production supplies
		● Materials
		● Work-in-progress
		● Finished goods
Provisions	Ind AS 37	● Provision for employee benefits
		● Others
Equity capital and reserves	Ind AS 1	● Paid-in capital
		● Share premium
		● Reserves

An entity should also disclose the following, either in Balance Sheet or Statement of Changes in Equity or in notes:

Each class of share capital	● Number of shares authorised
	● Number of shares issued and fully paid, and issued but not fully paid
	● Par value per share or that the shares have no par value
	● Reconciliation of the number of shares outstanding at the beginning and at the end of the period
	● Rights, preferences and restrictions attached including restrictions on distribution of dividends and the repayment of capital
	● Shares in the equity held by the equity or by its subsidiaries or associates
	● Shares reserved for issue under options and contracts for sale of shares including terms and amount
Reserves	● Brief description of the nature and purpose of each reserve within equity

An entity without share capital such as partnership or trust, should disclose information showing changes during the period in each category of equity interest, rights and preferences and restrictions attached with each category of equity interest.

Statement of Profit and loss and Other Comprehensive Income

The statement of profit and loss and other comprehensive income (statement of comprehensive income) shall present, in addition to the profit or loss and other comprehensive income sections–

- profit or loss (the total of income less expenses, excluding the components of other comprehensive income);
- total other comprehensive income (comprises items of income and expenses, including reclassification adjustments, that are not recognised in profit and loss as required or permitted by other Ind ASs);
- comprehensive income for the period (being the total of profit and loss and other comprehensive income).

If an entity presents a separate statement of profit and loss it does not present the profit or loss section in the statement presenting comprehensive income.

An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period –

(a) profit or loss for the period attributable to :

  (i) non-controlling interests; and

  (ii) owners of the parent.

(b) comprehensive income for the period attributable to :

  (i) non-controlling interests; and

  (ii) owners of the parent

If an entity presents profit or loss in a separate statement it shall present (a) in that statement.

Information to be presented in the profit or loss section of the statement of profit and loss

In addition to items required by other Ind ASs, the profit or loss section of the statement of profit and loss shall include line items that present the following amounts for the period –

- revenue;
- gains and losses arising from the derecognition of financial assets measured at amortised cost;
- finance cost;
- share of the profit or loss of associates and joint ventures accounted for using the equity method;
- if a financial asset is reclassified so that it is measured at fair value, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date (as defined in Ind AS 109);

- tax expense;
- a single amount for the total of discontinued operations (as per Ind AS 105).

Information to be presented in the other comprehensive income section

The other comprehensive income section shall present line items for amounts of other comprehensive income in the period, classified by nature (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method) and grouped into those that, in accordance with other Ind ASs

(a) will not be reclassified subsequently to profit or loss –

- Changes in revaluation surplus (Ind AS 16 and Ind AS 38);
- Actuarial gains and losses on defined benefit plans (Ind AS 19);
- Gains and losses from investments in equity instruments measured at fair value through Other Comprehensive Income (Ind AS 109);
- For those liabilities designated at fair value through profit or loss, changes in fair value attributable to changes in the liability's credit risk (Ind AS 109).

(b) may be reclassified subsequently to profit and loss when specific conditions are met –

- Foreign exchange gains and losses arising from translations of financial statements of a foreign operation (Ind AS 21);
- Effective portion of gains and losses on hedging instruments in a cash flow hedge (Ind AS 109).

An entity shall not present any items of income or expense as extraordinary items, in the statement of profit and loss and other comprehensive income or in the notes.

Profit or Loss for the period

An entity shall recognise all items of income and expenses in a period in profit or loss unless an Ind AS requires or permits otherwise.

Some Ind ASs specify circumstances when an entity recognises particular items outside profit or loss in the current period. Ind AS 8 specifies two such circumstances : the correction of errors and the effect of changes in accounting policies. Other Ind ASs require or permit components of other comprehensive income that meet the Conceptual framework's definition of income or expense to be excluded from profit or loss.

Other comprehensive income for the period

An entity shall disclose the amount of income tax relating to each item other comprehensive income, including reclassification adjustments, either in the statement of profit and loss and other comprehensive income or in the notes.

An entity may present items of other comprehensive income either :

(a) net of related tax effects, or

(b) before related tax effects with one amount shown for the aggregate amount of income tax relating to those items.

If an entity elects alternative (b), it shall allocate the tax between the items that might be reclassified subsequently to the profit or loss section and those that will not be reclassified subsequently to the profit or loss section.

An entity shall disclose reclassification adjustments relating to components of other comprehensive income.

Other Ind ASs specify whether and when amounts previously recognised in other comprehensive income are reclassified to profit or loss. Such reclassifications are referred to in the Standard as reclassification adjustments. **A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss. These amounts may have been recognised in other comprehensive income as unrealised gains in the current or previous periods. Those unrealised gains must be deducted from other comprehensive income in the period in which the realised gains are reclassified to profit or loss to avoid including them in total comprehensive income twice.**

An entity may present reclassification adjustments in the statement(s) of profit and loss and other comprehensive income or in the notes. An entity presenting reclassification adjustments in the notes presents the items of other comprehensive income after any related reclassification adjustments.

Information to be presented in the statement(s) of profit and loss and other comprehensive income or in the notes

When items of income or expense are material, an entity shall disclose their nature and amount separately.

Circumstances that would give rise to the separate disclosure of items of income and expense include :

(a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;

(b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;

(c) disposals of items of property, plant and equipment;

(d) disposals of investments;

(e) discontinued operations;

(f) litigation settlements; and

(g) other reversals of provisions.

An entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant.

Entities are encouraged to present the above analysis in the statement of profit and loss and other comprehensive income.

Expenses are subclassified to highlight components of financial performance that may differ in terms of frequency, potential for gain or loss and predictability. This analysis is provided in one of two forms.

The first form of analysis is the 'nature of expense' method. An entity aggregates expenses within profit or loss according to their nature (eg, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and does not reallocate them among functions within the entity. This method may be simple to apply because no allocations of expenses to functional classifications are necessary. An example of a classification using the nature of expense method is as follows :

Revenue		X
Other income		X
Changes in inventories of finished goods and work in progress	X	
Raw materials and consumables	X	
Employee benefits expense	X	
Depreciation and amortisation expense	X	
Other expenses	X	
Total expenses		(X)
Accounting profit		X
Tax expense –		
Current Tax	X	
Deferred tax expense/(income)	X	
Profit for the period		X

The second form of analysis is the 'function of expense' or 'cost of sales' method and classifies expenses according to their function as part of cost of sales or, eg, the costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses. This method can provide more relevant information to users than the classification of expenses by nature, but allocating costs to functions may require arbitrary allocations and involve considerable judgement. An example of a classification using the function of expense method is as follows:

Revenue		X
Cost of sales		(X)
Gross profit		X
Other income		X
Distribution costs		(X)
Administrative expenses		(X)
Other expenses		(X)
Accounting profit		X
Tax expense –		
Current Tax	X	
Deferred tax expense/(income)	X	
Profit for the period		X

An entity classifying expenses by function shall disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense.

The choice between the function of expense method and the nature of expense method depends on historical and industry factors and the nature of the entity. Both methods provide an indication of those costs that might vary, directly or indirectly, with the level of sales or production of the entity. Because each method of presentation has merit for different types of entities, this standard requires management to select the presentation that is *reliable* and more *relevant*. However, because information on the nature of expense is useful in predicting future cash flows, additional disclosure is required when the function of expense classification is used.

Example 19

This is a model single Statement of Comprehensive Income.

ABC Ltd.

Statement of Comprehensive Income for the period ended 31 March

Particulars	2012 (in millions)	2011 (in millions)
Revenue		
Other Income		
Changes in Inventories of Finished Goods and Work in Progress		
Work Performed by the Entity and Capitalised		
Raw Material and Consumables Used		
Employee Benefit Expenses		
Depreciation and Amortisation		
Impairment of Assets		
Other Expenses		
Finance Costs		
Share of Profit/loss of Associates and		
Joint Venture accounted for using the equity method		
Accounting Profit		
Tax Expense –		
Current Tax		
Deferred tax expense/(income)		
Profit for the Year from Continuing Operations (A)		
Profit/Loss for the Year from Discontinued Operations (B)		
Profit for the Year (A + B)		
Other Comprehensive Income		
Exchange Differences on Translating Foreign Operations Cash Flow Hedges		
Gains on Property Revaluation		

Actuarial Gains (Losses) on Defined Employee Benefit Plans Share of Other Comprehensive Income of Associates Income Tax Components of Other Comprehensive Income		
Other Comprehensive Income for the Year, Net of Tax (C) Total Comprehensive Income for the Year (A+B+C) Profit Attributable to		
Owners of the Parent		
Non-controlling Interests		
Total Comprehensive Income Attributable to		
Owners of the Parent		
Non-controlling Interests		
Basic Earnings per Share		
Diluted Earnings per Share		
Earnings per Share		

The Earnings per Share is calculated on profit for the year rather than on total comprehensive income.

An entity may present components of other comprehensive income either :

- net of related tax effects, or

Example 20

Other comprehensive income net of tax

Statement of Profit and Loss for the period ended 31 March

Particulars	2016 (in millions)	2015 (in millions)
Revenues		
Cost of sales		
Accounting Profit		
Tax expense		
Other Comprehensive Income		
Exchange Differences on Translating Foreign Operations		
Cash Flow Hedges		
Gains on Property Revaluation		
Actuarial Gains (Losses) on Defined Employee Benefit Plans		
Share of Other Comprehensive Income of Associates and joint ventures		
Other Comprehensive Income for the Year, Net of Tax		

In this method, each component is shown net of tax and the income tax relating to each component is disclosed in the notes.

Notes : Disclosure of tax effects relating to each component of other comprehensive income

Particulars	2016 (in millions)			2015 (in millions)		
	Before-tax amount	Tax (expense) benefit	Net of tax amount	Before-tax amount	Tax (expense) benefit	Net of tax amount
Exchange Differences on Translating						
Foreign Operations						
Cash Flow Hedges						
Revaluation of Property						
Actuarial Gains (Losses) on Defined Benefit						
Plans						
Share of Other Comprehensive Income of						
Associates and Joint Ventures						
Other Comprehensive Income, net of tax						

- before related tax effects with one amount shown for the aggregate amount of income tax relating to those components.

Example 21

Other Comprehensive Income with an aggregate amount of income tax

Statement of Comprehensive Income for the perior ended 31 March

Particulars	2016 (in millions)	2015 (in millions)
Revenue		
Cost of Sales		
Accounting Profit		
Tax expense		
Profit for the Year		
Other Comprehensive Income		
Exchange Differences on Translating Foreign Operations		
Cash Flow Hedges		
Gains on Property Revaluation		
Actuarial Gains (Losses) on Defined Employee Benefit Plans		
Share of Other Comprehensive Income of Associates		
Income Tax Components of Other Comprehensive Income		
Other Comprehensive Income for the period, Net of Tax		
Total Comprehensive Income		

Statement of changes in equity

A statement of changes in equity shows the movement in owners' equity over time. It bridges the gap between owner's equity at the beginning of the reporting period and at the end of the reporting period.

A Statement of Changes in Equity will show, eg :

1.	Total comprehensive income for the period, showing separately total amount attributable to owners of the parent and to non-controlling interests	Total comprehensive income attributable to – ● Owner of parent ● Non-controlling interests
2.	For each component of equity, the effects of retrospective application or restatement	● Changes in accounting policy

3.	For each component of equity, a reconciliation between the carrying amount at the beginning and at the end, separately disclosing changes resulting from –		
	○ Profit or loss	●	Retained Earnings
	○ Each item of Other Comprehensive Income	●	Translation of foreign operation reserve
		●	Revaluation reserve
		●	Cash flow hedges
		●	Actuarial gains reserve
	○ Transactions with others in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in loss of control.	●	Issue of share capital
		●	Dividends
		●	Transfer to retained earnings
		●	Reacquisition of entity's own equity
		●	Transaction costs directly related to such transaction
	○ Any item recognised directly in equity	●	Capital Reserve
		●	Translation of foreign currency long-term monetary items reserve

A parent is an entity that has one or more subsidiaries. Therefore, owners of parent refer to shareholders of the parent company. Non-controlling interest is the minority interest in a subsidiary and is mostly reported on consolidated Balance Sheet under equity.

An entity should present either in Statement of Changes in Equity or in notes, the amount of dividends recognised as distributions to owners during the period and the related amount per share.

In the model Statement of Changes in Equity, the components of equity are –

- Each class of equity contributed;
- Each component of Other Comprehensive Income; and
- Retained earnings.

As per Ind AS 8, retrospective adjustments have to be made to incorporate changes in accounting policies. Retrospective adjustments and retrospective restatements are not changes in equity, but they are adjustments to the opening balance of retained earnings, except when an Ind AS requires retrospective adjustment of another component of equity.

Example 22

This is a model Statement of changes in equity.

ABC Ltd.
Statement of Changes in Equity for the period ended 31 March 2012 (in millions)

Particulars	Share Capital	Retained Earnings	Translation of Foreign	Cash Flow	Revaluation Surplus Operations	Other Reserves Hedge Reserve	Equity of Owners	Minority Interest	Total Equity
Balance at 1 April 2010									
Changes in accounting policy									
Restated balance									
Changes in equity for 2010									
Dividends									

Total comprehensive income for the year									
Balance at 31 March 2011									
Changes in equity for 2011									
Issue of capital									
Dividends									
Total comprehensive									
income for the year									
Transfer to retained earnings									
Balance at 31 March 2012									

Statement of Cash Flows

The cash flow statement shows the flow of cash in and out of business. It provides users information about the entity's ability to generate cash and cash equivalents and then utilisation of that cash.

There is a separate standard Ind AS 7 *Statement of Cash Flows* which gives the detail requirements of presentation and disclosure of cash flow information.

Notes

Notes contain information in addition to that presented in the balance sheet, statement(s) of profit and loss and other comprehensive income, separate income statement (if presented), statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in these statements.

The notes should present the following disclosures –

- Basis of preparation of financial statements and specific accounting policies;
- Information required by Ind ASs not presented elsewhere in the financial statements; and
- Information not presented elsewhere in the financial statements, but is relevant to the understanding of any of them.

Notes should be presented in a systematic manner as far as practicable and cross references to the notes should be provided wherever required - such as for each item in Balance Sheet, Statement of Profit and Loss, Statement of Changes in Equity and Statement of Cash Flows.

The general order of notes is :

- A statement of compliance with Ind ASs;
- Summary of significant accounting policies applied;
- Supporting information on each item presented in the entire set of financial statements;
- Other disclosures, such as –
  - Contingent liabilities;
  - Unrecognised contractual commitments;
  - Non-financial disclosure.

Disclosure of accounting policies

An entity should disclose in the summary of accounting policies –

- The measurement basis (or bases) used in preparing the financial statements; and
- The other accounting policies used that are relevant to the understanding of the financial statements.

By measurement bases we mean, the basis on which an entity recognises an asset and liability at initial recognition as well as subsequent measurement. An entity can recognise an asset at either :

- Historical cost;
- Current cost;
- Fair value;
- Net realisable value;
- Value in use.

Therefore, it is important to inform the users regarding the basis of recognition in order to make useful analysis.

Example 23

ABC Ltd follows cost model for its plant and machinery, motor vehicles and office equipments. It follows revaluation model for its land as well as land and buildings.

Ind AS is not just financial accounting but it has a lot to do with the non-financial aspects as well. In fact, that is why it in not International Financial Accounting Standards but it is International Financial Reporting Standards. An entity should, therefore, disclose the judgment used by the management in the process of applying the accounting policies, such as –

- Whether a particular class of property, plant and equipment is measured at cost or fair value or value in use;
- Whether revenue is deferred.

Example 24

The Company provides extensive after sale service to its customers. Therefore, as per management judgement the amount of selling price associated with the servicing is deferred and recognised only when the servicing is provided. Management needs to use judgment in determining when to recognise the income from after sale service. This recognition is based on past experience.

Sources of Estimation Uncertainty

When information or data are uncertain or incomplete, we tend to make estimates, which are nothing but appropriation of results made on some basis such as judgment or past experience. An entity should disclose this information about the assumptions it makes about the uncertain future and also other sources of estimation uncertainty. Thus notes should include :

- their nature; and
- their carrying amount as at the end of the reporting period. The key aspects of accounting that require estimation are as follows:
- Useful lives of property, plant and equipment;

Example 25

The Company assesses the estimated useful lives of property, plant and equipment at the end of each reporting period. The management decides that useful lives of some equipment need to be shortened due to technological obsolescence.

- Provision for outcome of future litigation;

Example 26

The Company is presently defending a lawsuit brought against it by a supplier. The actual outcome of the case may differ from the amount recognised in the financial statements as provision. The detailed discussion on the provision recognised for this court case will be dealt in the notes on Provisions.

- Valuation of financial instruments in the absence of observed market prices;

Example 27

The Company uses valuation techniques such as inputs for the assets and liabilities that are not based on observed market data. This is used for valuation of unlisted financial assets that are recognised at fair value through Other Comprehensive Income. The detailed assumptions and valuation techniques are provided in the corresponding notes on financial assets.

- Inventories valuation;

Example 28

Inventories are measured at lower of cost and net realisable value. In estimating the realisable value, the management has taken evidence from the time the estimate was made. Since the business of the company is based on price changes in different segments of computer hardware, that is also taken into account.

- Property prices used as a basis of revaluing properties:

Example 29

Land and buildings are measured using revaluation model and, therefore, the company uses estimation for some land and building for which there is no observed market data. In order to arrive at their fair value, management, therefore, uses some estimation. This disclosure is not required for assets or liabilities, if they are measured at fair value based on observed market prices by independent valuers. Such fair value changes may change materially again next year, but these are not based on any assumption or estimation.

The above are just some of the possible sources of estimation uncertainty that an entity faces.

Now, mostly estimation has its basis on management judgment, which can be very subjective as well as very complex. These management judgments can materially affect the carrying amount of assets and liabilities.

Capital

An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. Therefore, the entity discloses the following :

(a) qualitative information about its objectives, policies and processes for managing capital, including –

  (i) a description of what it manages as capital;

  (ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and

  (iii) how it is meeting its objectives for managing capital.

(b) summary quantitative data about what it manages as capital. Some entities regard some financial liabilities (eg, some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (eg, components arising from cash flow hedges).

(c) any changes in (a) and (b) from the previous period.

(d) whether during the period it complied with any externally imposed capital requirements to which it is subject.

(e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

The entity bases these disclosures on the information provided internally to key management personnel. An entity may manage capital in a number of ways and be subject to a number of different capital requirements.

Example 30

Notes on capital management objectives, policies and procedure

The company's capital management objectives are to –

- ensure that the company is able to continue as going concern; and

- provide adequate return to shareholders.

The company manages its capital on the basis of carrying amount of equity *plus* its subordinated debt *less* cash and cash equivalents as presented on the face of Balance Sheet.

The company's targeted capital to overall financing ratio is 0.35:1. The company manages its capital structure and makes adjustments to it, in the light of changes in economic conditions and the risk characteristics of the underlying assets.

Capital structure for the reporting period is as follows :

Particulars	**2012**	**2011**	**2010**
Total equity	5,000	4,500	4,000
Subordinated loan	400	400	400
Cash and cash equivalent	(2,300)	(2,700)	(2,100)
Capital (A)	3,100	2,200	2,300
Total equity	5,000	4,500	4,000
Borrowings	2,800	2,500	2,200
Overall financing (B)	7,800	7,000	6,200
Capital to overall financing ratio (A/B)	0.397	0.314	0.371

The ratio has reduced in the year 2011, due to financing the acquisition of X Ltd.

Other disclosures

An entity should also disclose :

- the amount of dividends proposed or declared before the authorisation of the financial statements;

Example 31

The directors of the company propose the payment of dividend of 6,500 (1 per share). The distribution of dividends requires the approval of shareholders and, therefore, no liability is recognised in respect of this in the financial statements of the current period.

- the amount of any cumulative preference dividend not recognised;
- the domicile and the legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);
- the name of the parent and the ultimate parent of the group;
- if it is a limited life entity, information regarding the length of its life; and

Example 32

ABC Ltd is the parent company of the Group comprising 124 subsidiaries. The company is a limited liability company incorporated and domiciled in India. The address of ABC Ltd's registered office is 132 Park Avenue, Kolkata 700026, West Bengal, India. The company's principal office is also located in the above address. ABC Ltd's shares are listed in Bombay Stock Exchange as well as London Stock Exchange.

- a description of the nature of the entity's operations and its principal activities.

Example 33

After the entire set of financial statements the following disclosures should be given –

1. Corporate information
2. Statement of compliance with Ind ASs
3. Basis of preparation
4. Summary of significant accounting policies
5. Significant management judgment and estimates

6. Other disclosures of each items of assets, liabilities, income and expenses (in detail)

7. Contingent liabilities

8. Contractual commitments

9. Risk management and policies

10. Capital management objectives, policies and procedures

Example 34

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Fair value 50 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		20		20		20		25		25
Accounting Profit		80		80		80		75		75
Tax expense –										
Current tax	30		30		30		30		40	
Deferred tax expense / (liability)	2	32	2	32	2	32	–	30	(10)	30
Profit for the Period		48		48		48		45		45
Other Comprehensive Income										
Revaluation surplus (net of tax)		–		–		6		–		–
Total Comprehensive Income		48		48		54		45		45

Statement of Change in Equity

Year	3	4	5
Revaluation surplus			
Opening balance	–	6	3
Created through other comprehensive income	6	–	–
Transferred to retained earnings	–	(3)	(3)
Closing balance	6	3	–

Workings : Current Tax

Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	2	4	10	10
Created through –					
Profit and loss	2	2	2	–	–
Other comprehensive income	–	–	4	–	–
Reversed through profit and loss	–	–	–	–	(10)
Closing balance	2	4	10	10	–

Carrying Amount of the Asset

Restated proportionately

Year	1	2	Revaluation Increase	3	4	5
Gross block	100	100	100	125	125	125
Accumulated depreciation	20	40	60	75	100	125
Carrying Amount	80	60	40	50	25	–

Eliminated against gross carrying amount

Year	1	2		3 Revaluation Increase	4	5
Gross block	100	100	100	50	50	50
Accumulated depreciation	20	40	60	–	25	50
Carrying Amount	80	60	40	50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Journal for : Income tax	**Revaluation**		**Transfer to retained earnings**	
Year 1				
(1) Current tax	30			
Cash		30		
(2) Deferred tax expense	2			
Deferred tax liability		2		
(3) Tax expense	32			
Current tax		30		
Deferred tax expense		2		
Year 2				
(1), (2) and (3) – same as above				
Year 3				
(1), (2) and (3) – same as above	(1) Asset	25		
Accumulated depreciation		15		
Revaluation surplus		6		
Deferred tax liability		4		
OR				
Accumulated depreciation	60			
Asset		50		
Revaluation surplus		6		
Deferred tax liability		4		
Year 4				
(1) Current tax	30		(1) Revaluation surplus	3
Cash		30	Retained earnings	3
(2) Tax expense	30			
Current tax		30		
Year 5				
(1) Current tax	40		(1) Revaluation surplus	3
Cash		40	Retained earnings	3

(2) Deferred tax liability	10		
Tax expense		10	
(3) Tax expense	40		
Current tax		40	

Example 35

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Fair value 75 at the beginning of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		20		20		25		25		25
Accounting Profit		80		80		75		75		75
Tax expense –										
Current tax	30		30		30		30		40	
Deferred tax expense / (liability)	2	32	2	32	–	30	–	30	(10)	30
Profit for the Period		48		48		45		45		45
Other Comprehensive Income										
Revaluation surplus (net of tax)		–		–		9		–		–
Total Comprehensive Income		48		48		54		45		45

Statement of Change in Equity

Year	3	4	5
Revaluation surplus			
Opening balance	–	6	3
Created through other comprehensive income	9	–	–
Transferred to retained earnings	(3)	(3)	(3)
Closing balance	6	3	–

Workings : Current Tax

Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	2	4	10	10
Created through –					
Profit and loss	2	2	–	–	–
Other comprehensive income	–	–	6	–	–
Reversed through profit and loss	–	–	–	–	(10)
Closing balance	2	4	10	10	–

Carrying Amount of the Asset

Restated proportionately						
Year	1	2	Revaluation Increase	3	4	5
Gross block	100	100	125	125	125	125
Accumulated depreciation	20	40	50	75	100	125
Carrying Amount	80	60	75	50	25	–
Eliminated against gross carrying amount						
Year	1	2	Revaluation increase	3	4	5
Gross block	100	100	75	75	75	75
Accumulated depreciation	20	40	–	25	50	75
Carrying Amount	80	60	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 36

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%. Fair value 90 at the beginning of year 2; and 50 at the beginning of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		25		30		25		25		–
Accounting Profit		75		70		75		75		100
Tax expense –										
Current tax	32		32		32		32		32	
Deferred tax (income) / asset	(2)		(2)		(2)		(2)		8	
Deferred tax liability	–	30	(2)	28	–	30	–	30	–	40
Profit for the Period		45		42		45		45		60
Other Comprehensive Income										
Revaluation surplus (net of tax)		–		9		(6)		–		–
Total Comprehensive Income		45		51		39		45		60

Statement of Change in Equity

Year	2	3
Revaluation surplus		
Opening balance	–	6
Created through other comprehensive income	9	–
Reversed through other comprehensive income	–	(6)
Transferred to retained earnings	(3)	–
Closing balance	6	–

Workings : **Current Tax**

Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current tax @ 40%	32

Deferred Tax Liability

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	2	–	4	4	6	–	8	–
Created through –										
Profit and oss	2	–	2	–	2	–	2	–	–	–
Other comprehensive income	–	–	–	6	–	–	–	–	–	–
Reversed through –										
Profit and loss	–	–	–	–	–	–	–	–	(8)	–
Other comprehensive income	–	–	–	(2)	–	(4)	–	–	–	–
Closing Balance	2	–	4	4	6	–	8	–	–	–

Carrying Amount of the Asset

Restated proportionately

Year	1	2 Revaluation increase		3 Revaluation decrease		4
Gross block	100	120	120	100	100	100
Accumulated depreciation	25	30	60	50	75	100
Carrying Amount	75	90	60	50	25	–

Eliminated against gross carrying amount

Year	1	2 Revaluation increase		3 Revaluation decrease		4
Gross block	100	90	90	50	50	50
Accumulated depreciation	25	–	30	–	25	50
Carrying Amount	75	90	60	50	25	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 37

Profit before amortisation – year 1 : 100; year 2 : 120; year 3, 4 and 5 : 130 per year. Intangible asset 100. Amortisation (SLM) – Financial 20%, Tax 25%. Fair value 90 at the end of year 2. Income tax rate 40%.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3		4		5
Profit before amortisation		100		120		130		130		130
Amortisation		20		20		30		30		30
Accounting Profit		80		100		100		100		100
Tax expense –										
Current tax	30		38		42		42		52	
Deferred tax expense / (liability)	2	32	2	40	(2)	40	(2)	40	(12)	40
Profit for the Period		48		60		60		60		60
Other Comprehensive Income										
Revaluation surplus (net of tax)		–		18		–		–		–
Total Comprehensive Income		48		78		60		60		60

Statement of Change in Equity

Year	2	3	4	5
Revaluation surplus				
Opening balance	–	18	12	6
Created through other comprehensive income	18	–	–	–
Transferred to retained earnings	–	(6)	(6)	(6)
Closing balance	18	12	6	–

Workings : Current Tax

Year	1	2	3 and 4	5
Profit before amortisation	100	120	130	130
Amortisation allowed	25	25	25	–
Taxable Profit	75	95	105	130
Current tax @ 40%	30	38	42	52

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	2	16	14	12
Created through –					
Profit and loss	2	2	–	–	–
Other comprehensive income	–	12	–	–	–
Reversed through profit & loss	–	–	(2)	(2)	(12)
Closing balance	2	16	14	12	–

Carrying Amount of the Asset

Restated proportionately

Year	1	2		3	4	5
			Revaluation increase			
Gross block	100	100	150	150	150	150
Accumulated amortisation	20	40	60	90	120	150
Carrying Amount	80	60	90	60	30	–

Eliminated against gross carrying amount

Year	1	2		3	4	5
			Revaluation increase			
Gross block	100	100	90	90	90	90
Accumulated amortisation	20	40	–	30	60	90
Carrying Amount	80	60	90	60	30	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Amortisation allowed	25	50	75	100
Tax Base	75	50	25	–

Journal for : Income tax			**Revaluation**			**Transfer to retained earnings**		
Year 1								
(1) Current tax	30							
Cash		30						
(2) Deferred tax expense	2							
Deferred tax liability		2						
(3) Tax expense	32							
Current tax		30						
Deferred tax expense		2						
Year 2								
(1) Current tax	38		(1) Asset	50				
Cash		38	Accumulated amortisation		20			
(2) Deferred tax expense	2		Revaluation surplus		18			
Deferred tax liability		2	Deferred tax liability		12			
(3) Tax expense	40		OR					
Current tax		38	Accumulated amortisation	40				
Deferred tax expense	2		Asset		10			
			Revaluation surplus		18			
			Deferred tax liability		12			
Year 3								
(1) Current tax	42					(1) Revaluation surplus	6	
Cash		42				Retained earnings		6
(2) Deferred tax liability	2							
Tax expense		2						
(3) Tax expense	42							
Current tax		42						
Year 4								
(1), (2) and (3) – same as above						(1) same as above		
Year 5								
(1) Current tax	52					(1) same as above		
Cash		52						
(2) Deferred tax liability	12							
Tax expense		12						
(3) Tax expense	52							
Current tax		52						

Example 38

Profit 100 per year. Income tax rate 40%. Year 1 : Investment in equity instruments 100. Year-end fair value of investment in equity instruments – year 1 : 110, year 2 : 120. Disposal of investment in equity instruments – year 3 : 130.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3
Accounting Profit		100		100		100
Tax expense –						
Current tax	40		40		52	
Deferred tax liability	–	40	–	40	(12)	40
Profit for the Period		60		60		60
Other comprehensive income						
Gain from investment in equity instruments (net of tax)		6		6		6
Total comprehensive income		66		66		66

Statement of Change in Equity

Year	1	2	3
Gain from investment in equity instruments			
Opening balance	–	6	12
Created through other comprehensive income	6	6	6
Transferred to retained earnings	–	–	(18)
Closing balance	6	12	–

Workings : Current Tax

Year	1	2	3
Profit	100	100	100
Gain from disposal of investment in equity instruments	–	–	30
Taxable Profit	100	100	130
Current tax @ 40%	40	40	52

Deferred Tax Liability

Year	1	2	3
Opening balance	–	4	8
Created through other comprehensive income	4	4	4
Reversed through profit and loss	–	–	(12)
Closing balance	4	8	–

Investment in Equity Instruments

Year	1	2	3
Carrying amount	110	120	130
Tax base	100	100	100
Deferred tax liability	4	8	12

Journal

Year 1			
(1)	Investment in equity instruments	100	
	Cash		100
(2)	Investment in equity instruments	10	
	Gain from investment in equity instruments		6
	Deferred tax liability		4
Year 2			
(1)	Investment in equity instruments	10	
	Gain from investment in equity instruments		6
	Deferred tax liability		4

Year 3

(1)	Investment in equity instruments	10	
	Gain from investment in equity instruments		6
	Deferred tax liability		4
(2)	Cash	130	
	Investment in equity instruments		130
(3)	Deferred tax liability	12	
	Tax expense		12
(4)	Gain from investment in equity instruments	18	
	Retained earnings		18

Example 39

Profit 100 per year. Income tax rate 40%. Year 1 : Investments in equity instruments 100. Year-end fair value of investment in equity instruments – year 1 : 110; year 2 : 120. Disposal of investment in equity instruments – year 3 : 115.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3
Accounting Profit		100		100		100
Tax expense –						
Current tax	40		40		46	
Deferred tax liability	–	40	–	40	(6)	40
Profit for the Period		60		60		60
Other comprehensive income						
Gain from investment in equity instruments (net of tax)		6		6		(3)
Total comprehensive income		66		66		57

Statement of Change in Equity

Year	1	2	3
Gain from investment in equity instruments			
Opening balance	–	6	12
Created through other comprehensive income	6	6	–
Reversed through other comprehensive income	–	–	(3)
Transferred to retained earnings	–	–	(9)
Closing balance	6	12	–

Workings : Current Tax

Year	1	2	3
Profit	100	100	100
Gain from disposal of investment in equity instruments	–	–	15
Taxable Profit	100	100	115
Current tax @ 40%	40	40	46

Deferred Tax Liability

Year	1	2	3
Opening balance	–	4	8
Created through other comprehensive income	4	4	–
Reversed through –			
Other comprehensive income	–	–	(2)
Profit and loss	–	–	(6)
Closing balance	4	8	–

Investment in Equity Instruments

Year			1	2	3
Carrying amount			110	120	115
Tax base			100	100	100
Deferred tax liability			4	8	6
Journal					
Year 1					
(1)	Investment in equity instruments	100			
	Cash		100		
(2)	Investment in equity instruments	10			
	Gain from investment in equity instruments		6		
	Deferred tax liability		4		
Year 2					
(1)	Investment in equity instruments	10			
	Gain from investment in equity instruments		6		
	Deferred tax liability		4		
Year 3					
(1)	Gain from investment in equity instruments	3			
	Deferred tax liability		2		
	Investment in equity instruments		5		
(2)	Cash	115			
	Investment in equity instruments		115		
(3)	Deferred tax liability	6			
	Tax expense		6		
(4)	Gain from investment in equity instruments	9			
	Retained earnings		9		

Example 40

Profit 100 per year. Income tax rate 40%. Year 1 : Investment in equity instruments 100. Year-end fair value of investment in equity instruments – year 1 : 120; year 2 : 110. Disposal of investment in equity instruments – year 3 : 115.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3
Accounting Profit		100		100		100
Tax expense –						
Current tax	40		40		46	
Deferred tax liability	–	40	–	40	(6)	40
Profit for the Period		60		60		60
Other comprehensive income						
Gain from investment in equity instruments (net of tax)		12		(6)		3
Total comprehensive income		72		54		63

Statement of Change in Equity

Year	1	2	3
Gain from investment in equity instruments			
Opening balance	–	12	6
Created through other comprehensive income	12	–	3
Reversed through other comprehensive income	–	(6)	–
Transferred to retained earnings	–	–	(9)
Closing balance	12	6	–

Workings : **Current Tax**

Year	1	2	3
Profit	100	100	100
Gain from disposal of investment in equity instruments	–	–	15
Taxable Profit	100	100	115
Current tax @ 40%	40	40	46

Deferred Tax Liability

Year	1	2	3
Opening balance	–	8	4
Created through other comprehensive income	8	–	2
Reversed through –			
Other comprehensive income	–	(4)	–
Profit and loss	–	–	(6)
Closing balance	8	4	–

Investment in Equity Instruments

Year	1	2	3
Carrying amount	120	110	115
Tax base	100	100	100
Deferred tax liability	8	4	6

Journal

Year 1			
(1)	Investment in equity instruments	100	
	Cash		100
(2)	Investment in equity instruments	20	
	Gain from investment in equity instruments		12
	Deferred tax liability		8
Year 2			
(1)	Gain from investment in equity instruments	6	
	Deferred tax liability		4
	Investment in equity instruments		10
Year 3			
(1)	Investment in equity instruments	5	
	Gain from investment in equity instruments		3
	Deferred tax liability		2
(2)	Cash	115	
	Investment in equity instruments		115
(3)	Deferred tax liability	6	
	Tax expense		6
(4)	Gain from investment in equity instruments	9	
	Retained earnings		9

Example 41

Profit 100 per year. Income tax rate 40%. Year 1 : Investment in equity instruments 100. Year-end fair value of investment in equity instruments 110. Year 2 : 50% disposal of investment in equity instruments 60. Year 3 : Remaining disposal of investment in equity instruments 65.

Statement of Profit and Loss and Other Comprehensive Income

Year		1		2		3
Accounting Profit		100		100		100
Tax expense –						
Current tax	40		44		46	
Deferred tax liability	–	40	(4)	40	(6)	40
Profit for the Period		60		60		60
Other comprehensive income						
Gain from investment in equity instruments (net of tax)		6		6		3
Total comprehensive income		66		66		63

Statement of Change in Equity

Year	1	2	3
Gain from investment in equity instruments			
Opening balance	–	6	6
Created through other comprehensive income	6	6	3
Transferred to retained earnings	–	(6)	(9)
Closing balance	6	6	–

Workings : Current Tax

Year	1	2	3
Profit	100	100	100
Gain from disposal of investment in equity instruments	–	10	15
Taxable Profit	100	110	115
Current tax @ 40%	40	44	46

Deferred Tax Liability

Year	1	2	3
Opening balance	–	4	4
Created through other comprehensive income	4	4	2
Reversed through profit and loss	–	(4)	(6)
Closing balance	4	4	–

Investment in Equity Instruments

Year	1	2	3
Carrying amount	110	60	65
Tax base	100	50	50
Deferred tax liability	4	4	6

Journal

Year 1			
(1)	Investment in equity instruments	100	
	Cash		100
(2)	Investment in equity instruments	10	
	Gain from investment in equity instruments		6
	Deferred tax liability		4
Year 2			
(1)	Investment in equity instruments	10	
	Gain from investment in equity instruments		6
	Deferred tax liability		4
(2)	Cash	60	
	Investment in equity instruments		60

(3)	Deferred tax liability	4	
	Tax expense		4
(4)	Gain from investment in equity instruments	6	
	Retained earnings		6
Year 3			
(1)	Investment in equity instruments	5	
	Gain from investment in equity instruments		3
	Deferred tax liability		2
(2)	Cash	65	
	Investment in equity instruments		65
(3)	Deferred tax liability	6	
	Tax expense		6
(4)	Gain from investment in equity instruments	9	
	Retained earnings		9

Example 42

Profit before depreciation and gain on disposal of investment in equity instruments 100 per year. Income tax rate 40%. Asset 100, Depreciation (SLM) – Financial 20%; Tax 25%. Fair value 75 at the end of year 2. Investment in equity instruments 100 at the beginning of year 1. Year-end fair value of investment in equity instruments – year 1 : 120; 2 : 110; 3 : 115; 4 : 120. Disposal of investment in equity instruments - year 5 : 130.

Statement of Comprehensive Income

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		20		20		25		25		25
Accounting Profit		80		80		75		75		75
Tax expense –										
Current tax	30		30		30		30		52	
Deferred tax expense / (liability)	2	32	2	32	–	30	–	30	(22)	30
Profit for the Period		48		48		45		45		45
Other comprehensive income										
Gain from investment in equity instruments	20		(10)		5		5		10	
Revaluation surplus	–		15		–		–		–	
	20		5		5		5		10	
Income tax relating to the above	(8)	12	(2)	3	(2)	3	(2)	3	(4)	6
Total comprehensive income		60		51		48		48		51

Statement of Change in Equity

Year	1	2	3	4	5
Gain from investment in equity instruments					
Opening balance	–	12	6	9	12
Created through other comprehensive income	12	–	3	3	6
Reversed through other comprehensive income	–	(6)	–	–	–
Transferred to retained earnings	–	–	–	–	(18)
Closing balance	12	6	9	12	–
Revaluation surplus					
Opening balance	–	–	9	6	3
Created through other comprehensive income	–	9	–	–	–
Transferred to retained earnings	–	–	(3)	(3)	(3)
Closing balance	–	9	6	3	–

Workings : **Current Tax**

Year	1	2	3	4	5
Profit	100	100	100	100	100
Depreciation allowed	(25)	(25)	(25)	(25)	–
Gain from disposal of investment in equity instruments	–	–	–	–	30
Taxable Profit	75	75	75	75	130
Current tax @ 40%	30	30	30	30	52

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	10	14	16	18
Created through –					
Profit and loss	2	2	–	–	–
Other comprehensive income	8	2	2	2	4
Reversed through profit and loss	–	–	–	–	(22)
Closing balance	10	14	16	18	–

Investment in Equity Instruments

Year	1	2	3	4	5
Carrying amount	120	110	115	120	130
Tax base	100	100	100	100	100
Deferred tax liability	8	4	6	8	12

Carrying Amount of the Asset

Restated proportionately

Year	1	2		3	4	5
			Revaluation increase			
Gross block	100	100	125	125	125	125
Accumulated depreciation	20	40	50	75	100	125
Carrying Amount	80	60	75	50	25	–

Eliminated against gross carrying amount

Year	1	2		3	4	5
			Revaluation increase			
Gross block	100	100	75	75	75	75
Accumulated depreciation	20	40	–	25	50	75
Carrying Amount	80	60	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax base	75	50	25	–
Deferred tax liability	2	10	10	10

Example 43

Profit before depreciation and gain on disposal of investment in equity instruments 100 per year. Income tax rate 40%. Asset 100; Depreciation (SLM) - Financial 20%; Tax 25%. Fair value 90 at the end of year 2 and 40 at the end of year 3. Investment in equity instruments 100 at the beginning of year 1. Year-end fair value of investment in equity instruments — year 1 : 110; 2 : 120; 3 : 125. 50% disposal of investment in equity instruments 65 in year 4. Remaining disposal of investment in equity instruments 75 in year 5.

Statement of Comprehensive Income

Year		1		2		3		4		5
Profit before depreciation		100		100		100		100		100
Depreciation		20		20		30		20		20
Accounting Profit		80		80		70		80		80
Tax expense –										
Current tax	30		30		30		36		50	
Deferred tax expense / (liability)	2	32	2	32	(2)	28	(4)	32	(18)	32
Profit for the Period		48		48		42		48		48
Other comprehensive income										
Gain from investment in equity instruments	10		10		5		5		10	
Revaluation surplus	–		30		(20)		–		–	
	10		40		(15)		5		10	
Income tax relating to the above	(4)	6	(16)	24	6	(9)	(2)	3	(4)	6
Total comprehensive income		54		72		33		51		54

Statement of Change in Equity

Year	1	2	3	4	5
Gain from investment in equity instruments					
Opening balance	–	6	12	15	9
Created through other comprehensive income	6	6	3	3	6
Transferred to retained earnings	–	–	–	(9)	(15)
Closing balance	6	12	15	9	–
Revaluation surplus					
Opening balance	–	–	18	–	–
Created through other comprehensive income	–	18	–	–	–
Reversed through other comprehensive income	–	–	(12)	–	–
Transferred to retained earnings	–	–	(6)	–	–
Closing balance	–	18	–	–	–

Workings : Current Tax

Year	1	2	3	4	5
Profit	100	100	100	100	100
Depreciation allowed	(25)	(25)	(25)	(25)	–
Gain from disposal of investment in equity instruments	–	–	–	15	25
Taxable Profit	75	75	75	90	125
Current tax @ 40%	30	30	30	36	50

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	6	24	16	14
Created through –					
Profit and loss	2	2	–	–	–
Other comprehensive income	4	16	–	2	4
Reversed through –					
Profit and loss	–	–	(2)	(4)	(18)
Other comprehensive income	–	–	(6)	–	–
Closing balance	6	24	16	14	–

Investment in Equity Instruments

Year	1	2	3	4	5
Carrying amount	110	120	125	65	75
Tax base	100	100	100	50	50
Deferred tax liability	4	8	10	6	10

Carrying Amount of the Asset

Restated proportionately

Year	1	2		3		4	5
			Revaluation increase		Revaluation decrease		
Gross block	100	100	150	150	100	100	100
Accumulated depreciation	20	40	60	90	60	80	100
Carrying Amount	80	60	90	60	40	20	–

Eliminated against gross carrying amount

Year	1	2		3		4	5
			Revaluation increase		Revaluation decrease		
Gross block	100	100	90	90	40	40	40
Accumulated depreciation	20	40	–	30	–	20	40
Carrying Amount	80	60	90	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax base	75	50	25	–
Deferred tax liability	2	16	6	8

Example 44

Balance Sheet as at 31 December

Year	20x3	20x2
Assets		
Non-current assets		
Land and building	800	1,500
Plant and machinery	1,000	900
Investment in foreign operation	1,500	2,500
Investment property	2,800	2,500
Financial assets	1,100	1,200
Deferred tax assets	681	339
Current assets		
Inventories	318	612
Right to recover assets	180	–
Trade receivables	2,512	473
Other current assets	1,336	257
Cash and cash equivalents	7,117	6,583
Total Assets	19,344	16,864
Equity and Liabilities		
Equity		
Share capital	6,000	6,000
Retained earnings	5,788	3,542

Other components of equity	716	883
Non-current liabilities		
5% convertible preference shares	–	878
Zero-coupon convertible bonds	–	792
Deferred tax liability	1,010	808
Current liability		
5% convertible preference shares	937	–
Zero-coupon convertible bonds	892	–
Deferred revenue	2,000	1,000
Refund liability	300	–
Trade payables	465	713
Current tax liability	1,236	2,248
Total Equity and Liabilities	19,344	16,864

Statement of Changes in Equity for the period ended 31 December 20x3

Particulars			Other Components of Equity								
			Revaluation surplus								
	Share capital	Retained earnings	Foreign operation	Land and building	Plant and machinery	Exchange difference	Financial assets	Share based payment	Convertible preference shares	Convertible bonds	Total
Opening balance	6,000	3,542	180	210		120	160	30	62	121	883
Created through —											
P/L		2,879						70			70
OCI			240	(140)	140	60	(80)				220
Transferred to —											
P/L						(90)					(90)
RE		367	(210)	(70)					(29)	(58)	(367)
Dividends		(1,000)									
Closing balance	6,000	5,788	210	–	140	90	80	100	33	63	716

Statement of Comprehensive Income for the year ended 31 December 20x3

Revenue		7,700
Cost of sales		(2,820)
Gross Profit		4,880
Other income		1,000
Administrative expenses		(712)
Distribution expenses		(584)
Other expenses		(879)
Accounting Profit		3,705
Tax expense –		
Current tax expense	1,236	
Deferred tax expense	270	
Deferred tax income	(672)	
Deferred tax liability	(248)	
Deferred tax asset	330	916
Profit for the Period (before reclassification adjustment)		2,789
Exchange difference reclassified		90
Profit for the Period (after reclassification adjustment)		2,879

Other Comprehensive Income		
Items not to be reclassified		
Revaluation surplus on foreign operation	400	
Deferred tax liability @ 40%	(160)	240
Downward revaluation on land and building	(200)	
Deferred tax liability @ 30%	60	(140)
Reversal of unrealised gain from financial assets	(100)	
Deferred tax liability @ 20%	20	(80)
Revaluation surplus on plant and machinery	200	
Deferred tax liability @ 30%	(60)	140
Item may be reclassified		
Exchange difference on foreign operation	100	
Deferred tax liability @ 40%	(40)	60
Exchange difference reclassified		(90)
Total Comprehensive Income		3,009

Workings : (1) Deferred Tax Liability

Particulars	Foreign operation	Land and building	Plant and machinery	Exchange difference	Financial assets	Investment property	Convertible preference shares	Convertible bonds	Total
Opening balance	120	150		80	40	320	36	62	808
Created through —									
P/L		30				240			270
OCI	160		60	40					260
Reversed through —									
P/L	(140)			(60)			(18)	(30)	(248)
OCI		(60)			(20)				(80)
Closing balance	140	120	60	60	20	560	18	32	1,010

(2) Deferred Tax Asset

Particulars	Deferred revenue	Refund liability	Plant and machinery	Share based payment	Total
Opening balance	300		30	9	339
Created	600	36	15	21	672
Reversed	(300)		(30)		(330)
Closing balance	600	36	30	45	681

(3) Other Income

Fair value increase in investment property	300
Dividends received	700
Total	1,000

(4) Other Expenses

Share based payment	70
Unwinding and amortisation of zero-coupon convertible bonds	100
Interest and amortisation of 5% convertible preference shares	109
Depreciation on – land and building	500
plant and machinery	300
Impairment reversal	(200)
Total	879

(5) Current Tax

Revenue	7,000
Cost of sales	(3,000)
Deferred revenue	2,000
Administrative expenses	(712)
Distribution expenses	(584)
Depreciation on – land and building	(600)
plant and machinery	(250)
investment property	(400)
Total	3,454
Tax @ 30% on 3,454	1,036
Tax @ 40% on sale of foreign operation	200
Current tax liability	1,236

Earnings per Share (Ind AS 33)

Introduction

Earnings per share (EPS) is a fundamental measure of profitability that shows how much profit was generated on per-ordinary share basis, ie , the portion of an entity's profit allocated to each ordinary share of the entity.

Earnings per share data are widely used in judging the operating performance of an entity. This ratio appears in financial statements and is considered the most significant figure appearing on the income statement. This is because, it condenses into a single figure the data reflecting the current net income of the reporting period in relation to the number of ordinary shares outstanding.

Measurement

Basic earnings per share

The objective of basic earnings per share information is to provide a measure if the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period. An entity shall calculate the basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders. Basic earnings per share shall be calculated as follows –

$$\frac{\text{Profit or loss attributable to ordinary stakeholders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

Earnings

For calculating basic earnings per share, the amounts attributable to ordinary equity holders of the parent entity in respect of profit or loss –

(a) from continuing operations attributable to the parent entity; and

(b) attributable to the parent entity

shall be the amounts in (a) and (b) adjusted for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

All items of income and expenses attributable to ordinary equity holders of the parent entity that are recognised in a period, including tax expenses and dividends on preference shares classified as liabilities are included in the determination of profit or loss for the period attributable to ordinary equity holders of the parent entity.

The after- tax amount of preference dividends that is deducted from profit or loss is the after-tax amount of –

- any preference dividends on non-cumulative preference shares declared in respect of the period; and
- the preference dividends for cumulative preference shares required for the period, whether or not the dividends have been declared. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

Example 1

ABC Ltd issues 1,000 non-cumulative preference shares of 10 par value. On year 1, the entity does not pay the dividend of 500 on such shares. However, in year 2, the entity pays 500 relating to that period. Income tax rate for both the years is 40%. Since, non-cumulative preference shares are not entitled to receive any unpaid dividends, the entity has no obligation to pay for the dividend related to year 1. In effect, for calculation of basic earnings per share, the entity will –

- not make any adjustments for the preference dividend expense in year 1; and
- adjust the amount of profit or loss for post tax dividend of 300 [(100 – 40)% on 500]

Example 2

Let us take the previous example with some changes. Say, ABC Ltd issues 1,000 cumulative preference shares of same par value. In this case, the profit or loss for both year 1 and year 2 will have to be adjusted for post tax dividend of 300 for the calculation of basic earnings per share. Holders of cumulative preference shares are entitled to receive dividend, whether declared or not. Any amount of dividend declared but not paid is accumulated for future payment.

All items of income and expenses attributable to ordinary equity holders of the parent entity that are recognised in a period, including tax expense and dividends on preference shares classified as liabilities are included in the determination of profit or loss for the period attributable to ordinary equity holders of the parent entity (as per Ind AS 1). The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

Increasing rate preference shares refer to the preference shares that are provided for –

- a low initial dividend in order to compensate an entity for selling such shares at a discount; or
- an above-market dividend in later periods to compensate investors for purchasing such shares at a premium.

Any discount or premium at the time of original issue is amortised to retained earnings using the effective interest method and treated as a preference dividend for the purposes of calculating earnings per share, irrespective of whether such discount or premium is debited or credited to share premium account.

Example 3

ABC Ltd issues preference shares of par value 100 at a discount of 6. However, the entity is to pay 100 at the time of redemption. This is a case of discount on original issue of shares which shall be amortised to retained earnings over the life of the preference shares. For calculating earnings per share, the amortised amount is added to the dividend on such preference shares whose post tax amount is ultimately deducted from profit or loss for the period.

Example 4

ABC Ltd issued non-convertible, non-redeemable preference shares of 100 par value on 1 January 2009. The preference shares are entitled to a cumulative annual dividend of 7 per share starting 2012. At the time of issue, the market rate dividend yield on such preference shares was 7% a year. Thus, the entity could have expected to receive proceeds of approximately 100 per preference share if the dividend rate of 7 per share had been in effect at the date of issue.

Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes.

In consideration of the dividend payment terms, however, the preference shares were issued at 81.63 per share, ie, at a discount of 18.37 per share. The issue price can be calculated by taking the present value of 100, discounted at 7% over a 3-year period. The present value is computed at 81.63 [$100\ (1 + 0.07)^{3}$]. The difference between the present value so calculated and the par value is treated as discount on issue of such preference shares. This amount of discount shall be amortised to retained earnings for each of the years till 2011.

To calculate basic earnings per share, the imputed dividend per preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity. The carrying amount so determined at 31 December each year represents amounts that are before the payment of dividend.

Reporting period	Carrying amount of preference shares as on 1 January	Imputed dividend @ 7%	Carrying amount of preference shares(before dividend payment) as on 31 December	Dividend paid
2009	81.63	5.71	87.34	–
2010	87.34	6.12	93.46	–
2011	93.46	6.54	100.00	–
2012 onwards	100.00	7.00	107.00	(7.00)

Preference shares may be repurchased under an entity's tender offer to the holders. The excess of the fair value of the consideration paid to the preference shareholders over the carrying amount of the preference shares represents a return to the holders of preference shares and a charge to the retained earnings for the entity. This amount is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

Example 5

ABC Ltd issues preference shares of par value 10 on 1 January 2009. However, it carries a call provision along with it which would enable the issuing entity to repurchase them when required. On 31 January 2012 the entity buys back all the shares at 15 each due to the availability of spare cash. This is a case of buy back of preference shares at a premium. The amount of premium of 5 (15 – 10) will be charged to retained earnings directly. No amount will be recognised in profit or loss. However, it shall be taken into consideration while calculating the basic earnings per share and, therefore, 5 per share shall be deducted from profit or loss for computing earnings.

Early conversion of convertible preference shares may be induced by an entity through favourable changes to the original conversion terms or the payment of additional consideration. The excess of fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms is a return to the preference shareholders, and is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

For calculation of the profit attributable to ordinary shareholders, any excess of carrying amount of the preference shares over the fair value of the consideration paid to settle them is added.

Example 6

ABC Ltd had issued 200 mandatorily redeemable preference shares at 100 each on 1 January 2007. The shareholders were given an option of either redeeming the preference shares at the end of 5 years or getting each of their preference shares converted to 2 ordinary equity shares. On 1 January 2012, the shareholders got their shares converted when the market price of each ordinary equity share was 54. In this case, the preference shares are converted to ordinary shares whose fair value is 108 (54 2). Therefore, the fair value exceeds the carrying amount of the preference shares by 8 (108 – 100). This amount has to be deducted in order to arrive at profit or loss attributable to the ordinary shareholders.

Example 7

Let us take the previous example into consideration with some changes. Say, the market value of the shares were 48 each instead of 54. Therefore, the difference between the fair value of the ordinary shares and the carrying amount of the preference shares is 4 [100– (48 x 2)]. For calculating earnings per share, the discount will be credited in the period of the transaction. Unlike the previous example, this amount will be added in arriving at profit or loss attributable to the ordinary shareholders.

Shares

For calculating basic earnings per share, the number of ordinary shares shall be weighted average number of ordinary shares outstanding during the period. The weighted number of ordinary shares outstanding during the period is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor which is the number of days that the shares are outstanding as a proportion of the total number of days in the period. A reasonable approximation of the weighted average is acceptable in many circumstances. The weighted average number of ordinary shares outstanding during the period, when used reflects the possibility that the amount of shareholders' capital varied during the period as a result of a larger or smaller number of shares being outstanding at any time.

Example 8

20X1	Particulars			Shares issued	Treasury shares
1 January	Balance			2,000	300
1 June	New shares			800	–
1 December	Treasure shares			–	250

20X1	Period (months)	Particulars	Shares issued	Treasury shares	Shares outstanding
1 January		Balance	2,000	300	1,700
1 June	5	New shares	800	–	2,500
1 December	6	Treasury shares	–	250	2,250
31 December	1	Balance	2,800	550	2,250

Weighted average shares : (1,700 x 5/12) + (2,500 x 6/12) + (2,250 x 1/12) = 2,146 shares

Shares are generally included in the weighted average number of shares from the date consideration is receivable which is generally the date of their issue. The timing of the inclusion of ordinary shares is determined by the terms and conditions attaching to their issue. Due consideration is given to the substance of any contract associated with their issue.

For example :

Ordinary shares issued –	are included –
● in exchange for cash	● when cash is receivable.
● in the voluntary reinvestment of dividends on ordinary or preference shares	● when dividends are reinvested.
● as a result of the conversion of a debt instrument to ordinary shares	● from the date that interest ceases to accrue.
● in place of interest or principal on other financial instruments	● from the date that interest ceases to accrue.
● in exchange for the settlement of a liability of the entity	● from the settlement date.
● as consideration for the acquisition of an asset other than cash	● as of the date on which the acquisition is recognised.
● for the rendering of services to the entity	● as the services are rendered.

Example 9

ABC Ltd wanted to settle an obligation of 50 by paying 20 in cash followed by an issue of 3 shares. The date for the payment of cash was settled to be 31 March 2012 whereas the issue of shares would be made on 31 July same year. But the settlement terms were accepted on the date the cash was paid, 31 March, 2012. While preparing the financial statements for the year ended as on 31 December 2012, the management treated the new shares as having been issued on the settlement date. Therefore, for computation of basic earnings per share, the issue of 3 new shares would be included in the weighted average number of shares from 31 March 2012.

Example 10

ABC Ltd has convertible bond which is supposed to be converted into ordinary shares. The bond holders will receive interest till 31 August 2012 after which the bond would get converted. In this case, the number of shares issued for the purpose of conversion of bond into ordinary shares would be included in the weighted average number of shares from 1 September 2012.

Ordinary shares issued as part of the consideration transferred in a business combination are included in the weighted average number of shares from the acquisition date when the acquirer incorporates the acquiree's profit and losses into its Statement of Profit and Loss.

Ordinary shares that will be issued upon the conversion of a mandatorily convertible instrument are included in the calculation of basic earnings per share from the date the contract is entered into.

Contingently issuable shares are treated as outstanding and are included in the calculation of basic earnings per share only from the date all the conditions are satisfied (ie, the event has occurred). Shares that are issuable solely after the passage of time is a certainty. Outstanding ordinary shares that are contingently returnable, ie, subject to recall are not treated as outstanding and are excluded from the calculation of basic earnings per share until the date the shares are no longer subject to recall.

The weighted average number of ordinary shares outstanding during the period and for all periods presented shall be adjusted for events, other than the conversion of potential ordinary shares that have changed the number of ordinary shares outstanding without a change in resources.

The various situations which can lead to the issue of ordinary shares or reduction in the number of ordinary shares, without a corresponding change in resources are –

- Capitalisation or bonus issue;
- Bonus element in any other issue, eg, rights issue;
- Share split; and
- Reverse share split.

In case of a capitalisation or bonus issue or a share split, ordinary shares are issued to existing shareholders for no additional consideration which leads to an increase in the number of shares without a corresponding increase in resources. In such circumstances, the number of ordinary shares outstanding before the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period presented.

Example 11

ABC Ltd made a bonus issue of 1 ordinary share for every 3 ordinary shares held on 1 July 2012. Before such bonus issue, the entity had 30,000 ordinary shares outstanding for the last 4 years. The profit after tax of the entity for the period ended 2011 and 2012 were 369,000 and 450,000 respectively. The earliest period presented is 2011. Therefore, for the purpose of presenting earnings per share, the entity will have to adjust the earnings per share figure of 2011 in tune with the event of bonus issue. The calculation of earnings per share is as follows –

- The total number of shares outstanding after the bonus issue is 40,000 [30,000 + (30,000 x 1/3)].
- The basic earnings per share for 2012 is 11.25 (450,000 / 40,000).
- The adjusted basic earnings per share for 2011 is 9.225 (369,000 / 40,000).

In this case, since the bonus issue was without consideration, it is treated as if it had occurred before the beginning of the earliest period stated, i.e., 2011.

The issue of ordinary shares at the time of exercise or conversion of potential ordinary shares does not usually give rise to a bonus element. This is because, the potential ordinary shares are usually issued for full value, resulting in a proportionate change in the resources available to the entity. However, in case of a rights issue, the exercise price is often less than the fair value of the shares. Therefore, such a rights issue includes a bonus element. If a rights issue is offered to all existing shareholders, the number of ordinary shares to be used in calculating basic and diluted earnings per share for all periods before the rights issue is derived as :

$$\text{Number of ordinary share outstanding before rights issue} \times \frac{\text{Fair Value of share immediately before the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate market value of the shares immediately before the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. In case, these rights are to be traded separately from the shares before the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Example 12

Year	**20X0**	**20X1**	**20X2**
Profit attributable to equity holders of the parent entity	1,100	1,500	1,800

Shares outstanding before rights issue : 500

Rights issue : 1 new share for each 5 outstanding shares

Exercise price : 5

Date of rights issue : 1 January 20X1

Last date to exercise rights : 1 March 20X1

Market price of 1 share immediately before exercise on 1 March 20X1 : 11

Reporting date : 31 December

Theoretical ex-rights value per share

$$\frac{\text{Fair value of all outstanding shares before exercise of rights + Total amount received from exercise of rights}}{\text{Number of shares outstanding before exercise + Number of shares issued in the exercise}}$$

= [(11x500) + (5x100)] /(500 + 100) = 10

Adjustment factor

$\frac{\text{Fair value per share before exercise of rights}}{\text{Theoretical ex-rights value per share}}$ = 11/10 = 1.1.

Basic earnings per share

Year		20X0	20X1	20X2
20X0	Basic EPS as originally reported (1,100/500)	2.20		
	Basic EPS restated for rights issue 1,100/(500x1.1)	2.00		
20X1	Basic EPS including effects of rights issue 1,500/[(500x1.1x2/12) + (600x10/12)]		2.54	
20X2	Basic EPS 1,800/600			3.00

A consolidation of ordinary shares generally reduces the number of ordinary shares outstanding without a corresponding reduction in resources. However, when overall effect is a share repurchase at fair value, the reduction in the number of ordinary shares outstanding is the result of a corresponding reduction in resources. A share consolidation with special dividend is an example to such a situation.

The weighted average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognised.

Example 13

ABC Ltd decided to consolidate its shares from 1 October 2012. As per the consolidation, 10 shares of par value 10 will be replaced by 1 share of 100. The shareholders would also receive a special dividend of 10 on 31 October 2012. Therefore, the revised number of shares will be included in the weighted average number of ordinary shares from 31 October 2012 when the special dividend is recognised.

Diluted earnings per share

An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding, for the effects of all diluted potential ordinary shares.

The objective of diluted earnings per share is consistent with that of basic earnings per share

– to provide a measure of the interest of each ordinary share in the performance of an entity

– while giving effect to all dilutive potential ordinary shares outstanding during the period. As a result –

- profit or loss attributable to ordinary equity holders of the parent entity is increased by the after-tax amount of dividends and interest recognised in the period in respect of the dilutive potential ordinary shares and is adjusted for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares; and
- the weighted average number of ordinary shares outstanding is increased by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

Example 14

On 31 December 2012 ABC Ltd has 1,000 ordinary shares in issue of par value of 100 and 800 convertible bonds of 10. The bonds bear an interest rate of 5%. Each bond is convertible into 2 shares. The after-tax profit for the period is 4,600. The income tax rate is 40% .

The basic earnings per share = 4.60 (4,600÷1,000).

For the purpose of diluted earnings per share, the following adjustments shall be made –

- Profit for the period would be increased by the after tax amount of interest recognised in respect of the convertible bonds. The adjusted profit stands at : 4,840 [4,600 + {(5% on 800×10)×(100 – 40) %}].
- Weighted average number of shares shall be increased assuming that all bonds are converted. The adjusted weighted average number of shares stands at : 2,600 [1,000 shares + 1,600 (800×2) potential shares].

Therefore, the diluted earnings per share = 1.86 (4,840÷2,600). The figure shows that if the bonds are converted as on 31 December 2012, it would lead to a fall in earnings per share from 4.60 to 1.86. Though the earnings would rise due to non-payment of the interest on bonds, the earnings per share will reduce due to the increase in the number of shares.

Earnings

For calculating diluted earnings per share, profit or loss attributable to ordinary equity holders of the parent entity, as calculated in the case of basic earnings per share, shall be adjusted for the after-tax effect of any –

- dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders of the patent entity;
- interest recognised in the period related to dilutive potential ordinary shares; and
- other changes in income or expenses that would result from the conversion of the dilutive potential ordinary shares.

Once the potential ordinary shares are converted into ordinary shares, the items discussed above do not arise in the calculation of the diluted earnings per share. However, the above mentioned items and any related taxes shall be included in the calculation of the basic earnings per share as the new shares are entitled to participate in profit or loss attributable to the ordinary equity holders of the parent entity. The expenses associated with potential ordinary shares include transaction costs and discounts accounted for in accordance with effective interest rate as defined in Ind AS 109.

The conversion of potential ordinary shares may lead to consequential changes in income or expenses. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in profit or reduction in loss may lead to an increase in the expense related to non-discretionary employee profit-sharing plan. Any such consequential changes in income or expense shall be given effect to while calculating the diluted earnings per share.

Example 15

Let us follow the previous example with some adjustments. ABC Ltd has a policy wherein the employees benefit from an employee profit-sharing plan. According to the plan, the employees are entitled to 3% of the net profit after tax as calculated for the purpose of diluted or basic earnings per share, whichever is lower. In this case, the computation of basic earnings per share is as follows –

Earnings for the purpose of basic earnings per share = 4,980 – (3% on 4,980) = 4,980 – 149.40 = 4,830.60.

Therefore, the basic earnings per share = 16.102 (4,830.60÷300).

Adjusted earnings for the purpose of diluted earnings per share = 4,990 – (3% on 4,990) = 4,990 – 149.70 = 4,840.30.

Due to a reduction in the interest expense related to potential ordinary shares, the earnings get increased which ultimately increases the expense related to non-discretionary employee profit-sharing plan from 149.40 to 149.70. Since the benefit as calculated for basic earnings per share of 149.40 is lower than that calculated for the purpose of diluted earnings per share of 149.70, the expense of the entity in relation to the non-discretionary employee profit-sharing plan, the expense is determined to be 149.40. Therefore, the revised diluted earnings per share = 9.6812 [(4,990 – 149.40)÷500].

Shares

For the purpose of calculating diluted earnings per share, the number of ordinary shares is calculated as :

Number of ordinary shares for the purpose of calculating diluted earnings per share	=	Weighted average number of ordinary shares, as determined for the purpose of calculating basic earnings per share	+	Weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares

For calculating diluted earnings per share, the average market price of ordinary shares assumed to be issued is calculated on the basis of the average market price of the ordinary shares during the period. Theoretically, every market transaction for an entity's ordinary shares could be included in the determination of the average market price. As a practical matter, however, a simple average of weekly or monthly prices is usually adequate.

Normally, the closing market prices are adequate for calculating the average market price. However, in cases when prices fluctuate widely, an average of the high and low prices usually produces a more representative price. The method used to calculate the average market price is used consistently unless it is no longer representative because of changed conditions. For example, an entity that uses closing market prices to calculate the average market price for several years of relatively stable prices might change to an average of high and low prices if price start fluctuating greatly and the closing market prices no longer produce a representative average price.

Dilutive potential ordinary shares shall be determined independently for each period presented. The number of dilutive potential ordinary shares included in the year-to-date period is not a weighted average of the dilutive potential ordinary shares included in each interim period.

Potential ordinary shares are weighted for the period they are outstanding. Potential ordinary shares that are cancelled or allowed to lapse during the period are included in the calculation of diluted earnings per share only for the portion of the period during which they are outstanding. Potential ordinary shares that are converted into ordinary shares during the period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.

The number of ordinary shares that would be issued on conversion of dilutive potential ordinary shares is determined from the terms of the potential ordinary shares. When more than one basis of conversion exists, the calculation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.

Dilutive potential ordinary shares

Potential ordinary shares shall be treated as dilutive when, and only when, their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.

An entity uses profit or loss from continuing operations attributable to the patent entity as the control number to establish whether potential ordinary shares are dilutive or anti-dilutive. Potential shares are anti-dilutive when their conversion to ordinary shares would increase earnings per share or decrease loss per share from continuing operations. The calculation of diluted earnings per share does not assume conversion, exercise or other issue of potential ordinary shares that would have an anti-dilutive effect on earnings per share.

Example 16

ABC Ltd has furnished the following :

Profit from continuing operations attributable to the parent entity of 4,800. Loss from discontinued operations attributable to the parent entity of 7,200. Loss attributable to the parent entity 2,400. It has 2,000 ordinary shares and 400 potential shares outstanding. Therefore the entity's basic earnings per share for continuing operations is 2.40 (4,800 2,000). This is the control number to be used in order to establish whether the potential ordinary shares are dilutive or anti-dilutive.

Loss per share for discontinued operations is 3.60 (7,200 2,000). Loss per share is 1.20 (2,400 2,000). If the 400 potential shares are included in diluted earnings per share calculation, the earnings per share is found to be 2.00 (4,800 2,400). Since the conversion of potential ordinary shares into ordinary shares decreases the earnings per share from continuing operations, the potential shares are treated as dilutive. The loss per share for discontinued operations is 3.00 (7,200 2,400) and loss per share is 1.00 (2,400 2,400). The entity also includes those 400 potential ordinary shares in the calculation of the other earnings per share amount, even though the resulting earnings per share amounts are anti-dilutive to their comparable basic earnings per share amounts, ie, the loss per share is less, because profit from continuing operations attributable to the parent entity is the control number.

In determining whether potential ordinary shares are dilutive or anti-dilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate. The sequence in which potential ordinary shares are considered may affect in deciding whether they are dilutive. Therefore, to maximise the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive, ie, dilutive potential ordinary shares with the lowest 'earnings per incremental share' are included in the diluted earnings per share calculation before those with a higher 'earnings per incremental share'. Options, warrants and their equivalents are generally included first because they do not affect the numerator of the calculation.

Example 17

On 1 January 20x1, an equity has 100 ordinary shares and grants 1 share option to each of its 50 employees, which will vest on 31 December 20x3. The exercise price and the entity's share price at the date of grant is 10. Profit before remuneration expense – year 1 : 100; year 2 : 200; year 3 : 300. Income tax rate @ 40%.

End of year	Employees remain in employment (Nos.)	Share price	Increase in share price	Intrinsic value
20x1	48	10.50	0.50	0.50
20x2	45	10.75	0.25	0.75
20x3	40 (exercised)	13.00	2.25	3.00

Statement of Profit and Loss

Year		20x1		20x2		20x3
Profit (before remuneration expense)		100		200		300
Remuneration expense (Note 1)		8		15		97
Accounting Profit		92		185		203
Tax expense –						
Current tax expense	40		80		72	
Deferred tax income	(3)		(6)		(39)	
Deferred tax asset	–	37	–	74	48	81
Profit for the Period		55		111		122
Earnings per share –						
Basic (Note 3)		0.55		1.11		2.42
Diluted (Note 4)		0.52		0.92		1.29

Workings : (1) Cumulative Remuneration Expense and Deferred Tax Asset

End of year	Calculation	Expenses			Deferred Tax Asset		
		Created	Transferred	Balance	Created	Reversed	Balance
20x1	48 x 0.50 x 1/3	8	–	8	3	–	3
20x2	(45 x 0.75 x 2/3) – 8	15	–	23	6	–	9
20x3	(40 x 3) – 23	97	120	–	39	48	–

(2) Current Tax

Year	20x1	20x2	20x3
Profit (before remuneration expense)	100	200	300
Remuneration expense allowed [40 x (13 – 10)]	–	–	120
Taxable profit	100	200	180
Current tax @ 40%	40	80	72

(3) Basic Earnings per Share

Year	20x1	20x2	20x3
Profit for the Period	55	111	122
Transferred to retained earnings	–	–	120
Profit Available to Ordinary Shareholders (A)	55	111	242
Basic earnings per share (A ÷100)	0.55	1.11	2.42

(4) Diluted Earnings per Share

Year	20x1	20x2	20x3
Profit	100	200	300
Tax expense @ 40%	40	80	120
Profit for the Period (A)	60	120	180
Existing + Potential shares (B)			
[100 + (48 ÷ 3)]	116		
[100 + (45 ÷ 3 x 2)]		130	
[100 + 40]			140
Diluted Earnings per Share (A ÷ B)	0.52	0.92	1.29

Example 18

On 1 January 20x1, an entity has 100 ordinary shares and issues 100, 5% convertible bonds of 10 each. Each bond is convertible into 2 ordinary shares on 31 December 20x3. Interest rate without the conversion feature (ie, effective interest rate) is 10%. Profit before finance cost 200 per year. Income tax rate 40%. Transaction cost 50.

Statement of Profit and Loss

Year		20x1		20x2		20x3
Profit before finance cost		200		200		200
Finance cost		101		108		116
Accounting Profit		99		92		84
Tax expense –						
Current tax expense	40		60		60	
Deferred tax liability	–	40	(23)	37	(27)	33
Profit for the Period		59		55		51
Earnings per share –						
Basic		0.80		0.80		0.80
Diluted		0.44		0.42		0.40

Statement of Changes in Equity

Year	20x1	20x2	20x3
Equity component of convertible bond			
Balance b/d	75	54	29
Transferred to retained earnings	21[1]	25[2]	29[3]
Balance c/d	54	29	–

[1][60% of (51 – 16)] [2][60% of (58 – 16)] [3][60% of (66 – 18)]

Workings **(1) Present Value of 5% Convertible Bonds**

Year-end	Particulars	Cash Outflow	Effective Interest Rate @ 10%	Present Value
20x1				
Jan 1	Transaction cost	(50)		(50)
Dec 31	Interest	50	0.909	45
20x2				
Dec 31	Interest	50	0.826	41
20x3				
Dec 31	Interest and conversion	1,050	0.751	789
Present value of 5% Convertible Bonds				825

(2) Carrying Amount of Convertible Bonds

Year	20x1	20x2	20x3
Balance b/d	825	876	934
Finance cost amortised[1]	101	108	116
Interest paid	(50)	(50)	(50)
Balance c/d	876	934	1,000

[1] At an effective interest of 12.2%

(3) Current Tax

Year		20x1		20x2		20x3
Profit before finance cost		200		200		200
Finance cost –						
Interest	50		50		50	
Transaction	50	100	–	50	–	50
Taxable Profit		100		150		150
Current tax @ 40%		40		60		60

(4) Basic Earnings per Share

Year	20x1	20x2	20x3
Profit for the Period	59	55	51
Transferred to retained earnings	21	25	29
Profit Available to Ordinary Shareholders (A)	80	80	80
Basic earnings per share (A ÷100)	0.80	0.80	0.80

(5) Diluted Earnings per Share

Year	20x1	20x2	20x3
Profit	200	200	200
Tax expense @ 40%	80	80	80
Profit for the Period (A)	120	120	120
Existing + Potential shares (B)			
[100 + (876 ÷10 x 2)]	275		
[100 + (934 ÷ 10 x 2)]		287	
[100 + (1,000 ÷ 10 x 2)]			300
Diluted Earnings per Share (A ÷ B)	0.44	0.42	0.40

Example 19

On 1 January 20x1, an entity has 100 ordinary shares and issues 100, zero-coupon convertible bonds of 10 each. Each bond is convertible into 2 ordinary shares on 31 December 20x3. Interest rate without the conversion feature (ie, effective interest rate) is 10%. Profit before finance cost 300 per year. Transaction cost 50. Income-tax rate 40

Statement of Profit and Loss

Year		20x1		20x2		20x3
Profit before finance cost		300		300		300
Finance cost		87		99		113
Accounting Profit		213		201		187
Tax expense –						
Current tax expense	100		120		120	
Deferred tax liability	(15)	85	(40)	80	(45)	75
Profit for the Period		128		121		112
Earnings per share –						
Basic		1.71		1.71		1.68
Diluted		0.70		0.65		0.60

Statement of Changes in Equity

Year	20x1	20x2	20x3
Equity component of zero-coupon convertible bonds			
Balance b/d	149	106	56
Transferred to retained earnings	43[1]	50[2]	56[3]
Balance c/d	106	56	–

[1][60% of (87 – 16)] [2][60% of (99 – 16)] [3][60% of (113 – 18)]

Workings **(1) Present Value of Zero-coupon Convertible Bonds**

Year	Opening Value at Effective Rate of 10%	Finance cost at Effective Interest Rate of 12.5%	Present Value
20x3	1,000 x 0.909 = 909	887 x .125 = 113	887 + 113 = 1,000
20x2	1,000 x 0.826 = 826	788 x .125 = 99	788 + 99 = 887
20x1	1,000 x 0.751 = 751	701 x .125 = 87	701 + 87 = 788

(2) Current Tax

Year	20x1	20x2	20x3
Profit	300	300	300
Transaction cost allowed	50	–	–
Taxable Profit	250	300	300
Current tax @ 40%	100	120	120

(3) Basic Earnings per Share

Year	20x1	20x2	20x3
Profit for the Period	128	121	112
Transferred to retained earnings	43	50	56
Profit Available to Ordinary Shareholders (A)	171	171	168
Basic earnings per share (A ÷ 100)	1.71	1.71	1.68

(4) Diluted Earnings per Share

Year	20x1	20x2	20x3
Profit	300	300	300
Tax expense @ 40%	120	120	120
Profit for the Period (A)	180	180	180
Existing + Potential shares (B)			
[100 + (788 ÷10 x 2)]	258		
[100 + (887 ÷10 x 2)]		277	
[100 + (1,000 ÷10 x 2)]			300
Diluted Earnings per Share (A ÷ B)	0.70	0.65	0.60

Example 20

On 1 January 20x1, an entity has 100 ordinary shares and issues 100, 5% convertible preference shares of 10 each. Each preference share is mandatorily convertible into 1 ordinary share on 31 December 20x3. Effective interest rate is 10%. Profit before finance cost 300 per year. Income-tax rate 40%. Transaction cost 50.

Statement of Profit and Loss

Year		20x1		20x2		20x3
Profit before finance cost		300		300		300
Finance cost		101		108		116
Accounting Profit		199		192		184
Tax expense –						
Current tax expense	100		120		120	
Deferred tax liability	–	100	(23)	97	(27)	93
Profit for the Period		99		95		91
Earnings per share –						
Basic		1.20		1.20		1.20
Diluted		0.96		0.93		0.90

Statement of Changes in Equity

Year	20x1	20x2	20x3
Equity component of Convertible Preference Shares			
Balance b/d	75	54	29
Transferred to retained earnings	21[1]	25[2]	29[3]
Balance c/d	54	29	–

[1][60% of (51 – 16)] [2][60% of (58 – 16)] [3][60% of (66 – 18)]

Workings **(1) Present Value of Convertible Preference Shares**

Year-end	Particulars	Cash Outflow	Effective Interest Rate @ 10%	Present Value
20x1				
Jan 1	Transaction cost	(50)		(50)
Dec 31	Interest	50	0.909	45
20x2				
Dec 31	Interest	50	0.826	41
20x3				
Dec 31	Interest and conversion	1,050	0.751	789
Present value of 5% Convertible Preference Shares				825

(2) Carrying Amount of Convertible Preference Shares

Year	20x1	20x2	20x3
Opening balance	825	876	934
Finance cost amortised[1]	101	108	116
Interest paid	(50)	(50)	(50)
Balance c/d	876	934	1,000

[1]At an effective interest of 12.2%

(3) Current Tax

Year	20x1	20x2	20x3
Profit	300	300	300
Transaction cost allowed	50	–	–
Taxable Profit	250	300	300
Current tax @ 40%	100	120	120

(4) Basic Earnings per Share

Year	20x1	20x2	20x3
Profit for the Period	99	95	91
Transferred to retained earnings	21	25	29
Profit Available to Ordinary Shareholders (A)	120	120	120
Basic earnings per share (A ÷ 100)	1.20	1.20	1.20

(5) Diluted Earnings per Share

Year	20x1	20x2	20x3
Profit	300	300	300
Tax expense @ 40%	120	120	120
Profit for the Period (A)	180	180	180
Existing + Potential shares (B)			
[100 + (876 ÷ 10 x 1)]	188		
[100 + (934 ÷10 x 1)]		193	
[100 + (1,000 ÷ 10 x 1)]			200
Diluted Earnings per Share (A ÷ B)	0.96	0.93	0.90

Statement of Cash Flows (Ind AS 7)

Introduction

Cash is anything that a banker can accept as a deposit at its face value. Cash is critical to every single entity, since it can be transferred without any restriction. Therefore, it is important to understand where the cash is coming from and going to. By using accrual basis, it does not necessarily follow that profit (loss) for a reporting period will be matched by a corresponding increase (decrease) in cash balance. The profit or loss for a reporting period is calculated by allowing for accruals and prepayments (in respect of income, expenses and taxes) at the beginning and end of the reporting period. Some items of income and expenses charged to Statement of Profit and Loss, eg, depreciation or profit on sale of non-current assets, do not affect the movement of cash. In addition, items regarded as equity (which affect movement of cash), ie, issue of shares or the purchase of non-current assets do not find a place in Statement of Profit and Loss.

A **Statement of Cash Flows** summarises the movements of cash into and out of the entity, illustrating the differences between income and receipts, and between expenses and payments. In the same way that a Statement of Profit and Loss does not show the cash made by an entity, a Statement of Cash Flows does not show the income. Therefore, a Statement of Cash Flows is related only loosely to income. It is the link between income and cash balance movements.

Benefits of Cash Flow information

Cash flows are inflows and outflows of cash and cash equivalents. The Statement of Cash Flows is relatively free of the drawbacks of the accrual basis (income that should have been received is matched with expenses that should have been paid), which fails to provide adequate information about the liquidity and solvency of the entity.

A Statement of Cash Flows, when used in conjunction with the rest of the financial statements, provides information that enable users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.

Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enable users to develop models to assess and compare the present value of the future cash flows of different entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using accounting treatments for the same transactions and events. In other words, since the cash flows are not affected by variations in accounting principles and estimates, it is more useful than reported income in assessing liquidity and solvency.

Historical cash flow information is used as an indicator of the amount, timing and certainty of future cash flows. It also helps in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flows and the impact of changing prices.

Example 1

ABC Ltd has presented a complete set of financial statements at the end of the reporting period. P Ltd is a creditor to the entity and at that date, ABC Ltd is supposed to pay an amount of 2,000 to P Ltd for buying materials on credit. In order to identify the ability of ABC Ltd to pay back the same, P Ltd assesses the statement of cash flows. It compares the income and expenses as per the Statement of Profit and Loss with the cash receipts and payments as per Statement of Cash Flows. This gives a clear picture about the timing and certainty of the future cash flows to be generated by the entity based on which the cash inflows of P Ltd can be predicted. This information helps P Ltd to analyse whether continuation of the relation with ABC Ltd would be profitable or not.

Cash and Cash Equivalents

Cash comprises cash on hand and demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value.

In order to meet the short-term obligations, an entity requires cash. Sometimes cash equivalents are also made to take part in the cash management activities of an entity. These cash equivalents are normally short term investments that have a maturity period of 3 months or less from the date of acquisition. Cash equivalents are primarily held for the purpose of meeting short-term cash commitments rather than for investment. Therefore, the inflows and outflows of cash equivalents are also considered while preparing the statement of cash flows. Whatever may be the case, an entity should disclose the accounting policy it adopts regarding the composition of the cash and cash equivalents.

Investments

When excess liquidity of a business is parked in short-term investments of maturity period of 3 months or less, they are considered as cash investments. But funds that are invested in instruments for investment purpose would not qualify as cash equivalents.

Example 2

ABC Ltd has invested its excess funds as follows –

- 50 in bonds on 1 February, 2012 with a maturity period of 6 months;
- 10 in bonds on 28 February, 2012 which would mature on 31 May, 2012; and
- 60 in bonds on 15 March, 2012 which would mature after 3 years.

In the first case, though the bond is short-term in nature, it would not be classified as cash equivalents. An entity should generally consider an investment to be a cash equivalent when the maturity period is 3 months or less.

In the second case, the bond's maturity period is exactly 3 months which enables the entity to consider it to be a cash equivalent.

In the third case, the entity has an intension to invest rather than to use it for the purpose of meeting the short term obligations. This is definitely not a cash equivalent.

Equity investments in general do not qualify as cash equivalents. They are subject to risk of changes in values that could be significant depending on the fluctuation in their market value as a consequence of changes in the economic conditions or other factors. However, if the substance of the transaction is such that they behave like cash equivalents, then they will be included in the computation of the total cash and cash equivalent of the entity.

Example 3

ABC Ltd has acquired redeemable preference shares of PQR Ltd for an amount of 100 in the month of January, 2012 and the shares would be redeemed in full for an amount of 105 in the month of March. On 30 March, PQR Ltd redeems the same. Though the investment is in equity instruments, it has the nature of a short-term highly liquid instrument. The entity knows the amount of cash that it would receive at the end of the redemption period and the investments are subject to insignificant risk of changes in value. Therefore, it is a cash equivalent in substance.

Bank Borrowings

Normally, bank borrowings are dealt as financing activities and not considered as a component of cash or cash equivalent. But, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. These bank arrangements have a characteristic where the balance fluctuates from being favourable to overdrawn. In such cases, bank overdrafts are considered to be a part of the entity's cash equivalents.

Example 4

ABC Ltd conducts seasonal business. Since the cash inflows are restricted to the winter season, the entity has positive balances in the bank. During the rest of the period the bank balance fluctuates from positive to negative balances. Any shortfall in the bank balance is financed by the bank itself. This bank balance would be included in the cash and cash equivalents of the entity in the preparation of Statement of Cash Flows.

The cash flow movements between the components of cash and cash equivalents are excluded from the computation of cash flows because these form a part of the cash management of an entity rather than being a part of its operating, investing and financing activities. The cash management includes the investment of excess cash in cash equivalents.

Presentation of a statement of cash flows

In the statement of cash flows, an entity shall report cash flows during the period classified by operating, investing and financing activities. This classification helps in –

- assessing the impact of those activities on the –
  - financial position of the entity; and
  - amount of cash and cash equivalents
- evaluating the relationships among those activities

This classification is entity specific, ie, the classification must be done in such a manner that is most appropriate to its business. For example, operating activities of a financial institution may be either investing or financing activities of a non-financial institution but they cannot be classified as operating activities. Sometimes, a single transaction can also be classified differently.

Example 5

The installment paid in respect of a non-current asset required on deferred payment basis includes both interest and loan. Here, the classification of the two components would be –

- Interest element as financing activity; and
- Loan element as investing activity

Operating Activities

Operating activities are the principal revenue- producing activities of the entity and other activities that are not investing or financing activities. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to –

- repay loans;
- maintain the operating capability of the entity;
- pay dividends; and
- make new investments without recourse to external source of financing.

When the users of financial statements analyse the information about specific components of historical operating cash flows along with other information, they are able to forecast the future operating cash flows.

Not all transactions recorded in Statement of Profit and Loss are classified as operating activities. For example, the gain or loss on sale of an item of property, plant and equipment is recorded in Statement of Comprehensive Income but it is classified as cash flows from investing activities. On the other hand entities that manufacture or acquire assets held for rental to others and subsequently held for sale, would classify the same as operating activities.

Example 6

ABC Ltd deals in machineries which are used in the construction of real estate. For the entity, these machineries are inventories as per Ind AS 2 rather than assets as per Ind AS 16. Therefore, the transactions and events related to their purchase, sale or hire are principal revenue generating activities and, therefore, the relating cash flows are classified as cash flows from operating activities. But, the machineries that the entity acquires to manufacture the same are assets to the entity and, therefore, any cash flows relating to those assets would be classified as cash flows from investing activities.

Some entities might hold securities and loans for transacting or trading purposes. In such cases, they are similar to inventories acquired specifically for resale. Therefore, the entity classifies the cash flows arising from the purchase and sale of these securities as cash flows from operating activities. Similarly, cash advances and loans made by financial institutions are usually classified as operating activities as they relate to the main revenue producing activity of that entity, because, providing loans and accepting repayments of such loans are the primary activities of the business.

The following are the examples of cash flows from operating activities :

- Cash receipts from –
  - the sale of goods and the rendering of services;
  - royalties, fees, commissions and other revenue
- Cash payments to –
  - suppliers for goods and services;
  - and on behalf of employees
- Cash receipts and payments –
  - of an insurance entity for premiums and claims, annuities and other policy benefits;
  - from contracts held for dealing on trading purposes.
- Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities.

Investing Activities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Cash flows from investing activities are cash flows that represent the extent to which expenses are incurred for the resources intended to generate future income and cash flows. Therefore, a separate disclosure is required for cash flows from investing activities. It has been specifically mentioned in this Standard that only those expenditure that result in the recognition of assets in Statement of Financial Position are eligible for the classification as cash flows from investing activities.

Some examples of cash flows from investing activities are :

- Cash payments made in relation to property, plant and equipment, intangibles and other non-current assets, include those in relation to capitalised development costs and self constructed assets;

Example 7

ABC Ltd constructs an office building in a new location. Since the asset is not meant to be sold after the construction, it is a self constructed asset for the entity. All cash payments made in relation to the construction of the office building would be classified as cash flows from investing activities.

Example 8

ABC Ltd purchases a plot of land and spends a lump sum amount for bringing it to the desired condition. As per Ind AS 16 this cost is capitalised and the related cash flows would be classified as cash flows from investing activities.

- Cash receipts from sale of property, plant and equipment, intangibles and other long term assets;

Example 9

ABC Ltd sells a plot of land whose carrying amount stood at 50 and makes a profit of 40. The gain is recognised in Statement of Profit and Loss. This is not a principal revenue generating transaction. Therefore, the entire amount of sale would be treated as cash flows from investing activities.

- Cash payments made, to acquire equity or debt instruments of other entities and interest in joint ventures;

Example 10

ABC Ltd purchases a bond that reaches its maturity date within 3 months from the date of its acquisition. Though the nature of the transaction is that of an investment, the substance of the transaction is that of a cash equivalent.

Example 11

ABC Ltd purchases equity instruments of other entities for the purpose of trading. This transaction is not an investing activity; rather it resembles nature of inventories and, therefore, the cash flows relating to the purchase and sale would be dealt as cash flows from operating activities.

- Cash receipts from sales of equity or debt instruments of other entities and interest in joint ventures (other than receipts for those instruments that are considered as cash equivalents and those held for dealing or trading purposes);
- Cash advances and loans made to other parties (other than loans and advances made by a financial institution);
- Cash receipts from the repayment of advances and loans made to other parties (other than loans and advances made by a financial institution);
- Cash payments for future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- Cash receipts from future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as those of the position being hedged.

Example 12

ABC Ltd is an airline company that uses jet fuel. The prices of jet fuel are highly volatile which proves to be a challenging factor to the entities that are in the airline industry. Therefore, in order to stay in business, the entity enters into future contracts to hedge their exposure to the price of jet fuel. The cash flows in relation to it are classified as cash flows from investing activities.

Financing Activities

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. In order to enable users of financial statements to predict claims on future cash flows by providers of capital to the entity, the cash flows from financing activities need to be disclosed separately.

Examples of cash flows arising from financing activities are :

- Cash proceeds from issuing –
  - shares or other equity instruments.
  - debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings.
- Cash payments –
  - to owners to acquire or redeem the entity's shares.
  - by a lessee for the reduction of the outstanding liability relating to a lease.
- Cash repayments of amounts borrowed.

Example 13

ABC Ltd has entered into a lease with P Ltd to lease plant and machinery. A lease has the similar effect as that of a loan. The lease payments throughout the lease term include payment of two components; principal and the interest. The payment of the principal amount is classified as cash flows from financing activities whereas the interest payment has to be classified as cash flows from operating activities.

Reporting Cash Flows from Operating Activities

An entity shall report cash flows from operating activities from either of the following 2 methods :

- **Direct Method** calculates net cash provided by operating activities as collections *minus* operating disbursements. This method represents the major categories of cash receipts and payments – the net cash flows from operating activities being the difference between these receipts and payments.

Entities are encouraged to report cash flows from operating activities using the direct method. This is because, this method provides information about major classes of gross cash receipts and gross cash payments which may be obtained either :

- from the accounting records; or

- by adjusting sales, costs of sales and other items in Statement of Comprehensive Income for –
  - changes during the period in inventories and operating receivables and payables;
  - other non-cash items, eg, depreciation/amortisation, deferred taxes, provisions, unrealised foreign currency gains/losses etc; and
  - other items for which the cash effects are investing or financing cash flows.
- **Indirect Method** adjusts profit or loss for the effects of –
  - transactions of a non-current nature;
  - any deferrals or accruals of past or future operating cash receipts or payments; and
  - items of income or expense associated with investing or financing cash flows (ie, non-operating transactions).

Under this method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of–

- changes during the period in inventories and opening receivables and payables;
- non-cash items, eg, depreciation/amortisation, provisions, deferred taxes, unrealised foreign currency gains/losses etc;
- all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flows from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in Statement of Comprehensive Income and the changes during the period in inventories and operating receivables and payables.

Reporting cash flows from investing and financing activities

An entity shall report separately major classes of gross receipts and gross payments of cash arising from investing and financing activities, except to the extent that the cash flows are reported on a net basis.

Reporting cash flows on a net basis

Cash flows arising from operating, investing or financing activities that may be reported on a net basis are :

- Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and

  The examples of cash receipts and payments referred to the above are –
  - the acceptance and repayment of demand deposits of a bank;
  - funds held for customers by an investment entity; and
  - rents collected on behalf of, and paid over to, the owners of properties.

Example 14

ABC Ltd operates as an immigration agent. It collects cash from its clients and pays to the service providers like the high commission of the respective countries, airline companies, the job providers and the accommodation providers of those countries. Its main income is commission from the clients as well as the several service providers. While preparing Statement of Cash Flows, the entity should report the cash receipts and payments on a net basis. This would help in representing the substance of the transaction that is the commission received by the entity.

- Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

  The examples of cash receipts and payments referred to above are advances made for, and the repayment of –
  - principal amounts relating to credit card customers;
  - the purchase and sale of investments; and
  - other short term borrowings, e.g., those which have a maturity period of 3 months or less.

Example 15

ABC Ltd has investments in debt and equity of different companies. The users are interested in the total amount of investment rather than the purchases and sales separately. Therefore, the reporting of net amount of purchase and sale of the investments would enhance the representation of the cash flows in Statement of Cash Flows.

Interests and Dividends

Cash flows from interest and dividends received and paid shall each be disclosed separately. Each shall be classified in a consistent manner from period to period as operating, investing or financing activities.

Interest payments made during a period are either charged as an expense in Statement of Profit and Loss or capitalised as per Ind AS 23. Whatever the treatment the entity follows, the cash flows in its relation are to be disclosed in Statement of Cash Flows.

Example 16

ABC Ltd borrows an amount of 1,000 out of which it utilises 700 for the construction of a new office building and the balance 300 is used for general purposes. The interest rate is at 5% per annum.

The entity uses 700 for a specific purpose and so, the interest on the amount of 35 will be added to the cost of the building assuming that the building is a qualifying asset as per Ind AS 23. The interest amount of 15 on the remaining 300 will be charged as an expense in Statement of Profit and Loss. However, the cash flows of total interest paid of 50 (35 + 15) will be disclosed in Statement of Cash Flows.

Interest paid and interest and dividends received may be classified as operating cash flows because as they enter into the determination of profit or loss. Alternatively, interest paid may be classified as financing cash flows, and interest and dividends received as investing cash flows, because they are costs of obtaining financial resources or return on investment.

Dividends paid may be classified as a –

- financing cash flow, because they are a cost of obtaining financial resources; or
- component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.

Taxes on Income

The transactions whose cash flows are classified as operating, investing and financing activities give rise to taxes on income. It is possible to identify the tax expense related to the investing and financing activities. However, identification of the related tax cash flows are often impracticable since they may arise on a different period from the cash flows of the underlying transaction. Therefore, taxes paid are usually classified as operating cash flows of the underlying transaction. However, if it is practicable to identify the same, the tax cash flows may be classified as investing or financing cash flows. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

In any case, cash flows arising from taxes on income shall be disclosed separately.

Example 17

ABC Ltd could identify the tax cash flows with investing and financing activities. The tax cash flows relating to operating activities, investing activities and financing activities are 60, 25 and 30 respectively.

For the preparation of Statement of Cash Flows, they are classified as above but the total amount of tax cash flows of 115 (60 + 25 + 30) are to be disclosed in the notes to financial statements.

Non-cash Transactions

Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from the statement of cash flows. The reason for such treatment is that these transactions do not have a direct impact on the cash flows of the entity. Such transactions shall be disclosed elsewhere in the financial statements in a way that would provide information relevant enough for the users of financial statements to get clear picture regarding these investing and financing activities. The examples of non-cash transactions are –

- conversion of debt to equity;

- acquisition of an entity by means of an equity issue;
- acquisition of assets either by assuming directly related liabilities or by means of lease.

Example 18

ABC Ltd acquires a building on a lease from X Ltd. As per the lease agreement, ABC Ltd is the lessee and X Ltd is the lessor. In the books of ABC Ltd, the entry would be as follows :

Right-of-use asset

Liability to make lease payments

There is no involvement of cash and cash equivalents. Therefore, for the purpose of Statement of Cash Flows, this transaction is excluded.

Example 19

ABC Ltd acquires S Ltd by payment of cash of an amount of 2,000 and issuing equity shares worth 5,000. The issue of equity shares does not involve the movements of cash or cash equivalents whereas the payment of cash does. Therefore, in Statement of Cash Flows, the transaction would be included but to the extent of 2,000 only classified as cash flows from investing activities.

Example 20

ABC Ltd had issued 1,000, 5% debentures in 2010 to be converted to equity after 2 years. In the year 2012, the entity redeems the same by the issue of equity shares of the same value. This transaction does not involve any cash and cash equivalents. Therefore, this transaction is excluded from Statement of Cash Flows in 2012.

Example 21

Sample notes to financial statements – Non-cash transactions during the period

During the period, ABC Ltd dealt the following transactions that are non-cash investing and financing activities which were not considered in the preparation of Statement of Cash Flows as they do not involve direct inflows and outflows of cash –

- The entity acquired a building on lease worth 50,000;
- S Ltd was acquired for a part consideration of equity shares of the entity; and
- 1,000, 5% debentures were converted to equity.

Components of Cash and Cash Equivalents

The users of financial statements are interested in every detail that an entity is able to provide in support of the amounts disclosed in its financial statements. An entity in respect of cash and cash equivalents may have to give the following details:

- Components of cash and cash equivalents;
- Reconciliation of the amounts in the statement of cash flows with the equivalent items reported in the balance sheet; and
- Accounting policy adopted in determining the components of cash and cash equivalents in compliance with Ind AS 1.

Any change in the accounting policy adopted for the determination of the components of cash and cash equivalents shall be reported as per Ind AS 8.

Example 22

ABC Ltd has made a change in the classification of financial instruments previously considered to be a part of an entity's investment portfolio. This is a change in the accounting policy adopted for the components of cash and cash equivalents. The effect of this change is to be reported as per Ind AS 8.

Example 23

Sample notes to financial statements – Accounting policy with respect to the components of cash and cash equivalents.

Cash and cash equivalents comprise cash on hand and demand deposits, net of outstanding bank overdrafts, together with other short-term, highly liquid investments that are convertible to known amount of cash and which are subject to an insignificant risk of changes in value. Normally, for this purpose short term deposits with an original maturity of 3 months or less are taken into consideration.

Example 24

Sample note to financial statements – Reconciliation of the amounts of cash and cash equivalents reported in the statement of cash flows with the related items in the balance sheet.

Particulars	31 Dec, 2017	31 Dec, 2016	1 Jan, 2015
Cash on hand	–	–	–
Bank balances	–	–	–
Bank overdraft	(-)	(-)	(-)
Cash and bank balances attributable to a discontinued operation	–	–	–
Cash and bank balances included in a disposal group	–	–	–

Example 25

Balance Sheet as at 31 December

Year	20x3	20x2
Assets		
Non-current assets		
Land and building	600	750
Plant and machinery	800	1,500
Investment in foreign operation	1,260	2,210
Investment property	150	280
Financial assets	600	550
Deferred tax asset	120	37
Current assets		
Inventories	3,249	2,510
Trade receivables	710	825
Other current assets	219	117
Cash and cash equivalents	6,192	4,219
Current tax asset	300	–
Total Assets	14,200	12,998
Equity and Liabilities		
Equity		
Share capital	8,400	7,000
Retained earnings	2,559	1,147
Other components of equity	450	627
Non-current liabilities		
Deferred tax liabilities	305	455
Current liabilities		
10% Redeemable preference shares	–	983
5% Convertible bonds	–	937
Deferred revenue	1,000	–
Trade payables	348	207
Current tax liability	1,138	1,642
Total Equity and Liabilities	14,200	12,998

Statement of Changes in Equity for the period ended 31 December 20x3

Particulars	Share capital	Retained earnings	Other Components of Equity						
			Revaluation surplus		Exchange difference	Financial assets	Share based payment	Convertible bonds	Total
			Foreign operation	Land and building					
Opening balance	7,000	1,147	270	105	156	40	23	33	627
5% Convertible bonds	1,000								
Share based payment	400								
Created through –									
P/L		1,208					97		97
OCI			90		96	20			206
Transferred to –									
P/L					(126)				(126)
RE		354	(180)	(21)			(120)	(33)	(354)
Dividends		(150)							
Closing balance	8,400	2,559	180	84	126	60	–	–	450

Statement of Comprehensive Income for the year ended 31 December 20x3

Revenue		6,000
Cost of sales		(3,000)
Gross Profit		3,000
Other income		70
Administrative expenses		(220)
Distribution expenses		(115)
Other expenses		(1,177)
Accounting Profit		1,558
Tax expense –		
Current tax expense	1,138	
Deferred tax expense	8	
Current tax income	(300)	
Deferred tax income	(119)	
Deferred tax liability	(287)	
Deferred tax asset	36	(476)
Profit for the Period (before reclassification adjustment)		1,082
Exchange difference reclassified		126
Profit for the Period (after reclassification adjustment)		1,208
Other Comprehensive Income		
Items not to be reclassified		
Revaluation surplus on foreign operation	150	
Deferred tax liability @ 40%	(60)	90
Unrealised gain from financial assets	25	
Deferred tax liability @ 20%	(5)	20
Item may be reclassified		
Exchange difference on foreign operation	160	
Deferred tax liability @ 40%	(64)	96
Exchange difference reclassified		(126)
Total Comprehensive Income		1,288

Statement of Cash Flow for the year ended 31 December 20x3

Cash Flows from Operating Activities		
Accounting profit		1,558
Other income –		
Dividends received	50	
Fair value increase of investment property	20	(70)
		1,488
Adjustments –		
Other expenses :		
Share based payment	97	
Interest and amortisation of convertible bonds	113	
Interest and amortisation of preference shares	117	
Depreciation on land and building	150	
Depreciation and impairment on plant and machinery	700	1,177
		2,665
Deferred revenue		1,000
		3,665
Increase in inventories		(739)
Decrease in trade receivables		115
Increase in other current assets		(102)
Increase in trade payables		141
Cash generated from operations		3,080
Current tax paid		(1,642)
Net Cash Flows from Operating Activities (A)		1,438
Cash Flows from Investing Activities		
Dividends received		50
Sale of foreign operation		1,260
Sale of investment property		150
Purchase of financial assets		(25)
Net Cash Flows from Investing Activities (B)		1,435
Cash Flows from Financing Activities		
Proceeds from share based payment		400
Redemption of 10% preference shares		(1,000)
Dividends paid		(150)
Interest on 10% preference shares		(100)
Interest on 5% convertible bonds		(50)
Net Cash Flows from Financing Activities (C)		(900)
Net increase in cash and cash equivalents (A + B + C)		1,973
Cash and cash equivalents at 1 January, 20x3		4,219
Cash and cash equivalents at 31 December 20x3		6,192

Workings : **(1) Deferred Tax Liability**

Particulars	Foreign operation	Land and building	Exchange difference	Financial assets	Investment property	Redeemable preference shares	Convertible bonds	Total
Opening balance	180	45	104	10	92	5	19	455
Created through —								
P/L					8			8
OCI	60		64	5				129
Reversed through —								
P/L	(120)	(9)	(84)		(50)	(5)	(19)	(287)
Closing balance	120	36	84	15	50	–	–	305

(2) Deferred Tax Asset

Particulars	Plant and machinery	Share based payment	Total
Opening balance	30	7	37
Created	90	29	119
Reversed		(36)	(36)
Closing balance	120	–	120

(5) Current Tax

Revenue		6,000
Cost of sales		(3,000)
Deferred revenue		1,000
Administrative expenses		(220)
Distribution expenses		(115)
Share based payment		(120)
Depreciation on – land and building		(150)
plant and machinery		(400)
Interest on convertible bonds		(50)
Depreciation written back on investment property		100
Total		3,045
Tax @ 30% on 3,045		914
Tax @ 40% on sale of –		
foreign operation	204	
investment property	20	224
Current tax expense		1,138

Events After the Reporting Period (Ind AS 10)

Introduction

Events after the reporting period are those events, favourable (the events that will lead to the inflow of economic benefits, which could be in the form of more profits, revenue or assets for the entity) and unfavourable (the event that will lead to a loss), that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue.

Normally, there is a time gap between the end of a reporting period and the date when the financial statements are published in order to enable the users to interpret the same. During this time gap, an entity continues with its activities. It may so happen that a significant event occurs which needs to be a part of the complete set of financial statements awaiting to be authorised by the board of directors for issue. The significant event might be in the form of an adjustment or a disclosure in the notes to financial statements.

Example 1

For copyright infringement, ABC Ltd was awarded damages by the court, after it sued XYZ Ltd. The event ensures the inflow of economic benefits to the entity in the form of compensation for damages that it had suffered. Therefore, the event is a favourable one for ABC Ltd.

Example 2

ABC Ltd had sold its finished goods to XYZ Ltd for an amount of 10, which XYZ Ltd used as a raw material. After the reporting period, it is found that ABC Ltd would not be able to get the entire amount owing, as XYZ Ltd becomes bankrupt. This event is an unfavourable one since it requires ABC Ltd to make a full provision of the amount owing from XYZ Ltd.

Events occurring after the reporting period may provide additional information about events that occurred before and up to the end of the reporting period. These events might not affect the figures reported in the financial statements but may warrant disclosures. Therefore, when financial statements are prepared, one needs to consider events that occur after the reporting period until a certain cut-off date, which is the date of board authorisation for the issue of the financial statements.

The cut-off date is the end of the post reporting period. Establishing this date is necessary to comply with the standard. The process involved in authorising the financial statements for issue will vary depending upon the following –

- Management structure;
- Statutory requirements; and
- Procedures followed in preparing and finanlising the financial statements.

When an entity is obliged to submit its financial statements to its shareholders for approval after they are issued, the financial statements are considered authorised for release on the date of issuance and not the date when shareholders will give their approval.

Example 3

The financial statements of an entity were prepared for the reporting period ended 31 December 2011 on 15 March 2012. The draft financial statements were considered at the meeting of the board of directors held on 25 March 2012, on which date the board approved them and authorised for issuance. The Annual General Meeting was held on 12 April 2012 where the shareholders approved the financial statements. These were filed by the company with the Statutory Board on 15 April 2012. Here, the approval date is 25 March 2012 when the board approved them for issue. Thus, all post reporting period events between 1 January 2012 and 25 March 2012 need to be considered for evaluating whether they are to be accounted or reported under Ind AS 10.

Sometimes, the management of an entity is required to issue its financial statements for approval to a supervisory board made up generally of representatives of shareholders, workers' representatives and other stakeholders. In such cases, the financial statements are authorised for issue when the management authorises them for issue to the supervisory board.

Example 4

The management of XYZ Ltd issued the draft financial statements to the supervisory board on 20 March 2012. The supervisory board approved them on 22 March 2012. Thereafter, the shareholders approved them in the Annual General Meeting held on 15 April 2012. The approved financial statements were filed with the Statutory Board on 25 April 2012. In this case, the date of approval is 20 March 2012.

Events after the reporting period include all the events up to date when the financial statements are authorised for issue, even if those events occur after the public announcement of profit or of other selected financial information.

Recognition and Measurement

The nature and circumstances of all post reporting events should be material so that users of the financial statements are made aware of them. This Standard divides the events after the reporting period into two categories namely adjusting events and non-adjusting events after the reporting period.

Adjusting events after the reporting period

Adjusting events after the reporting period are those events that provide evidence of conditions that existed at the end of the reporting period. In order to reflect adjusting events after the reporting period, an entity shall adjust the amounts already recognised in its financial statements, or is required to recognise items that were not previously recognised:

- The settlement after the reporting period of a court case that confirms that an entity had a present obligation at the end of the reporting period. The entity either –
  - adjusts any previously recognised provision related to this court case in accordance with Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets; or
  - recognises a new provision.

The entity shall not merely disclose a contingent liability because the settlement provides additional evidence in the form of 'opinion of experts' as described in Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets.

Example 5

A customer had filed a suit against an entity in the year 2010 and a corresponding contingent liability was disclosed. The entity prepared the financial statements for the period ended on 31 March 2012. In April 2012, the court case settled resulting in an obligation for the entity. The financial statements were authorised for issue on 25 May 2012. Though the court case was filed by the customer in 2010, the company had not recorded any liability then because it was not certain about the result. This is an adjusting event after the reporting date and, therefore, a new provision as per Ind AS 37 is to be recognised.

- The receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted.

Example 6

The bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period on a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable.

An entity prepared its financial statements for the reporting period ended March 31 2012. In May 2012, the company received a liquidator's notice indicating that the amount of 10 due from a customer would be irrecoverable. The financial statements were authorised for issue on 30 June 2012. The fact is that the irrecoverable debt was in existence at the reporting period, but the problem of its collection was not yet known to the company. The receipt of the notice represents an event after the reporting period and it provides additional information to the company on the status of the debt at the reporting date. This is an adjusting event and the company has to make full provision for the amount outstanding to reflect the most up-to-date status of the debt in the financial statements.

Example 7

The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.

An entity carries its inventory at the lower of cost and net realisable value. At 31 December 2011 the cost of inventory, determined under FIFO method, as reported in its financial statements for the period then ended, was 20. Due to recession in the market, the inventory could not be sold during January 2012. The company entered into an agreement to sell the entire inventory for 14. The financial statements were authorised for issuance on 15 February 2012. This is an adjusting event. The entity should recognise a write-down of 6 in financial statements for the reporting period ended 31 December 2011.

- The determination after the reporting period of the costs of the assets purchased, or the proceeds from assets sold, before the end of the reporting period.

Example 8

An entity closes its books of account on 31 December 2011. The entity had agreed to sell an asset to another entity on 20 December 2011. The price of the asset was, however, determined on 15 January 2012, ie, after the reporting date. The financial statements were authorised for issue on 15 February 2012. Therefore, the determination of the price is an adjusting event and need to be taken into account in the financial statements.

- The discovery of fraud or errors that show that the financial statements are incorrect.

Non-adjusting events after the reporting period

Non -adjusting events after the reporting period are those events that are indicator of conditions that arose after the reporting period. In order to reflect the non-adjusting events after the reporting period, an entity shall not adjust the amounts recognised in the financial statements. Instead, it shall provide specific disclosures considering the materiality of the event that has occurred.

Example 9

An entity has investments worth 10 that is recognised in Balance Sheet. Between the end of the reporting period and the date when the financial statements are authorised for issue, there was a decline in the market value of the investments. The decline does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently. Therefore, the entity does not adjust the amounts recognised in its financial statements for the investments, rather gives additional disclosures if the information is material enough.

Example 10

The reporting period of an entity ends on 30 June 2012. The financial statements were authorised for issue on 15 October 2012. In September 2012, the company was sued by a customer who claimed that the goods supplied in February 2012 were sub-standard. Based on the advice of the company's legal counsel, it was quite likely that the customer would receive compensation from the entity. This is a non-adjusting event. The entity should disclose the event in the notes to the financial statements.

Example 11

The destruction of inventory by fire, after the end of the reporting period but before the date of authorisation for issue, would be a non-adjusting event. It would not justify writing down that inventory to a nil net present value in the financial statements being prepared, since it reflects circumstances that occurred in the following period.

Dividends

If an entity declares dividends to holders of equity instruments after the reporting period but before the financial statements are authorised for issue, the entity shall not recognise those dividends as a liability at the end of the reporting period. It is because, they do not meet the criteria of a present obligation as per Ind AS 37. In addition, an entity's past practice of paying dividends cannot be considered a constructive obligation as such practices do not give rise to a liability to pay dividends. Therefore, the very concept of proposed dividend will now disappear from the financial statements. Such dividends are disclosed in the notes in accordance with Ind AS 1 Presentation of Financial Statements.

Going Concern

The going concern is the assumption that the entity has neither the intention, nor the need to liquidate, or curtail materially the scale of its operation. An entity shall not prepare its financial statements on a going concern basis if the management determines after the reporting period either that it intends to liquidate the entity, cease trading or it has no realistic alternative but to do so.

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern is inappropriate, the effect is so pervasive that this standard requires an entity to make a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.

As per Ind AS 1 Presentation of Financial Statements, specific disclosures are required if –

- the financial statements are not prepared on a going concern basis; or
- management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The events or conditions requiring disclosures may arise after the reporting period.

Example 12

An entity is preparing its financial statements for the year ended 31 March 2012. In April 2012, a major earthquake occurred and the whole plant of the entity was destroyed. A natural disaster of this kind is not covered by insurance policy taken out by the entity. To restart the business, the entity failed to raise adequate capital and, therefore, decided to close down the whole operation. Therefore, the financial statements to March 2012 should be prepared on a liquidation basis, not on a going concern basis.

Disclosure

Date of Approval for Issue

An entity shall disclose the date when the financial statements were authorised for issue and who gave that authorisation. If the entity's owners or others have the power to amend the financial statements after issue, the entity shall disclose that fact. It is important for users to know at which point in time the financial statements were authorised for issue, since the financial statements do not reflect events after this date.

Example 13

Notes to the financial statements of ABC Ltd will include the following :

The financial statements for the year ended as on 31 March 2012, have been approved for issue with a resolution by the Board of Directors on 15 April 2012.

Updating disclosure about conditions at the end of the reporting period

If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information. An entity shall update the disclosures, irrespective of any adjustments made to the amounts that are recognised in its financial statements.

Example 14

An entity has a contingent liability in its financial statements on 31 March 2012. An evidence is available relating to this contingent liability after the reporting period and before the approval of the financial statements. In addition to considering whether the entity should recognise a provision as per Ind AS 37, the entity should update its disclosures about the contingent liability in the light of that evidence.

Non-adjusting events after the reporting period

If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after reporting period –

- The nature of the event; and
- An estimate of its financial effect, or a statement that such an estimate cannot be made.

Example 15

ABC Ltd closed its financial statements on 31 December 2011. On 1 January 2012, an office building with a net book value of 100 was severely damaged by earthquake. It is expected that the insurance company will compensate for the claim but still the proceed will fall short by 50. The company needs to give disclosure regarding this non-adjusting event specifying its nature as well as an estimate of the financial effect.

Example 16

ABC Ltd is having negotiations with the government for the expropriation of a plot of land by the latter on which a part of the factory is situated. The financial effect of this has to be disclosed in the notes. If an estimate of its financial effect cannot be made, disclosure should be made through a statement.

The following are examples of non-adjusting events after reporting period that would generally result in disclosure –

- A major business combination or disposing of a major subsidiary after the end of the reporting period and before the authorisation date.

Example 17

ABC Ltd closes its financial statements on 31 December 2011. On 17 January 2012, the company announced its intension to acquire XYZ Ltd for a consideration of 100. The transaction is yet to be approved by ABC Ltd's shareholders. The acquisition is expected to be completed by the end of September 2012. This is a non-adjusting event which needs to be disclosed.

- Announcing a plan to discontinue an operation;
- Major purchases of assets, classification of assets as held for sale in accordance with Ind AS 105, other disposals of assets, or expropriation of major assets by governments;
- The destruction of major production plant by a fire after the reporting period;
- Announcing, or commencing the implementation of, a major restructuring as per Ind AS 37;
- Major ordinary share transactions and potential ordinary share transactions after the reporting period;
- Abnormally large changes after the reporting period in asset prices or foreign exchange rates;
- Changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities as per Ind AS 12 Income Taxes;

Example 18

For ABC Ltd, the income tax rate is 30%. A new income tax rate of 35% is enacted after the reporting period but before the date the financial statements were authorised for issue. If the effect of the new tax rate has material effect on deferred tax liabilities and deferred tax assets, the company shall disclose details of the changes in the income tax rate and its related effect on the company.

- Entering into significant commitments or contingent liabilities, eg, by issuing significant guarantees; and
- Commencing major litigation arising solely out of events that occurred after the reporting period.

Inventories (Ind AS 2)

Introduction

Inventories are assets:

- held for sale in the ordinary course of business
- in the–
  - process of production for such sale; or
  - form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventories encompass goods purchased and held for resale including, eg, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. Costs incurred to fulfill a contract with a customer that do not give rise to inventories (or assets in the scope of another standard) are accounted for in accordance with Revenue from Contracts with Customers.

This standard distinguishes between net realisable value and fair value.

- Net realisable value

  It is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Therefore, it is the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business.

- Fair value

  It is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. It reflects the amount for which the same inventory could be exchanged between knowledgable and willing buyers and sellers in the market place.

The point to note is that where the net realisable value is an entity-specific value, fair value is not.

Net realisable value for inventories may not be equal to fair value less costs to sell.

Example 1

At the end of the reporting period an entity has 5,000 quintals of inventory. The company has to sell 70% of the inventory to the Government at 125 per quintal and the remaining 30% can be sold in the market (estimated price 250 per quintal). The cost of the inventory is 150 perquintal.

Per Quintal Valuation

For inventory to be sold :	to government	in the open market
Cost	150	150
Net realisable value	125	250
Value of inventory (lower of the above)	125	150

Net realisable value is the amount that can be obtained by the entity from sale of inventory. For 70% of the inventories to be sold to the government,net realisable value is 125 per quintal. For the rest 30% to be sold in the market, the net realisable value is the amount that a buyer would normally be ready to give in an arm's length transaction, ie, 250 per quintal. The fair value of the inventory is the amount that the entity will fetch in the open market for 250 per quintal. Therefore, for the 70% net realisable value is not equal to its fair value whereas, for the rest 30% both values are the same.

Measurement

Inventories shall be measured at lower of cost and net realisable value. Inventories are usually written down to net realisable value, item by item or in groups of similar items where it is not practical to evaluate separate items.

Cost of inventories

Cost of inventories will include all the direct costs incurred for acquisition, conversion and bringing the same to their present location and condition.

Costs of Purchase

Costs of purchase include costs directly attributable to the acquisition of finished goods, materials and services which comprise purchase price, import duties and other taxes, transportation costs, handling and other costs. In case of taxes which are subsequently recoverable by the entity from the taxing authorities are not included in the cost of inventories. Trade discounts, rebates and other similar terms need to be deducted in determining cost of purchase.

Example 2

An entity purchases 1,000 units of inventories @ 5 per unit. The amount of commission and transportation charges are 100 and 300 respectively. The entity estimates a normal loss of 10%. The computation of cost per unit of inventory is as follows:

Total cost of inventory

Particulars	Amount
Purchases (1,000 x 5)	5,000
Commission	100
Transportation charges	300
Total Cost	5,400

Per unit cost of inventory

Total units purchased are 1,000. Normal loss is calculated at 100 units (10% on 1,000). Total number of units are 900 (1,000 – 100). Therefore, the cost per unit of inventory is 6 (5,400÷900).

Costs of conversion

Costs of conversion includes direct costs related to the production process and a systematic allocation of fixed and variable overheads that are incurred in converting materials to finished goods. Variable production overheads include indirect materials and indirect labour that vary directly, or nearly directly, with the volume of production. Fixed production overheads include indirect costs that remain relatively constant regardless of the volume of production, eg, depreciation, maintenance of factory buildings and equipment, cost of factory management, etc.

Allocation of fixed production overheads to the costs of conversion is based on the normal capacity of production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account loss of capacity resulting from planned maintenance. Unallocated fixed overheads should be recognised as expenses in the period in which they are incurred. In case of production beyond the normal capacity, the fixed overhead per unit of production is reduced to avoid measuring inventories above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Example 3

An entity pays a monthly rent of 5,000. The optimum monthly production is 1,000 units. During May 2012, the production was 960 units only. In June, the entity produced 1,150 units.

Fixed production overhead per unit is 5 (5,000 ÷1,000). In May, fixed production overhead per unit is 5.0283 (5,000÷960). However, this Standard stipulates an increase in the amount of fixed overhead allocated to each unit of production as a consequence of low production. In stead, the unallocated amount of fixed production overhead of 200 [5x(1,000–960)] shall be recognised as an expense in Statement of Profit and Loss. Therefore, the cost of inventories does not include the above amount of unallocated overheads.

In June, the number of units produced is more by 150 units (1,150–1,000) than the normal capacity. In this case, the fixed overhead allocated per unit would be reduced to 4.3478 (5,000÷1,150) in order to ensure that measurement of inventories do not exceed its cost.

The following two examples will help understand the several aspects of cost determination during the conversion stage. Example 4 uses the FIFO cost formula and normal loss is a percentage on number of units introduced. Example 5 uses Weighted Average cost formula and normal loss is a percentage on number of units produced.

Example 4

ABC Ltd provides the following information regarding the production in September 2012.

During the month, 2,000 units were introduced into process1 at a cost of 60,000. The normal loss was estimated at 5% of the units introduced which are expected to fetch 25 per unit, based on past experience. A total of 1,400 units were produced and transferred to the next process. 460 units were partially complete and 140 units were scrapped. It was estimated that in respect of the various factors of production, the partially complete units had reached the following stages of production–

Materials – 100%; Labour and Overheads – 50% Additional cost incurred during the month –

Indirect materials – 17,000; Labour – 33,400; Variable overheads – 16,700

The units scrapped realised 40 per unit. The normal operating capacity is 2,000 units and fixed overhead relating to these is 4,000. There was no opening WIP (work in progress) for this process.

Statement of Equivalent Units

Particulars	Total Units	Materials				Labour		Overhead	
		1		2					
		Completion	Units	Completion	Units	Completion	Units	Completion	Units
Opening WIP	0								
Normal loss	100								
Abnormal loss	40	100%	40	100%	40	50%	20	50%	20
Finishedunits	1,400	100%	1,400	100%	1,400	100%	1,400	100%	1,400
Closing WIP	460	100%	460	100%	460	50%	230	50%	230
Total	2,000		1,900		1,900		1,650		1,650

Normal loss is 100 units (5% on 2,000). The units which were partially complete form the closing WIP.

*Abnormal loss is the number of units lost over and above normal loss. Units scrapped were 140, out of which 100 units were estimated. Therefore, abnormal loss is 40 (140 – 100) units.

For computation of equivalent units, first the respective percentage of completion have been multiplied by the total units dedicated to losses, finished units, opening and closing WIP and then the units are summed up.

Cost per Unit

Particulars	Total cost		Cost per unit
Material 1	60,000		
Less: Scrap (100 X 25)	(2,500)	57,500	30.26
Material 2		17,000	8.95
Labour		33,400	20.24
Overhead		*20,000	12.12
Total		127,900	71.57

*****The amount of overhead is 20,000 which is the summation of variable overhead of 16,700 and fixed overhead of 3,300 [(4,000÷2,000)×1,650]. The normal capacity is 2,000 units whereas, the equivalent units for overhead are 1,650 which means that the entity has produced below normal capacity by 350 units (2,000–1,650). An amount of 700 [(4,000÷2,000)×350)] of fixed overheads which are unallocated would be charged to Statement of Profit and Loss.

Process

Particulars	Dr	Cr	Balance
Material 1	60,000		60,000
Material 2	17,000		77,000
Labour	33,400		110,400
Overhead	20,000		130,400
Normal loss		2,500	127,900
Finished goods		100,198*	27,702
Abnormal loss		2,863**	24,839

*The cost of finished goods is 100,198 (1,400 ×71.57).

**The cost of abnormal loss units is 2,863 (40 ×71.57).

Abnormal Loss

Particulars	Dr	Cr	Balance
Process account	2,863		2,863
Scrap sold		1,600	1,263*

*The entity incurs a loss by selling the abnormal loss units since their cost of 2,863 exceeds the amount received by selling those at 1,600 (40×40).

Example 5

ABC Ltd provides the following details relating to process 2 for the month of March 2012 :

Opening stock was of 60 units (Material 1 – 700, Material 2 – 800, Labour – 1,000 and Overhead – 1,200).

Transfer from Process 1 – 1,100 units at 5,500. Transfer to Process3 – 820units

Additions made to Process 2 –

Direct material – 2,410; Labour – 7,155; Overhead – 9,450.

120 units were scrapped, but the normal loss was estimated at 15% on production.

Units scrapped realised – 1 per unit; Normal capacity – 900 units; Fixed Overhead – 1,500; Closing WIP – 160 units

Degree of completion

Particulars	Material	Labour and overhead
Opening stock	80%	60%
Scrapped units	100%	70%
Closing stock	70%	60%

Statement of Equivalent Units

Particulars	Total Units	Materials				Labour		Overhead	
		1		2					
		Completion	Units	Completion	Units	Completion	Units	Completion	Units
Opening WIP	60	100%	60	80%	48	60%	36	60%	36
Normal loss	150								
Abnormal gain*	(30)	100%	(30)	100%	(30)	70%	(21)	70%	(21)
Finishedunits	820	100%	820	100%	820	100%	820	100%	820
Closing WIP	160	100%	160	70%	112	60%	96	60%	96
Total	1,160		1,010		950		931		931

Normal loss is 150 units (15% on 1,000), which is calculated on the number of units produced, ie, 1,000 units (60+1, 100–160). The units which were partially complete form the closing WIP.

*Abnormal gain is the difference between the number of units anticipated to be lost and the units actually scrapped at the end of the process. Total units scrapped were 120, whereas 150 units were estimated from before. Therefore, number of units of abnormal gain is 30 (150–120).

For computation of equivalent units, first the respective percentage of completion have been multiplied by the total units dedicated to losses, finished units, opening and closing WIP and then the units are summed up. The percentage of completion for material 1 in process 2 is 100%.

Cost per Unit

Particulars	Total cost		Cost per unit
Material 1	6,200		
Material 1 (5,500 + 700)	(150)	6,050	5.99
Less: Scrap (150 X 1)		3,210	3.38
Material 2 (2,410 + 800)		8,155	8.76
Labour (7,155 + 1,000)		12,150*	13.05
Overhead (9,450 + 1,200 + 1,500)			
Total		29,565	31.18

*****The amount of overhead is 12,150 which is the summation of variable overhead of 9,450 and 1,200 (opening WIP) and fixed overhead of 1,500. The production is higher than the normal capacity which requires the entity to reduce the per unit allocation of fixed overhead from 1.67 (1,500÷900) to 1.61 (1,500÷931).

Process

Particulars	Dr	Cr	Balance
Opening WIP	3,700		3,700
Material 1	5,500		9,200
Material 2	2,410		11,610
Labour	7,155		18,765
Overhead	10,950		29,715
Normal loss		150	29,565
Finished goods		27,438*	2,127
Abnormal gain	935**		3,062

*The cost of finished goods is 27,438 [(820 + 60) ×31.18].

**The cost of abnormal gain units is 935 (30 ×31.18).

Abnormal Gain

Particulars	Dr	Cr	Balance
Process account		935	935
Loss of profit on sale of scrapped units (30 ×1)]	30		905*

*There is a net saving of 905 after adjusting the loss from sale of scrapped units.

Often more than one product is produced simultaneously, either joint products or a main product and by-product(s). Allocation of costs of conversion should be made separately, if separate identification is possible, otherwise a rational and consistent basis should be used. The allocation may be based, eg, on the relative sales value of each product either at a stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Example 6

This is in continuation to Example 5 with the following additional information. The production process has given rise to 4 products A, B, C and D

Products	A	B	C	D
Units (Nos.)	396	264	176	44
Additional cost after further processing	8,000	7,500	9,000	10,500
Sale Value after processing	112	75	50	95
Sale Value at the split-off point	22.5	12	23	20
Percentage of composition (finished units)	45%	30%	20%	5%

Total number of units produced after process 2 is 880 units (820 + 60). The joint cost is 85,000.

Profitability after Further Processing

Product	Sale value after further processing	Share of joint cost	Additional processing cost after split-off point	Total cost	Profit / (Loss)
A	44,352	44,534	8,000	52,534	(8,182)
B	19,800	15,834	7,500	23,334	(3,534)
C	8,800	20,233	9,000	29,233	(20,433)
D	4,180	4,398	10,500	14,898	(10,718)
Total	77,132	85,000		120,000	(42,868)

Profitability at Spilt-off Point

Product	Sale value at split-off point	Share of joint cost	Profit/(Loss) at split-off point
A	8,910	44,534	(35,624)
B	3,168	15,834	(12,666)
C	4,048	20,233	(16,185)
D	880	4,398	(3,518)
Total	17,006	85,000	(67,994)

Decision regarding further processing

Product	Profit/(Loss) after further processing	Profit/(Loss) at split-off point	Further processing
A	(8,182)	(35,624)	Yes
B	(3,534)	(12,666)	Yes
C	(20,433)	(16,185)	No
D	(10,718)	(3,518)	No

Other costs

Other costs include costs incurred in bringing the inventories to the required location and condition. It may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories. Some costs are expensed off rather than being included in the cost of inventories. Examples of such costs are abnormal loss; storage; administrative overheads; selling; and borrowing.

Storage costs would be included in the cost of inventories, only if this expenditure is required in the production process before another production stage. Administrative overheads would become a part of the inventory cost if it is incurred for bringing the inventories to their present location and condition. Borrowing costs are generally charged as an expense but can be a part of cost of inventories in limited circumstances as mentioned in IndAS 23 Borrowing Costs. As per the definition of a qualifying asset, cheese, wine etc. take a substantial period of

time to be ready for sale, but then again treatment of borrowing costs related to these are guided by Ind AS 41 Agriculture. But in the case of customised products borrowing costs may be capitalised.

Example 7

An entity got an assignment to construct a ship which would take an estimated time period of 3 years. For the construction of this ship, the entity arranges a loan of 100 at 10% p.a. The borrowing cost amounting to 10 per year would be capitalised because, in this case, the borrowing cost can be easily related to the inventory and can be monitored along the period of 3 years till it is sold.

Interest expense

Purchase of inventories might be on deferred settlement terms. In that case, the presence of a financing element should be disclosed and recognised as 'interest expense' in the face of Statement of Profit or Loss. The amount related to interest expense would be the difference between the purchase price for the normal credit terms and the amount paid.

Example 8

An entity purchases inventories always at 6 months' credit. The price is generally 10% higher than the amount, it purchase for cash. The additional price paid is to be treated as interest costs.

During 2012, it purchased inventories at 500 in stead of 475 as it had to pay interest for the credit period of 6 months. This interest expense can not be included in the cost of inventories as this is a financing element. It would be recognised in Statement of Profit or Loss.

Techniques for the measurement of cost

Various techniques of measurement of cost may be used for convenience such as standard cost method or retail method, provided that the results approximate actual cost. Standard cost method considers normal levels of materials and supplies, labour, efficiency, and capacity utilisation subject to regular revision.

The retail industry generally uses the retail method for measuring inventories, since there are huge rapidly changing items with similar margins for which other costing methods are impracticable to use. The cost of inventories is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The retail method of inventory valuation used by retail stores in which inventory is taken at retail price and then reduced to cost price by the use of margin percentage.

Example 9

The closing inventory of ABC Ltd includes inventory purchased at 90,000 of different grades, which were sorted out with their selling rate as under (all grades yield the same rate of profit):

Grade	Units	Sellingprice
X	5,000	12
Y	3,000	10
Z	2,000	5

Cost per unit

Grade	Units	Total selling price	Profit	Cost	Cost per unit
X	5,000	60,000	6,000	54,000	10.80
Y	3,000	30,000	3,000	27,000	9.00
Z	2,000	10,000	1,000	9,000	4.50
Total		100,000			
Less : cost of purchase		90,000			
Profit		10,000			

The percentage of profit on sales is 10% (10,000÷100,000×100). Therefore, for each grade, profit is calculated at 10% on its total selling price. The total cost for each grade is determined by deducting the profit from their individual total selling price, which when divided by the number of units gives per unit cost.

Cost Formulas

There are three different cost formulas that can be used depending upon the nature of inventories: Specific Identification; First In First Out; and Weighted Average.

For items that are not ordinarily interchangeable in nature, and goods or services produced and segregated for specific projects, regardless of whether they have been bought or produced, Specific Identification method should be used. However, this cost formula is inappropriate for large number of ordinarily interchangeable inventories. In that case, two other cost formulas can be used, first-in first-out or weighted average method. Whichever formula an entity chooses, the same has to be used for inventories of a similar nature and use to the entity. For example, merely a difference in geographical location does not justify the use of a separate cost formula.

Specific identification is a method which requires an entity to identify each unit of inventory with the unit cost and retain the identification until the inventory is sold. This method provides satisfactorily cost data for the closing inventory and cost of sales. It can be adopted only when the sales of inventory can be identified with specific purchase transactions. For example, this method is used for special purpose items like electric motors purchased for large pumps and compressors.

Example 10

An entity is involved in the following transactions:

Date	Rate	Opening inventory	Purchases	Issues
January 2012				
1	1.00	1,000		
7	1.50		6,000	
17				2,000
24	2.00		3,500	
31				500

We assume that the business keeps careful records of each unit in its inventory. It is ascertained that 2,000 units issued to production on 17 January are taken from the purchase of 6,000 units on 7 January and 500 units taken from the opening stock of 1,000 units as on 1 January.

Cost of Production

Units	Rate	Amount
2,000	1.50	3,000
500	1.00	500
		3,500

Cost of Closing Inventory

Units	Rate	Amount
500	1.00	500
4,000	1.50	6,000
3,500	2.00	7,000
8,000		13,500

The cost of inventories other than those that are dealt using special identification of their individual costs shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may bejustified.

Example 11

Inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

The **FIFO** formula assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.

Under the **Weighted Average Cost** formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period.

Net Realisable Value (NRV)

If the inventories are damaged or obsolete (partially or wholly) or their selling prices have declined, the amount realisable may be less than the amount recognised as cost. Sometimes, it may so happen that the estimated costs of completion or the selling costs have increased. These circumstances call for a write down of the inventories below cost to the NRV as assets these should not be carried in excess of what they are expected to realise from their sale or use.

Example 12

At the end of reporting period on 31 March 2016 an entity realised that the closing inventory (purchased at 5 per unit) is not that it would choose to acquire at the market place. An equivalent product is available for 4 per unit. The closing inventory, in its present physical form, can be sold at 2.25 per unit. If the entity wants to replace the existing inventory by the new equivalent product, it has to pay an additional amount of 1.50 per unit. The entity has the following two options–

- Sell the stock at 2.25 per unit and reacquire the stock at 4 per unit. In this case, it has to incur an additional cost of 1.75 (4–2.25) per unit; or
- Replace the stock by paying at 1.50 per unit.

Obviously, the 2nd option is cheaper. Therefore, the value of inventory is 2.50 (4 – 1.50) per unit.

Write down of inventories shall be done item by item. Wherever possible, it can be done in groups if the items are similar in nature or related to each other. Any amount of –

- write down shall be charged as an expense in the period of such write down.
- reversal of previous write down shall be adjusted with the cost of sales.

Example 13

An entity has items of inventory which relate to the same product line. They have similar end uses which are produced and marketed in the same geographical area, and can not be practicably evaluated separately from other items in that productline. In this case, it is appropriate for the entity to write inventories down after the items are grouped.

Net realisable value is purely an estimated figure which is based on the most reliable evidence available. While making these estimates, fluctuations of price or costs directly relating to events occurring at the end of the period to the extent that such events, confirm conditions existing at the end of the period are taken into consideration.

Example 14

ABC Ltd, a tea manufacturing company, had one batch of its inventory damaged after the end of the reporting period. The reason for the damage was faulty packing which was present in that inventory at the reporting date. The price of the inventory has to be reduced from 500 to 100 per kg after incurring an additional cost of 5 per kg. The inventory should be valued at 95 (100–5) per kg.

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

At each subsequent period, the net realisable value needs to be reassessed. When the circumstance that led to the write down of inventories no longer exist or when there is clear evidence that the changed economic circumstances lead to an increase in the net realisable value, the amount of write down is reversed but maximum to the extent of the original write down. This is done to ensure that the valuation of inventories is always at lower of cost or net realisable value. This is possible only when inventories are specifically identifiable. For example, when an item of inventory is carried at its net realisable value as a result of decline in its selling price, it is still on hand in a particular period and its selling price has gone up. The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period. This is an adjusting event as per Ind AS 10, which requires an entity to adjust the amount recognised as inventories in Balance Sheet to reflect adjusting events after the reporting period.

The amount of write down of inventories to net realisable value as well as all the losses of inventories is recognised as an expense in the period when the write down or loss occurs. The amount of reversal of a previous write down is recognised as a reduction in the amount of inventories recognised as an expense in the period in which such reversal takes place. As mentioned earlier, when inventories are sold, the carrying amount of inventories is recognised as an expense in the period in which its related revenue isrecognised.

Example 15

An entity manufactured a new premium segment car in 2011. It failed to grab a significant market share. At the end of the period, the price fell and the entity writes down the value of these cars as inventories at their net realizable value. In 2012, due to some changes in the design of the car, a rise in the net realisable value was estimated. In order to give effect to this rise in the net realisable value, the previous write down is being reversed.

Cars manufactured (Nos.)	15
Cost of manufacturing	1,200
Net realisable value at 31 December 2011	1,150
Cars unsold at 31 December 2011 (Nos.)	8
Estimated net realisable value in 2012	1,175
Cars unsold at 31 December 2012 (Nos.)	3

At 31 December 2011, the amount recognised as closing inventory was 9,200 (8 ×1,150). The amount of write down is 400 [8 ×(1,200 – 1,150)] which is the amount by which the cost is higher than its net realisable value.

At 31 December 2012, the amount of closing inventory recognised is 3,525 (1,175 ×3). These cars were manufactured in 2011. The net realisable value has increased to 1,175 for which the entity needs to recognise 75 [3X(1,175–1,150)] worth of reversal of the previous write down in Statement of Profit and Loss.

The purpose for which the inventory is held is also a valid consideration for computation of these estimates. For example, an entity might be into several contracts which it has to satisfy at the contract determined prices even if there is a fluctuation in the market selling prices. It might be a case that an entity may have fewer inventories than what is mentioned in the contract and it satisfies the contract by purchasing them from the market at general selling prices. This may lead to an onerous contract which is guided by Ind AS 37.

By the expression onerous contract, it means a contract where the benefits arising out of the contract is less than the costs of fulfilling the contract. The amount for which the provision is to be made is lower of the penalty to be paid for exiting the contract and the excess of costs over the benefits from the contract.

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. But in case the cost of materials goes down to an extent whereby costs exceed the net realisable value, the inventories are written down to their net realisable value. In these circumstances, the replacement cost of the materials is the best available measure of the net realisable value.

Example 16

The closing inventory of an entity includes an item which was purchased at wholesale price for 15 each, but the unit price has fallen to 12 each. In effect, the company has to reduce its retail selling price per unit from 18 to about 16. In this case, though the unit price has fallen to 12 from 15, the inventory will be valued at 15 because it will not exceed the revised selling price of16.

Some inventories may be allocated to other asset accounts, eg, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

Property, Plant and Equipment (Ind AS 16)

Introduction

Property, plant and equipment are tangible items that are –

- for use in the production or supply of goods or services, for rental to others, or for administrative purposes;and
- expected to be used during more than one reporting period.

The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if–

- it is probable that future economic benefits associated with the item will flow to the entity;and
- the cost of the item can be measured reliably.

  - Future economic benefits

  The future economic benefits embodied in an item of property, plant and equipment have the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.

  - Cost

  It is the amount of cash and cash equivalents paid or the value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Ind ASs, eg, Ind AS 102 Share-based payment.

Recognition

The unit of measure, ie, what constitutes an item of property, plant and equipment is a matter of judgement. The cost of an item of property, plant and equipment includes costs incurred initially to acquire or construct the item and costs incurred subsequently to add to, replace part of, or service it.

Measurement

After recognition as an asset, an item of property, plant and equipment –

- shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses;or
- whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

Example 1

An entity has 3 machines – A, B and C which make up an entire class of property, plant and equipment

Particulars	A	B	C	Total
Carrying amount after depreciation	20	25	30	75
Fair value at the measurement date	24	28	16	68

The entity decides to revalue A and B only. The following table shows a meaningful comparison among the carrying amounts derived thereon:

Analysis	A	B	C	Total
Carrying amount (after revaluation of A and B, not C)	24	28	30	82
Carrying amount (after revaluation of the entire class)	24	28	16	68

When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of revaluation is treated in one of the following ways –

- lrestated proportionately with the change in gross carrying amount; or

- eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset.

Example 2

Asset:		Share Capital	65
Grossblock	100	Revenue	50
Accumulated depreciation	20	Cost of sales	25
Fair value ofthe asset	100	Income tax rate	40%

Balance Sheet

Before Revaluation			After Revaluation			
			Restated proportionately*		Eliminated against gross carrying amount**	
Asset						
Gross block	100		125		100	
Accumulated depreciation	20	80	25	100	–	100
Equity and Liabilities						
Equity :						
Share capital	65		65		65	
Retained earnings	15		15		15	
Revaluation surplus	–		12		12	
Liabilities :						
Deferred tax liability	–	80	8	100	8	100

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Asset	25	Accumulated Depreciation	20
Accumulated Depreciation	5	Revaluation Surplus	12
Revaluation Surplus	12	Deferred Tax Liability	8
Deferred Tax Liability	8		

Statement of Profit and Loss and Other Comprehensive Income

Revenue	50
Cost of Sales	25
Accounting Profit	25
Tax expense (40%)	10
Profit for the period	15
Other comprehensive income	
Revaluation surplus (net of tax)	12
Total comprehensive income	27

Statement of Changes in Equity

Particulars	Share Capital	Retained Earnings	Revaluation Surplus
Opening balance	65	–	–
Created	–	15	12
Closing balance	65	15	12

If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

A revaluation –

affects	does not affect
● accounting profit; and	● taxable profit; and
● carrying amount of the asset	● tax base of the asset

Therefore, when an asset is revalued, the carrying amount is adjusted but there is no effect on the tax base. Hence, a deferred tax liability arises.

When an asset is revalued and there is a revaluation increase, the following adjustments are to be made–

- The carrying amount of the asset increases.
- Revaluation surplus is created by that amount but net of income taxes which is accumulated inequity.
- A deferred tax liability is created due to revaluation surplus in Other Comprehensive Income.
- Due to an increase in the carrying amount of the asset, the depreciation charge increases.
- Income tax expense reduces as a result of increased depreciation.
- If a part of the revaluation surplus is transferred to retained earnings (not through profit or loss) during the usage of the asset, the amount is the difference between the depreciation based on cost and depreciation based on revalued amount, net of any related income tax in Statement of Changes in Equity.

Depreciation

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

❍ Depreciable amount

It is the cost of an asset, or other amount substituted for cost, less its residual value.

❍ Usefullife

It is the –

- periodoverwhichanassetisexpectedtobeavailableforusebyanentity;or
- number of production or similar units expected to be obtained from the asset by an entity.

Therefore, the useful life of an asset may be shorter than its economic life.

❍ Residualvalue

It is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

Thedepreciationchargeforeachperiodshall berecognisedinprofitorlossunlessitisincluded in the carrying amount of another asset, eg, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories.

The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

Depreciation –

- is charged when fair value > carrying amount (as long as residual value is less than carryingamount);
- is zero, when residual value >= carrying amount
- ceases, when the asset is unused/held for sale or included in a disposal group that is classified as held for sale.

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. Methods of charging depreciation include –

- Straight line Results in a constant charge over the asset's useful life provided the residual value does not change.
- Diminishing balance Results in a decreasing charge over the useful life of the asset
- Units of production Results in a variable charge based on the expected use or output.

Example 3

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Fair value 75 at the end of the year 2.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before depreciation	100	100	100	100	100
Depreciation	20	20	25	25	25
Accounting Profit	80	80	75	75	75
Tax expense –					
Current tax	30	30	30	30	40
Deferred tax expense / (liability)	2 32	2 32	– 30	– 30	(10) 30
Profit for the Period	48	48	45	45	45
Other comprehensive income					
Revaluation surplus (net of tax)		9			
Total comprehensive income	48	57	45	45	45

Statement of Changes in Equity

Year	2	3	4	5
Revaluation surplus				
Opening balance	–	9	6	3
Created	9	–	–	–
Transferred to retained earnings	–	(3)	(3)	(3)
Closing balance	9	6	3	–

Workings **Current Tax**

Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5
Openingbalance	–	2	10	10	10
Createdthrough –					
Profit and loss	2	2	–	–	–
Other comprehensive income	–	6	–	–	–
Reversed through profit or loss	–	–	–	–	(10)
Closing balance	2	10	10	10	–

Carrying Amount of the Asset

Restated proportionately					
Year	1	2 Revaluation increase	3	4	5
Gross block	100	100 → 125	125	125	125
Accumulated depreciation	20	40 → 50	75	100	125
Carrying Amount	80	60 → 75	50	25	–
Eliminated against gross carrying amount					
Year	1	2 Revaluation increase	3	4	5
Gross block	100	100 → 75	75	75	75
Accumulated depreciation	20	40 → –	25	50	75
Carrying Amount	80	60 → 75	50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 4

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%. Fair value 60 at the end of year 2.

Statement of Profit and Loss and Other ComprehensiveIncome

Year	1	2	3	4	5
Profit before depreciation	100	100	100	100	100
Depreciation	25	25	30	30	–
Accounting Profit	75	75	70	70	100
Tax expense –					
Current tax	32	32	32	32	32
Deferred tax (income) / asset	(2)	(2)	(2)	(2)	8
Deferred tax liability	– 30	– 30	(2) 28	(2) 28	– 40
Profit for the Period	45	45	42	42	60
Other comprehensive income					
Revaluation surplus (net of tax)		6			
Total comprehensive income	45	51	42	42	60

Statement of Changes in Equity

Year	2	3	4
Revaluation surplus			
Opening balance	–	6	3
Created	6	–	–
Transferred to retained earnings	–	(3)	(3)
Closing balance	6	3	–

Workings **Current Tax**

Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current tax @ 40%	32

Deferred Tax Asset / Liability

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	2	–	4	4	6	2	8	–
Created through –										
Profit and oss	2	–	2	–	2	–	2	–	–	–
Other comprehensive income	–	–	–	4	–	–	–	–	–	–
Reversed through P/L	–	–	–	–	–	(2)	–	(2)	(8)	
Closing Balance	2	–	4	4	6	2	8	–	–	–

Carrying Amount of the Asset

Restated proportionately

Year	1	2 Revaluation increase	3	4
Gross block	100	100 → 120	120	120
Accumulated depreciation	25	50 → 60	90	120
Carrying Amount	75	50 → 60	30	–

Eliminated against gross carrying amount

Year	1	2 Revaluation increase	3	4
Gross block	100	100 → 60	60	60
Accumulated depreciation	25	50 → –	30	60
Carrying Amount	75	50 → 60	30	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 5

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 20%.

Fair value 100 at the end of year 1 when life is increased by 1 year.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5	6
Profit before depreciation	100	100	100	100	100	100
Depreciation	20	20	20	20	20	20
Accounting Profit	80	80	80	80	80	80
Tax expense –						
Current tax	32	32	32	32	32	40
Deferred tax liability	– 32	– 32	– 32	– 32	– 32	(8) 32
Profit for the Period	48	48	48	48	48	48
Other comprehensive income						
Revaluation surplus (net of tax)	12					
Total comprehensive income	60	48	48	48	48	48

Statement of Changes in Equity

Year	1	2	3	4	5	6
Revaluation surplus						
Opening balance	–	12	12	12	12	12
Created	12	–	–	–	–	–
Transferred to retained earnings	–	–	–	–	–	(12)
Closing Balance	12	12	12	12	12	–

Workings **Current Tax**

Year	1 to 5	6
Profit before depreciation	100	100
Depreciation allowed	20	–
Taxable Profit	80	100
Current Tax @ 40%	32	40

Deferred Tax Liability

Year	1	2	3	4	5	6
Opening balance	–	8	8	8	8	8
Created through other comprehensive income	8	–	–	–	–	–
Reversed through profit or loss	–	–	–	–	–	(8)
Closing balance	8	8	8	8	8	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3	4	5	6
Gross block	100 → 125	125	125	125	125	125
Accumulated depreciation	20 → 25	45	65	85	105	125
Carrying Amount	80 → 100	80	60	40	20	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3	4	5	6
Gross block	100 → 100	100	100	100	100	100
Accumulated depreciation	20 → –	20	40	60	80	100
Carrying Amount	80 → 100	80	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 6

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Fair value 100 at the end of year 1 when life is increased by 1 year.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5	6
Profit before depreciation	100	100	100	100	100	100
Depreciation	20	20	20	20	20	20
Accounting Profit	80	80	80	80	80	80
Tax expense –						
Current tax	30	30	30	30	40	40
Deferred tax expense (liability)	2 32	2 32	2 32	2 32	(8) 32	(8) 32
Profit for the Period	48	48	48	48	48	48
Other comprehensive income						
Revaluation surplus (net of tax)	12					
Total comprehensive income	60	48	48	48	48	48

Statement of Changes in Equity

Year	1	2	3	4	5	6
Revaluation surplus						
Opening balance	–	12	12	12	12	12
Created	12	–	–	–	–	–
Transferred to retained earnings	–	–	–	–	–	(12)
Closing Balance	12	12	12	12	12	–

Workings **Current Tax**

Year	1 to 4	5 and 6
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax	30	40

Deferred Tax Liability

Year	1	2	3	4	5	6
Opening balance	–	10	12	14	16	8
Created through –						
Profit and Loss	2	2	2	2	–	–
other comprehensive income	8	–	–	–	–	–
Reversed through profit or loss	–	–	–	–	(8)	(8)
Closing balance	10	12	14	16	8	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3	4	5	6
Gross block	100 → 125	125	125	125	125	125
Accumulated depreciation	20 → 25	45	65	85	105	125
Carrying Amount	80 → 100	80	60	40	20	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3	4	5	6
Gross block	100 → 100	100	100	100	100	100
Accumulated depreciation	20 → –	20	40	60	80	100
Carrying Amount	80 → 100	80	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 7

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Fair value – 100 at the end of year 1; and 60 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before depreciation	100	100	100	100	100
Depreciation	20	25	25	30	30
Accounting Profit	80	75	75	70	70
Tax expense –					
Current tax	30	30	30	30	40
Deferred tax expense (liability)	2 32	– 30	– 30	(2) 28	(12) 28
Profit for the Period	48	45	45	42	42
Other comprehensive income					
Revaluation surplus (net of tax)	12		6		
Total comprehensive income	60	45	51	42	42

Statement of Changes in Equity

Year	1	2	3	4	5
Revaluation surplus					
Opening balance	–	12	9	12	6
Created	12	–	6	–	–
Transferred to retained earnings	–	(3)	(3)	(6)	(6)
Closing Balance	12	9	12	6	–

Workings **Current Tax**

Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax	30	40

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	10	10	14	12
Created through –					
Profit and Loss	2	–	–	–	–
other comprehensive income	8	–	4	–	–
Reversed through profit or loss	–	–	–	(2)	(12)
Closing balance	10	10	14	12	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3 Revaluation increase	4	5
Gross block	100 → 125	125	125 → 150	150	150
Accumulated depreciation	20 → 25	50	75 → 90	120	150
Carrying Amount	80 → 100	75	50 → 60	30	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3 Revaluation increase	4	5
Gross block	100 → 100	100	100 → 60	60	60
Accumulated depreciation	20 → –	25	50 → –	30	60
Carrying Amount	80 → 100	75	50 → 60	30	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Accumulated Depreciation	25	50	75	100
Tax Base	75	50	25	–

Example 8

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation – Financial – 20%, Tax 25%. Fair value – 120 at the end of year 1; Life increased by 1 year at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1		2		3		4		5		6	
Profit before depreciation		100		100		100		100		100		100
Depreciation		20		30		30		20		20		20
Accounting Profit		80		70		70		80		80		80
Tax expense –												
Current tax	30		30		30		30		40		40	
Deferred tax expense (liability)	2	32	(2)	28	(2)	28	2	32	(8)	32	(8)	32
Profit for the Period		48		42		42		48		48		48
Other comprehensive income												
Revaluation surplus (net of tax)		24		–		–		–		–		–
Total comprehensive income		72		42		42		48		48		48

Statement of Changes in Equity

Year	1	2	3	4	5	6
Revaluation surplus						
Opening balance	–	24	20	16	16	16
Created through other comprehensive income	24	–	–	–	–	–
Transferred to retained earnings	–	(4)	(4)	–	–	(16)
Closing Balance	24	20	16	16	16	–

Workings **Current Tax**

Year	1 to 4	5 and 6
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5	6
Opening balance	–	18	16	14	16	8
Created through –						
Profit and Loss	2	–	–	2	–	–
other comprehensive income	16	–	–	–	–	–
Reversed	–	(2)	(2)	–	(8)	(8)
Closing balance	18	16	14	16	8	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3	4	5	6
Gross block	100 → 150	150	150	150	150	150
Accumulated depreciation	20 → 30	60	90	110	130	150
Carrying Amount	80 → 120	90	60	40	20	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3	4	5	6
Gross block	100 → 120	120	120	120	120	120
Accumulated depreciation	20 → –	30	60	80	100	120
Carrying Amount	80 → 120	90	60	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 9

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Fair value – 100 at the end of year 1; and 40 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1		2		3		4		5	
Profit before depreciation	100		100		100		100		100	
Depreciation	20		25		25		20		20	
Accounting Profit	80		75		75		80		80	
Tax expense –										
Current tax	30		30		30		30		40	
Deferred tax expense (liability)	2	32	–	30	–	30	2	32	(8)	32
Profit for the Period	48		45		45		48		48	
Other comprehensive income										
Revaluation surplus (net of tax)	12				(6)					
Total comprehensive income	60		45		39		48		48	

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	12	9
Created	12	–	6
Transferred to retained earnings	–	(3)	(3)
Reversed	–	–	(6)
Closing Balance	12	9	–

Workings **Current Tax**

Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	10	10	6	8
Created through –					
Profit and Loss	2	–	–	2	–
other comprehensive income	8	–	–	–	–
Reversed through –					
profit or loss	–	–	–	–	(8)
other comprehensive income	–	–	(4)	–	–
Closing balance	10	10	6	8	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3 Revaluation increase	4	5
Gross block	100 → 125	125	125 → 100	100	100
Accumulated depreciation	20 → 25	50	75 → 60	80	100
Carrying Amount	80 → 100	75	50 → 40	20	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3 Revaluation increase	4	5
Gross block	100 → 100	100	100 → 40	40	40
Accumulated depreciation	20 → –	25	50 → –	20	40
Carrying Amount	80 → 100	75	50 → 40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 10

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 20%. Fair value – 100 at the end of year 1; and 40 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before depreciation	100	100	100	100	100
Depreciation	20	25	25	20	20
Accounting Profit	80	75	75	80	80
Tax expense –					
Current tax	32	32	32	32	32
Deferred tax liability	– 32	(2) 30	(2) 30	– 32	– 32
Profit for the Period	48	45	45	48	48
Other comprehensive income					
Revaluation surplus (net of tax)	12		(6)		
Total comprehensive income	60	45	39	48	48

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	12	9
Created	12	–	–
Transferred to retained earnings	–	(3)	(3)
Reversed	–	–	(6)
Closing Balance	12	9	–

Workings **Current Tax**

Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current Tax @ 40%	32

Deferred Tax Liability

Year	1	2	3
Opening balance	–	8	6
Created through –			
Profit and Loss	–	–	–
other comprehensive income	8	–	–
Reversed through –			
profit or loss	–	(2)	(2)
other comprehensive income	–	–	(4)
Closing balance	8	6	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3 Revaluation increase	4	5
Gross block	100 → 125	125	125 → 100	100	100
Accumulated depreciation	20 → 25	50	75 → 60	80	100
Carrying Amount	80 → 100	75	50 → 40	20	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3 Revaluation increase	4	5
Gross block	100 → 100	100	100 → 40	40	40
Accumulated depreciation	20 → –	25	50 → –	20	40
Carrying Amount	80 → 100	75	50 → 40	20	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 11

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%. Fair value – 90 at the end of year 1; and 20 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before depreciation	100	100	100	100	100
Depreciation	25	30	30	20	–
Accounting Profit	75	70	70	80	100
Tax expense –					
Current tax	32	32	32	32	32
Deferred tax (income) / asset	(2)	(4)	(2)	–	8
Deferred tax liability	– 30	– 28	(2) 28	– 32	– 40
Profit for the Period	45	42	42	48	60
Other comprehensive income					
Revaluation surplus (net of tax)	9		(6)		
Total comprehensive income	54	42	36	48	60

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	9	6
Created	9	–	–
Transferred to retained earnings	–	(3)	–
Reversed	–	–	(6)
Closing Balance	9	6	–

Workings **Current Tax**

Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current Tax @ 40%	32

Deferred Tax Asset / Liability

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	2	6	6	4	8	–	8	–
Created through –										
Profit and oss	2	–	4	–	2	–	–	–	–	–
Other comprehensive income	–	6	–	–	–	–	–	–	–	–
Reversed through –										
Profit and oss	–	–	–	(2)	–	–	–	–	(8)	–
Other comprehensive income	–	–	–	–	–	(4)	–	–	–	–
Closing Balance	2	6	6	4	8	–	8	–	–	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3 Revaluation increase	4
Gross block	100 → 120	120	120 → 80	80
Accumulated depreciation	25 → 30	60	90 → 60	80
Carrying Amount	75 → 90	60	30 → 20	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3 Revaluation increase	4
Gross block	100 → 90	90	90 → 20	20
Accumulated depreciation	25 → –	30	60 → –	20
Carrying Amount	75 → 90	60	30 → 20	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 12

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%.

Fair value – 90 at the end of year 1; 20 at the end of year 3 when life is increased by 1 year.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before depreciation	100	100	100	100	100
Depreciation	25	30	30	10	10
Accounting Profit	75	70	70	90	90
Tax expense –					
Current tax	32	32	32	32	32
Deferred tax (income) / asset	(2)	(2)	(4)	4	4
Deferred tax liability	– 30	(2) 28	– 28	– 36	– 36
Profit for the Period	45	42	42	54	54
Other comprehensive income					
Revaluation surplus (net of tax)	9		(6)		
Total comprehensive income	54	42	36	54	54

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	9	6
Created	9	–	–
Transferred to retained earnings	–	(3)	–
Reversed	–	–	(6)
Closing Balance	9	6	–

Workings **Current Tax**

Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current Tax @ 40%	32

Deferred Tax Asset / Liability

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	2	6	4	4	8	–	4	–
Created through –										
Profit and oss	2	–	2	–	4	–	–	–	–	–
Other comprehensive income	–	6	–	–	–	–	–	–	–	–
Reversed through –										
Profit and oss	–	–	–	(2)	–	–	(4)	–	(4)	–
Other comprehensive income	–	–	–	–	–	(4)	–	–	–	–
Closing Balance	2	6	4	4	8	–	4	–	–	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3 Revaluation dcrease	4	5
Gross block	100 → 120	120	120 → 80	80	80
Accumulated depreciation	25 → 30	60	90 → 60	70	80
Carrying Amount	75 → 90	60	30 → 20	10	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3 Revaluation dcrease	4	5
Gross block	100 → 90	90	90 → 20	20	20
Accumulated depreciation	25 → –	30	60 → –	10	20
Carrying Amount	75 → 90	60	30 → 20	10	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Impairment of Assets (Ind AS 36)

Introduction

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

- Carrying amount

  It is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses thereon.

- Recoverable amount

  It is the higher of an asset's fair value less costs of disposal and value in use.

- Fair value

  It is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

- Costs ofdisposal

  Costs of disposal are incremental costs directly attributable to the disposal of an asset, eg, legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

- Value in use

  It is the present value of future cash flows expected to be derived from an asset.

  The following elements shall be reflected in the calculation of an asset's value in use –

  - an estimate of the future cash flows the entity expects to derive from the asset.
  - expectations about possible variations in the amount or timing of those future cash flows.
  - the time value of money, represented by the current market risk-free rate of interest.
  - the price for bearing the uncertainty inherent in the asset, and
  - other factors, such as liquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Recognising and measuring an impairment loss for an individual asset

If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. This reduction is an impairment loss which shall be recognised immediately in profit and loss. But, any impairment loss of are valued asset shall be treated as a revaluation decrease.

When the amount estimated for an impairment loss is greater the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another standard.

After the recognition of an impairment loss, the depreciation charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its useful life.

- Depreciation

  It is the systematic allocation of the depreciable amount of an asset over its useful life.

- Depreciable amount

  It is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

- Usefullife

  It is either the –

  - period of time over which an asset is expected to be used by the entity; or
  - number of production or similar units expected to be obtained from the asset by the entity.

Reversing an impairment loss for an individual asset

An impairment loss recognised in prior periods for an asset shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset shall be increased to its recoverable amount. That increase is a reversal of an impairment loss. But, the increased carrying amount of an asset attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised for the asset in prior years.

A reversal of an impairment loss for an asset shall be recognised immediately in profit and loss, unless the asset is carried at revalued amount – where the impairment loss shall be treated as a revaluation increase.

After a reversal of an impairment loss is recognised, the depreciation charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residualvalue (if any), on a systematic basis over its remaining usefullife.

Cash-generating unit

A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. But, recoverable amount of an individual asset can be determined if –

- the asset's value in use cannot be estimated to be close to its fair value less costs of disposal (eg, when the future cash flows from continuing use of the asset cannot be estimated to be negligible);and
- the asset does not generate cash inflows that are largely independent of those from otherassets.

In such cases, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

Impairment loss for a cash-generating unit

An impairment loss shall be recognised for a cash-generating unit if, and only if, the recoverable amount of the unit is less than the carrying amount of the unit.

The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit

pro-rata on the basis of the carrying amount of each asset in the unit. These reductions in carrying amounts shall be treated as impairment losses on individual assets. But, an entity shall not reduce the carrying amount of an asset below the highest of –

- its fair value less costs of disposal (if measureable);
- its value in use (if determinable); and
- zero.

The amount of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit.

Reversing an impairment loss for a cash-generating unit

A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit pro rata with the carrying amount of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets. But, the carrying amount of an asset shall not be increased above the lower of –

- its recoverable amount (if determinable); and

- the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised for the asset in prior periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit.

Corporate assets

These are assets that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units. Corporate assets include group or individual assets such as a building of a headquarters or a division of the entity, EDP equipment or a research centre.

The recoverable amount of an individual corporate asset cannot be determined, because corporate assets do not generate separate cash flows. As a consequence, recoverable amount is determined for the cash-generating unit or group of cash-generating units to which the corporate asset belongs, and is compared with the cash-generating unit or group of cash- generating units to recognise the impairment loss, if any.

In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:

- can be allocated on a reasonable and consistent basis to that unit, the entity shall compare the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to that unit, with its recoverable amount. Any impairment loss shall be recognised in profit or loss.
- can not be allocated on a reasonable and consistent basis to that unit, the entity shall–
  - compare the carrying amount of the unit, excluding the corporate assets, with its recoverable amount and recognise any impairment loss in profit or loss;
  - identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and
  - compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount if the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised in profit and loss.

Example 1

Beginning of year 1

Asset :	Gross block	100	Share capital	70
	Accumulated depreciation	10	Retained earnings	20
	Carrying amount	90		

End of year 1

Revenue 60. Cost of sales (before depreciation) 30. Depreciation 10. Fair value less costs of disposal 60. Value in use 70. Depreciation for financial accounting and tax accounting are the same. Income tax rate 40%.

An impairment loss –

affects	does not affect
• accounting profit; and	• taxable profit;and
• carrying amount of the asset	• tax base of the asset

Carrying amount after depreciation(A)	Fair Value(B)	Value in Use(C)	Recoverable amount [Higher of (B) and (C)]
80	60	70	70

Tax base	Revised carrying amount	Impairment loss	Deferred tax asset* [(80 – 70) x40%]
80	70	10	4

* Deferred tax asset arises when the tax base of an asset is more than its carrying amount.

Balance Sheet

Particulars	Impairment ofAsset			
	Before		After	
Assets				
Non-current				
Asset : Gross block	100		100	
Accumulated – depreciation	20		20	
impairment	–	80	10	70
Deferred tax asset		–		4
Current				
Cash and cash equivalents*		22		22
		102		96
Equity and Liabilities				
Equity		70		70
Retained earnings		32		26
		102		96

* (Revenue – Cost of sales – Income tax) = (60 – 30 – 8) = 22.

Statement of Profit and Loss

Particulars	Impairment ofAsset			
	Before		After	
Revenue		60		60
Cost of sales		30		30
Gross profit		30		30
Depreciation	10		10	
Impairment	–	10	10	20
Accounting Profit		20		10
Tax expense –				
Current tax	8		8	
Deferred tax (income)	–	8	(4)	4
Profit for the period		12		6

Statement of Changes in Equity

Retained Earnings	Impairment ofAsset	
	Before	After
Opening Balance	20	20
Created	12	6
Closing Balance	32	26

Example 2

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 25%, Tax 20%. Recoverable amount 40 at the end of year 2.

Statement of Profit and Loss

Year	1		2		3		4		5	
Profit before depreciation		100		100		100		100		100
Depreciation	25		25		20		20		–	
Impairment	–	25	10	35	–	20	–	20	–	–
Accounting Profit		75		65		80		80		100
Tax expense –										
Current tax	32		32		32		32		32	
Deferred tax (income) / asset	(2)	30	(6)	26	–	32	–	32	8	40
Profit for the Period		45		39		48		48		60

Workings **Current Tax**

Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current Tax @ 40%	32

Deferred Tax Asset

Year	1	2	3	4	5
Opening balance	–	2	8	8	8
Created	2	6	–	–	–
Reversed	–	–	–	–	(8)
Closing balance	2	8	8	8	–

Carrying Amount of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Accumulated Depreciation and impairment	25	60	80	100
Carrying Amount	75	40	20	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 3

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 20%. Recoverable amount 20 at the end of year 3.

Statement of Profit and Loss

Year	1		2		3		4		5	
Profit before depreciation		100		100		100		100		100
Depreciation	20		20		20		10		10	
Impairment	–	20	–	20	20	40	–	10	–	10
Accounting Profit		80		80		60		90		90
Tax expense –										
Current tax	32		32		32		32		32	
Deferred tax (income) / asset	–	32	–	32	(8)	24	4	36	4	36
Profit for the Period		48		48		36		54		54

Workings	**Current Tax**	
Year		1 to 5
Profit before depreciation		100
Depreciation allowed		20
Taxable Profit		80
Current Tax @ 40%		32

Deferred Tax Asset			
Year	3	4	5
Opening balance	–	8	4
Created	8	–	–
Reversed	–	(4)	(4)
Closing balance	8	4	–

Carrying Amount of the Asset					
Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated Depreciation and impairment	20	40	80	90	100
Carrying Amount	80	60	20	10	–

Tax Base of the Asset					
Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 4

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Recoverable amount 30 at the end of year 2.

Statement of Profit and Loss									
Year	1		2		3		4		5
Profit before depreciation	100		100		100		100		100
Depreciation	20		20		10		10		10
Impairment	–	20	30	50	–	10	–	10	–	10
Accounting Profit		80		50		90		90		90
Tax expense –									
Current tax	30		30		30		30		40	
Deferred tax expense / (liability)	2		(2)		–		4		(4)	
Deferred tax (income) / asset	–	32	(8)	20	6	36	2	36	–	36
Profit for the Period		48		30		54		54		54

Workings	**Current Tax**	
Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax @ 40%	30	40

Deferred Tax Liability / Asset

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	2	–	–	8	–	2	4	–
Created	2	–	–	8	–	–	4	–	–	–
Reversed	–	–	(2)	–	–	(6)	–	(2)	(4)	–
Closing Balance	2	–	–	8	–	2	4	–	–	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated Depreciation and impairment	20	70	80	90	100
Carrying Amount	80	30	20	10	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 5

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. At the end of Year 1, recoverable amount 75 and life reduced to 4 years.

Statement of Profit and Loss

Year	1		2		3		4	
Profit before depreciation		100		100		100		100
Depreciation	20		25		25		25	
Impairment	5	25	–	25	–	25	–	25
Accounting Profit		75		75		75		75
Tax expense –								
Current tax		30		30		30		30
Profit for the Period		45		45		45		45

Workings **Current Tax**

Year	1 to 4
Profit before depreciation	100
Depreciation allowed	25
Taxable Profit	75
Current Tax @ 40%	30

Carrying Amount of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Accumulated Depreciation and impairment	25	50	75	100
Carrying Amount	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 6

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Recoverable amount 60 at the end of year 1, 40 at the end of year 3.

Statement of Profit and Loss

Year	1		2		3		4		5	
Profit before depreciation		100		100		100		100		100
Depreciation	20		15		15		20		20	
Impairment	20	40	–	15	(10)	5	–	20	–	20
Accounting Profit		60		85		95		80		80
Tax expense –										
Current tax	30		30		30		30		40	
Deferred tax (income) / asset	(6)		4		2		–		–	
Deferred tax expense / (liability)	–	24	–	34	6	38	2	32	(8)	32
Profit for the Period		36		51		57		48		48

Workings **Current Tax**

Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax @ 40%	30	40

Deferred Tax Asset / Liability

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	6	–	2	–	–	6	–	8
Created	6	–	–	–	–	6	–	2	–	–
Reversed	–	–	(4)	–	(2)	–	–	–	–	(8)
Closing Balance	6	–	2	–	–	6	–	8	–	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated Depreciation and impairment	40	55	60	80	100
Carrying Amount	60	45	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 7

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Recoverable amount 60 at the end of year 1, 50 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1		2		3		4		5	
Profit before depreciation		100		100		100		100		100
Depreciation	20		15		15		25		25	
Impairment	20	40	–	15	(10)	5	–	25	–	25
Accounting Profit		60		85		95		75		75
Tax expense –										
Current tax	30		30		30		30		40	
Deferred tax (income) / asset	(6)		4		2		–		–	
Deferred tax expense / (liability)	–	24	–	34	6	38	–	30	(10)	30
Profit for the Period		36		51		57		45		45
Other comprehensive income										
Revaluation surplus (net of tax)		–		–		6		–		–
Profit for the Period		36		51		63		45		45

Statement of Changes in Equity

Year	3	4	5
Revaluation surplus			
Opening balance	–	6	3
Created through other comprehensive income	6	–	–
Transferred to retained earnings	–	(3)	(3)
Closing Balance	6	3	–

Workings **Current Tax**

Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax @ 40%	30	40

Deferred Tax Asset / Liability

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	6	–	2	–	–	10	–	10
Created through –										
Profit and Loss	6	–	–	–	–	6	–	–	–	–
Other Comprehensive Income	–	–	–	–	–	4	–	–	–	–
Reversed through P/L	–	–	(4)	–	(2)	–	–	–	–	(10)
Closing Balance	6	–	2	–	–	10	–	10	–	–

Carrying Amount of the Asset

Restated proportionately

Year	1	2	3 Impairment reversal	3 Revaluation increase	4	5
Gross block	100	100	100 → 100	→ 125	125	125
Accumulated Depreciation and impairment	40	55	70 → 60	→ 75	100	125
Carrying Amount	60	45	30 → 40	→ 50	25	–

Eliminated against gross carrying amount

Year	1	2	3 Impairment reversal	3 Revaluation increase	4	5
Gross block	100	100	100 → 100	→ 50	50	50
Accumulated Depreciation and impairment	40	55	70 → 60	→ –	25	50
Carrying Amount	60	45	30 → 40	→ 50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 8

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 20%. Fair value 100 at the end of year 1. Recoverable amount 30 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before depreciation	100	100	100	100	100
Depreciation	20	25	25	15	15
Impairment	– 20	– 25	10 35	– 15	– 15
Accounting Profit	80	75	65	85	85
Tax expense –					
Current tax	32	32	32	32	32
Deferred tax liability	–	(2)	(2)	–	–
Deferred tax (income) / asset	– 32	– 30	(4) 26	2 34	2 34
Profit for the Period	48	45	39	51	51
Other comprehensive income					
Revaluation surplus (net of tax)	12	–	(6)	–	–
Total comprehensive income	60	45	33	51	51

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	12	9
Created	12	–	–
Reversed	–	–	(6)
Transferred to retained earnings	–	(3)	(3)
Closing Balance	12	9	–

Workings **Current Tax**

Year	1 to 5
Profit before depreciation	100
Depreciation allowed	20
Taxable Profit	80
Current Tax @ 40%	32

Deferred Tax Liability / Asset

Year	1		2		3		4		5	
Deferred tax	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset
Opening balance	–	–	8	–	6	–	–	4	–	2
Created through –										
Profit and Loss	–	–	–	–	–	4	–	–	–	–
Other Comprehensive Income	8	–	–	–	–	–	–	–	–	–
Reversed through										
Profit and Loss	–	–	(2)	–	(2)	–	–	(2)	–	(2)
Other Comprehensive Income	–	–	–	–	(4)	–	–	–	–	–
Closing Balance	8	–	6	–	–	4	–	2	–	–

Carrying Amount of the Asset

Restated proportionately

Year	1			2	3			4	5
		Revaluation increase				Revaluation decrease	Impairment		
Gross block	100	→	125	125	125	→ 100	→ 100	100	100
Accumulated Depreciation and impairment	20	→	25	50	75	→ 60	→ 70	85	100
Carrying Amount	80	→	100	75	50	→ 40	→ 30	15	–

Eliminated against gross carrying amount

Year	1			2	3			4	5
		Revaluation increase				Revaluation decrease	Impairment		
Gross block	100	→	100	100	100	→ 40	→ 40	40	40
Accumulated Depreciation and impairment	20	→	–	25	50	→ –	→ 10	25	40
Carrying Amount	80	→	100	75	50	→ 40	→ 30	15	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Depreciation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 9

Profit before depreciation 100 per year. Asset 100. Income tax rate 40%. Depreciation (SLM) – Financial 20%, Tax 25%. Fair value 100 at the end of year 1. Recoverable amount 30 at the end of year 3.

Statement of Profit and Loss and Other Comprehensive Income

Year	1		2		3		4		5	
Profit before depreciation		100		100		100		100		100
Depreciation	20		25		25		15		15	
Impairment	–	20	–	25	10	35	–	15	–	15
Accounting Profit		80		75		65		85		85
Tax expense –										
Current tax	30		30		30		30		40	
Deferred tax expense / (liability)	2	32	–	30	(4)	26	4	34	(6)	34
Profit for the Period		48		45		39		51		51
Other comprehensive income										
Revaluation surplus (net of tax)		12		–		(6)		–		–
Total comprehensive income		60		45		33		51		51

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	12	9
Created	12	–	–
Reversed	–	–	(6)
Transferred to retained earnings	–	(3)	(3)
Closing Balance	12	9	–

Workings	**Current Tax**	
Year	1 to 4	5
Profit before depreciation	100	100
Depreciation allowed	25	–
Taxable Profit	75	100
Current Tax @ 40%	30	40

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	10	10	2	6
Created through –					
Profit and Loss	2	–	–	4	–
other comprehensive income	–	–	–	–	–
Reversed through –					
profit or loss	–	–	(4)	–	(6)
other comprehensive income	8	–	(4)	–	–
Closing balance	10	10	2	6	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3 Revaluation decrease	Impairment	4	5
Gross block	100 → 125	125	125 → 100	→ 100	100	100
Accumulated Depreciation and impairment	20 → 25	50	75 → 60	→ 70	85	100
Carrying Amount	80 → 100	75	50 → 40	→ 30	15	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3 Revaluation decrease	Impairment	4	5
Gross block	100 → 100	100	100 → 40	→ 40	40	40
Accumulated Depreciation and impairment	20 → –	25	50 → –	→ 10	25	40
Carrying Amount	80 → 100	75	50 → 40	→ 30	15	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Depreciation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 10

Cash generating unit :

- Individual carrying amount of assets –

  A: 40; B:30; C:20; D :10.

- Recoverable amount 80. Income tax rate 40%.

Scenario 1

None of the individual asset's fair value is measurable or value in use is determinable.

Assets	Carrying Amount	Recoverable Amount	Impairment Loss	Revised Carrying Amount	Deferred Tax Asset
A	40	32	8	32	3
B	30	24	6	24	2
C	20	16	4	16	2
D	10	8	2	8	1
	100	80	20	80	8

Scenario 2

Asset : A – Fair value 34; Value in use 38.

B – Fair value 21; Value in use 20.

Assets	Carrying Amount	Recoverable Amount	Impairment Loss	Revised Carrying Amount	Deferred Tax Asset
A	40	38	2	38	1
B	30	21	9	21	4
C	20	14	6	14	2
D	10	7	3	7	1
	100	80	20	80	8

Scenario 3

Asset – C : Fair value (–) 8; Value in use (–) 16.

Assets	Carrying Amount	Recoverable Amount	Impairment Loss	Revised Carrying Amount	Deferred Tax Asset
A	40	40	–	40	–
B	30	30	–	30	–
C	20	–	20	–	8
D	10	10	–	10	–
	100	80	20	80	8

Example 11

Carrying amount of cash generating unit 90.

Individual carrying amount of assets –

A: 40; B:25; C:15; D :10.

Recoverable amount of cash generating unit 120 –

Individual recoverable amount of assets – A :50; B:40; C and D : not determinable.

Impairment loss previously charged to individual assets – A :16; B:10; C:8; D:5. Income tax rate 40%.

Assets	Carrying Amount	Recoverable Amount	Impairment Loss Previously Charged	Carrying Amount without Impairment Loss	Carrying Amount after Impairment Reversal	Impairment Reversal	Deferred Tax Asset Reversal
A	40	50	16	56	50	10	4
B	25	40	10	35	35	10	4
C	15	–	8	23	21	6	2
D	10	–	5	15	14	4	2
	90	120	39	129	120	30	12

Example 12

Background

An entity has 3 cash-generating units : A, B and C. The operations are conducted from the headquarters. At the end of 20x0, the carrying amounts are –

- Cash generating units – A:100; B: 150; C :200.
- Headquarters – Building:150; Research Centre:50.

The remaining estimated useful lives are –

- Cash generating units – A :10 years; B, C and the headquarters : 20 years each.

The headquarters is depreciated on a straight-line basis. The relative carrying amounts of the cash-generating units are a reasonable indication of the proportion of the headquarters building devoted to each cash-generating unit. The carrying amount of the research centre cannot be allocaed on a reasonable basis to the individual cash-generating units.

The entity conducts impairment tests of each of its cash-generating units. The recoverable amount of each cash-generating unit is based on its value in use.

Identification of corporate assets

The entity first identifies all the corporate assets (headquarters building and the research centre) that relate to the individual cash-generating units under review. The entity then decides how to deal with each of the corporate assets, ie, the carrying amount of the –

- headquarters building can be allocated on a reasonable and consistent basis to the cash- generating units under review;and
- research centre can not be allocated on a reasonable and consistent basis to the individual cash-generating units under review.

Allocation of corporate assets

The carrying amount of the headquarters building is allocated to the carrying amount of each individual cash-generating unit.

Schedule 1

Calculation of a weighted allocation of the carrying amount of the headquarters building :

End of 20x0	A	B	C	Total
Carrying amount	100	150	200	450
Useful life (Years)	10	20	20	
Weightingbased on useful life	1	2	2	
Carrying amount after weighting	100	300	400	800
Pro-rata allocation of the building	12%	38%	50%	100%
	(100 ÷800)	(300 ÷800)	(400 ÷800)	
Allocation of the carrying amount of the building (based on pro-rata above)	18	57	75	150
Carrying amount (after allocation of the building)	118	207	275	600

Determination of recoverable amount and calculation of impairment losses

First, the recoverable amount of each individual cash-generating unit is to be compared with its carrying amount, including the portion of the carrying amount of the headquarters building allocated to the unit, and any resulting impairment loss recognised. Then the recoverable amount of the entity as a whole (ie, the smallest group of cash-generating units that includes the research centre) is to be compared with its carrying amount, including both the headquarters building and the research centre.

Schedule 2

- Value in use (as determined) – A :199; B:165; C:271; Entity :720.

It is assumed that the research centre generates additional future cash floats for the entity as a whole. Therefore, the sum of the value in use of each individual cash-generating unit is less than the value of the business as a whole. The additional cash flows are not attributable to the headquartersbuilding.

Schedule 3

Impairment testing of A, B and C :

End of 20x0	1	2	3
Carrying amount (Schedule 1)	118	207	275
Recoverable amount (Schedule 2)	199	165	271
Impairment loss	–	(42)	(4)

Schedule 4

The next step is to allocate the impairment losses between the assets of cash-generating units and the headquarters building.

Allocation of the impairment losses for cash-generating units B and C :

Cash-generating unit	B	C
To Headquarters building	(12) (42 x 56 ÷206)	(1) (4 x 75 ÷275)
To assets in cash-generating unit	(30) (42 x 150 ÷206)	(3) (4 x 200 ÷275)
	(42)	(4)

Schedule 5

Because the research centre could not be allocated on a reasonable and consistent basis to A, B and C's cash-generating units, the entity compares the carrying amount of the smallest group of cash-generating units to which the carrying amount of the research centre can be allocated (i.e., the entity as a whole) to its recoverable amount.

Impairment testing of the smallest group of cash-generating units to which the carrying amount of the research centre can be allocated (i.e., the entity as a whole).

End of 20x0	A	B	C	Building	Research Centre	Entity
Carrying amount	100	150	200	150	50	650
Impairment loss arising						
from the first step of the test	–	(30)	(3)	(13)	–	(46)
Carrying amount after the first step of the test	100	120	197	137	50	604
Recoverable amount (Schedule 2)						720
Impairment loss for the 'larger' cash-generating unit						–

Therefore, no additional impairment loss results from the application of the impairment test to theentityasawhole.Onlyanimpairmentlossof46isrecognisedasaresultoftheapplicationof the first step of the test to A, B and C. Thereafter, a deferred tax asset of 18 is to be created, assuming income tax rate is 40%.

Example 13

An entity, at the end of 20x0, tests a cash-generating unit (CGU) for impairment, which has a carrying amount of 3,000 (at depreciated historic cost) and a remaining useful life of 10 years.

The entity decided that the CGU will be restructured at an estimated cost of 100 at the end of 20x3.

At the end of 20x2, the entity becomes committed to the restructuring and accordingly, a provision is recognised for 100.

At the end of 20x3, actual restructuring costs of 100 are incurred and paid.

At the end of 20x0

The CGU's recoverable amount is calculated at 2,051. Since this amount is less than the carrying amount, an impairment loss of 949 (3,000–2,051) is recognised. Therefore, the carrying amount of the CGU after impairment loss is 2,051.

At the end of 20x1

There is no indication of impairment.

At the end of 20x2

The CGU's recoverable amount is calculated at 2,162. Since the CGU's recoverable amount is higher than its carrying amount, the entity reverses the impairment loss recognised for the CGU at the end of 20x0, as under:

Carrying amount at the end of 20x0	2,051
End of 20x2	
Depreciation for 20x1 and 20x2 (205 x 2)	410
Carrying amount before reversal	1,641
Recoverable amount	2,162
Reversal of the impairment loss (2,162 – 1,641)	521
Carrying amount after reversal	2,162

At the end of 20x3

Summary of the carrying amount of the CGU

End of Year	Depreciated Historical Cost	Recoverable Amount	Depreciation Charge	Impairment Loss (Reversal)	Carrying Amount after Depreciation	Deferred Tax Asset*
20x0	3,000	2,051	–	949	2,051	380
20X1	2,700	–	(205)	–	1,846	–
20X2	2,400	2,162	(205)	(521)	2,162	(208)
20x3	2,100	–	(270)	–	1,892	–

* assumed income tax rate is 40%.

Intangible Assets (Ind AS 38)

Introduction

An **intangible asset** is an identifiable non-monetary asset (derive value from their economic condition and do not have a fixed exchange value for money) without physical substance. Sometimes, intangible assets may be confined in a physical form such as compact disc (computer software) or film (motion picture). In such a case, whether the entity treats it as tangible or intangible will depend on management judgement and perspective. Intangible assets–

- obtain their worth from the rights and benefits approved to their owner/creator.
- can be contractual/non-contractual.

An intangible asset should meet the following conditions:

- **Identifiable** An asset is identifiable, if it either –
  - is separable, ie, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
  - arises from contractual or other legal rights, regardless of whether those rights are transferrable or separable from the entity or from other rights and obligations.
- **Controlled by an entity** An entity controls an intangible asset (e.g., through legal rights, market related knowledge or technical knowledge) when it enjoys the future economic benefits flowing from that asset (e.g., revenue, cost savings or other benefits) and when it can restrict the access of other entities to those benefits (e.g., through copyrights or trade agreements or legal duty on employees to maintain confidentiality).

Recognition and initial measurement

An intangible asset is recognised when both the following criteria are satisfied :

- the definition of an intangible asset; and
- the recognition criteria of an asset –
  - if it is probable that future economic benefits (on the basis of reasonable assumptions that represents the management's best estimate of the economic conditions that prevail over the useful life of the asset) will flow; and that
  - the cost can be measured reliably (since an intangible asset is initially measured at cost).

The application of recognition criteria would depend on whether the intangible assethas been:

- **Separately acquired** When an entity pays a price to acquire an intangible asset from another entity, it is certain that the entity expects future economic benefits to flow to the entity, but may be uncertain about timing or amount. The cost can be measured reliably because of the consideration paid either by cash or by other assets.

The cost of a separately acquired intangible asset consists of the following –

- Purchase price; plus
- Import duties; plus
- Non-refundable purchase taxes; minus
- Rebates; plus
- Directly attributable costs; plus
- Cost of employee benefits; plus
- Professional and legal fees; plus
- Cost oftesting.

The following expenditures are not part of the cost of a separately acquired intangible asset –

- Cost of introducing a new product or service such as advertising costand promotional activities;
- Cost of conducting business in a new location or with a new class of customers (including cost of staff training); and
- Administrative and other general overheads.

Costs such as those incurred in using or redeploying an intangible asset should not be included on initial measurement, for example–

- Cost incurred while the management is yet to use the asset even though the asset is capable of operating in the manner intended;and
- Initial operating losses such as those incurred while demand for the asset's output buildsup.

Some operations (incidental to the development of an intangible asset) may occur before or during the development activities, but are not necessary to bring the asset to its working condition. Thus, any income and expenses relating to those incidental operations should be recognised in profit orloss.

If there is a deferred payment for an intangible asset, then the difference between the cash price and the total payment is recognised as interest expense over the period of credit, unless it is capitalised as per Ind AS23.

- **Acquired by way of a government grant** An intangible asset may be acquired free of charge or for a nominal amount by way of a government grant, for example –
  - Airport landingrights;
  - Licenses to operate radio;
  - License to operate television stations;
  - Import licenses;
  - Quotas.

In such cases, the intangible item is initially recognised as an asset and the grant as a liability at fair value.

- **Exchange of assets** Intangible assets can also be acquired by way of exchanging –
  - One non-monetaryasset;
  - More non-monetaryassets;
  - A combination of monetary asset with non-monetary asset. There are two accounting treatments:

- Fair value –
  - If exchange transaction has commercial substance; and
  - Fair value of asset given up or received can be measured reliably.
- Carrying amount of the asset given up –
  - If exchange transaction lacks commercial substance; or
  - Fairvalueofneitherassetreceivednorgivenupisreliablymeasured.
- **Internally generated** Entities invest in research and development because they expect to produce profitable future products. Any kind of innovation process has two phases—
  - *Research phase* Research is to find something new. It should be noted that research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Any expenditure that is incurred in the research phase of an internal project should be expensed in the period it is incurred.

- *Development phase* Development is to modify or improve the new idea or existing product. Development is the application of research findings and other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use. In the development phase, if an entity is able to identify an asset that is capable of generating future economic benefits and whose cost can also be measured reliably, then it should be recognised as an intangible asset.

If an entity cannot differentiate between the research phase and the development phase of an internal project to develop an intangible asset, then the expenditure is treated as research phase expense.

Subsequent measurement

After initial recognition, an entity must choose either of the following for subsequent measurement:

- **Cost model** An intangible asset after initial recognition can be carried at cost less any accumulated amortisation and any accumulated impairment losses.

- **Revaluation model** Under revaluation model, the intangible asset needs to be revalued at regular intervals and should be recognised at the revalued amount, which is its fair value (by reference to an active market) on the date of revaluation, less any accumulated amortisation and any accumulated impairment losses.

  The multi-period excess earnings method is used to measure the fair value of some intangible assets. This method is predicted on the basis that the value of the intangible asset is the present value of the earnings it generates, net of a reasonable return on other assets which also contribute to that stream of earnings.

  The revaluation model does not allow –

  - revaluation of intangible assets that has not previously been recognised as assets; or
  - initial recognition of intangible assets, at amounts other than cost.

  The revaluation model can be applied for intangible assets acquired by way of a government grant even if they are recognised at nominal amounts.

  If only part of the cost of an intangible asset is recognised as an asset because the asset did not meet the recognition criteria until part of the way through the process, the revaluation model may be applied to the whole of that asset when it is complete.

Useful life assessment

An entity should assess the useful life of an intangible asset in order to amortise its cost over the life of the asset. The following are the factors that determine the useful life of an intangible asset

- Economic factors determine the period over which the intangible asset would generate future economic benefits;
- Legal factors restrict the period over which the entity would possess the access to those benefits.

The useful life of an intangible asset that arises from contractual or other legal rights should not exceed the period of the contractual or other legal rights, but it may be shorter depending on the period over which the entity expects to use the asset.

An intangible asset may have either :

- **Finite useful life** In this case, the tenure of useful life or number of production units constituting useful life, needs to be determined.

  The following aspects have to be dealt with –

  - Amortisation period
    - Intangible assets with finite useful life will be amortised over its useful life.
    - Amortisation commences only when the intangible asset is available for use.
    - Amortisation ceases at the earlier of the date the asset is classified as held forsale and the date the asset is derecognised.

- Amortisation method
  - The method (straight line, diminishing balance or units of production) should be a systematic allocation of the cost or revaluation amount less any residual value.
  - Amortisation is usually recognised in profit or unless some other Standard permits or requires otherwise (eg, added to another asset).
- Residual value

  The residual value of an intangible asset with a finite useful life is assumed to be zero, unless there is–
  - an active market for the asset; or
  - a commitment by a third party to purchase the asset at the end of its useful life.

  The depreciable amount of an asset with a finite useful life is determined after deducting its residual value. A residual value other than zero implies that an entity expects to dispose of the intangible asset before the end of its economic life.
- Review of amortisation period and amortisationmethod
  - Both amortisation period and amortisation method need to be reviewed at each financial yearend.
  - Useful life of an intangible asset is also an estimate and, therefore, if on review it is found to have changed, then the amortisation charge will also change accordingly.
  - Similarly, if there is a change in the pattern in which the entity expects to utilised the future economic benefits embodied in the asset, then the amortisation method also needs to be changed.
  - Both the changes are changes in accounting estimates and, therefore, should be treated as per Ind AS8.

- **Indefinite useful life** This is the case, when based on the analysis of all relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash flows. Therefore, an intangible asset with an indefinite useful life should not be amortised, but must be tested for impairment either annually or whenever there is an indication that the asset might have been impaired.

  The following aspects have to be dealt with –
  - The useful life of an intangible asset that is not being amortised should also be reviewed at the end of each reporting period to assess whether the events or circumstances still continue to support an indefinite useful life assessment for that asset and if those circumstances do not exist then the useful life assessment changes from indefinite to finite and it should be accounted as per Ind AS 8.
  - Annual impairment testing is necessary to check whether the carrying amount of an intangible asset, particularly those that have indefinite useful lives, are overstated.

Retirement and disposals

An intangible asset should be derecognised either –

- on disposal (that can either be a sale or by entering into a lease or by donation); or
- when no future economic benefits are expected from its use or disposal.

The gain or loss that arises on derecognition should be determined as the difference between net disposal proceeds, if any, and the carrying amount of the asset. The gain should not be classified as revenue but should be recognised as other income in profit or loss.

Amortisation of an intangible asset with finite useful life does not cease when the asset is no longer used. It however ceases, if the asset is fully amortised or is classified as held for sale in accordance with Ind AS 105.

The amount of consideration to be included in the gain or loss arising from the derecognition of an intangible asset is determined in accordance with the requirements for determining the transaction price in Revenue from Contracts with customers and shall not exceed the amount to which the entity is reasonably assured to be entitled in accordance

with Revenue from Contracts with customers. Subsequent change to the estimated amount of consideration that is reasonably assured shall be recognisedas a gain or loss in the period of the change in accordance with Ind AS8.

Example 1

A customer list is a customer-related intangible asset. It consists of information about customers, such as their names and contact information. A customer list may also be in the form of a database that includes other information about the customers, such as their order histories and demographic information. A customer list does not usually arise from contractual or other legal rights. However, customer lists are often leased or exchanged.

A direct-mail marketing company acquires a customer list and expects that it will be able to derive benefit from the information on the list for at least 1 year, but no more than 3 years.

The customer list would be amortised over management's best estimate of its useful life, say 18 months. Although the direct-mail marketing company may intend to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date it was acquired. The customer list also would be reviewed for impairment by assessing at the end of each reporting period whether there is any indication that the customer list may be impaired.

Example 2

Patented-technology

A patent is a technology-based intangible asset. It is an exclusive right to use a technology for alimited period of time in exchange for a public disclosure of an invention. It is usually granted by the jurisdiction of the land to an entity for its invention as an appreciation of its efforts.

Unpatented-technology

As the name suggests, unpatented-technology are those technologies or devices that are not protected by a patent or copyright. They are generally non-proprietary products that are available in the public domain and anyone can use or distribute them. Since they are unpatented, they are beyond the control of an entity.

An entity acquires patent that expires in 15 years. The product protected by the patented technology is expected to be a source of net cash inflows for at least 15 years. The entity has a commitment from a third party to purchase that patent in 5 years for 60% of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in 5 years.

The patent would be amortised over its 5-year useful life to the entity, with a residual value equal to the present value of 60% of the patent's fair value at the date it was acquired. The patent would also be reviewed for impairment by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example 3

A copyright is an artistic-related intangible asset. It is a set of exclusive rights granted by the jurisdiction to an author or creator of an original work, to copy, distribute and adapt the work. Copyright initially was used only in reference to books, but it covers a huge spectrum, such as photographs, paintings, musical works (such as composition, song lyrics, advertising jingles etc.), films, sculptures, plays, operas etc.

An entity acquires copyright that has a remaining legal life of 50 years. An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.

The copyright would be amortised over its 30-year estimated useful life. The copyright also would be reviewed for impairment by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example 4

A broadcasting right is a contract-based intangible asset. Broadcasting rights are the contractual rights that limit the footage of an event.These rights are acquired to showcase a play or movie or sports event on television, radio or any other broad-casting media.

An entity acquires broadcasting licence that expires in 5 years. The broadcasting licence is renewable every 10 years if the entity provides at least an average level of service to its customers and complies with the relevant legislative requirements.The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition. The acquiring entity intends to renew the licence indefinitely and evidence supports

its ability to do so. Historically, there has been no compelling challenge to the licence renewal. The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future.Therefore, the licence is expected to contribute to the entity's net cash in flows indefinitely.

The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity's net cash inflows indefinitely. Therefore, the licence would not be amortised until its useful life is determined to be finite.The licence would be tested for impairment annually and whenever there is an indication that it may beimpaired.

The licensing authority subsequently decides that it will no longer renew broadcasting licences, but rather will auction the licences. At the time the licensing authority's decision is made, the entity's broadcasting licence has 3 years until it expires. The entity expects that the licence will continue to contribute to net cash inflows until the licence expires.

Because the broadcasting licence can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired licence would be amortised over its remaining 3-year useful life and immediately tested for impairment.

Example 5

An entity acquires airline route authority between two cities that expires in 3 years. The route authority may be renewed every 5 years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals are routinely granted at a minimal cost and historically have been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service indefinitely between the 2 cities from its hub airports and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. Ananalysis of demand and cash flows supports those assumptions.

Because the facts and circumstances support the acquiring entity's ability to continue providing air service indefinitely between the 2 cities, the intangible asset related to the route authority is treated as having an indefinite useful life. Therefore, the route authority would not be amortised until its useful life is determined to be finite. It would be tested for impairment annually and whenever there is an indication that it may be impaired.

Example 6

A trademark is a marketing-related intangible asset. Trademarks are words, names, symbols or other devices used in business to indicate the source of a product and to distinguish it from the products of otherentities.

An entity acquires trademark used to identify and distinguish a leading consumer product that has been a market-share leader for the last 8 years.The trade mark has a remaining legal life of 5 years but is renewable every 10 years at little cost. The acquiring entity intends to renew the trademark continuously and evidence supports its ability to do so. An analysis of –

- product life cycle studies,
- market, competitive and environmental trends; and
- brand extension opportunities

provide evidence that the trade marked product will generate net cash inflows for the acquiring entity for an indefinite period.

The trademark would be treated as having an indefinite useful life because it is expected to contribute to net cash inflows indefinitely. Therefore, the trademark would not be amortised until its useful life is determined to be finite. It would be tested for impairment annually and whenever there is an indication that it may be impaired.

Example 7

An entity acquired trademark 10 years ago that distinguishes a leading consumer product. The trademark was regarded as having an indefinite useful life when it was acquired because the trade marked product was expected to generate net cash inflows indefinitely. However, unexpected competition has recently entered the market and will reduce future sales of the product. Management estimates that net cash inflows generated by the product will be 20% less for the foreseeable future. However, management expects that the product will continue to generate net cash inflows indefinitely at those reduced amounts.

As a result of the projected decrease in future net cash inflows, the entity determines that the estimated recoverable amount of the trademark is less than its carrying amount, and an impairment loss is recognised. Because it is still regarded as having an indefinite useful life, the trade mark would continue not to be amortised but would be tested for impairment annually and whenever there is an indication that it may be impaired.

Example 8

The following areexamples of some research and development activities:

- Research phase–
  - Activity aimed to obtain new knowledge.
  - Search for, evaluation and final selection of, applications of research findings or otherknowledge.
  - Search for alternatives for materials, devices, products, processes, systems or services.
  - Formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.
- Development phase–
  - Design, construction and testing of pre-production or pre-use prototypes or models.
  - Design of tools, jigs, moulds and dies involving new technology.
  - Design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.
  - Design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

In the development phase, an intangible asset is recognised, provided all the following criteria are satisfied :

- Technical feasibilitycompleted;
- Intention to complete the intangible asset and use or sell it;
- Entity's ability to use or sell the intangible asset;
- Existenceofanactivemarket,ifitcanbesoldorusefulness,ifusedinternally;
- Availability of adequate technical, financial and other resources to complete the intangible asset and use or sell it;
- Ability to measure reliably the expenditure attributable to the intangible asset during itsdevelopment.

Example 9

An entity (whose reporting period is calendar year) is developing a new production process. During 2011, expenditure incurred was 100, of which 90 was incurred before 1 December 2011 and 10 was incurred between 1 December 2011 and 31 December 2011.

The entity is able to demonstrate that, at 1 December 2011, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be 50.

At the end of 2011, the production process is recognised as an intangible asset at a cost of 10 (expenditure incurred since the date when the recognition criteria were met, i.e., 1 December 2011). The 90 expenditure incurred before 1 December 2011 is recognised as an expense because the recognition criteria were not met until 1 December 2011. This expenditure does not form part of the cost of the production process recognised in the Balance Sheet.

During 2012, expenditure incurred is 200. At the end of 2012, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be 190.

At the end of 2012, the cost of the production process is 210 (10 expenditure recognised at the end of 2011 plus 200 expenditure recognised in 2012). The entity recognises an impairment loss of 20 to adjust the carrying amount of the process before impairment loss (210) to its recoverable amount (190). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Ind AS 36 are met.

Example 10

Profit before amortisation – year 1 and 2 : 100 per year; year 3 : 90; and year 4 and 5 : 80 per year. Intangible asset 100, Amortisation (SLM) : Financial 20%, Tax 20%. Recoverable amount 20 at the end of year 3. Income tax rate 40%.

Statement of Profit and Loss

Year	1		2		3		4		5	
Profit before amortisation		100		100		90		80		80
Amortisation	20		20		20		10		10	
Impairment	–	20	–	20	20	40	–	10	–	10
Accounting Profit		80		80		50		70		70
Tax expense –										
Current tax	32		32		28		24		24	
Deferred tax (income) / asset	–	32	–	32	(8)	20	4	28	4	28
Profit for the Period		48		48		30		42		42

Workings **Current Tax**

Year	1 to 2	3	4 to 5
Profit before amortisation	100	90	80
Amortisation allowed	20	20	20
Taxable Profit	80	70	60
Current Tax @ 40%	32	28	24

Deferred Tax Asset

Year	3	4	5
Opening balance	–	8	4
Created through profit or loss	8	–	–
Reversed through profit or loss	–	(4)	(4)
Closing Balance	8	4	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated amortisation and impairment	20	40	80	90	100
Carrying Amount	80	60	20	10	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Amortisation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 11

Profit before amortisation – year 1 : 100; year 2 : 95; and year 3, 4 and 5 : 85 per year. Intangible asset 100, Amortisation (SLM) : Financial 20%, Tax 25%. Recoverable amount 45 at the end of year 2. Income tax rate 40%.

Statement of Profit and Loss

Year	1		2		3		4		5	
Profit before amortisation		100		95		85		85		85
Amortisation	20		20		15		15		15	
Impairment	–	20	15	35	–	15	–	15	–	15
Accounting Profit		80		60		70		70		70
Tax expense –										
Current tax	30		28		24		24		34	
Deferred tax expense / (liability)	2		(2)		2		4		(6)	
Deferred tax (income) / asset	–	32	(2)	24	2	28	–	28	–	28
Profit for the Period		48		36		42		42		42

Workings **Current Tax**

Year	1	2	3 and 4	5
Profit before amortisation	100	95	85	85
Amortisation allowed	25	25	25	–
Taxable Profit	75	70	60	85
Current Tax @ 40%	30	28	24	34

Deferred Tax Liability / Asset

Year	1		2		3		4		5	
Deferred tax	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset
Opening balance	–	–	2	–	–	2	2	–	6	–
Created	2	–	–	2	2	–	4	–	–	–
Reversed	–	–	(2)	–	–	(2)	–	–	(6)	–
Closing Balance	2	–	–	2	2	–	6	–	–	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated amortisation and impairment	20	55	70	85	100
Carrying Amount	80	45	30	15	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Amortisation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 12

Profit before amortisation – year 1 : 100, year 2 and 3 : 85 per year, year 4 and 5 : 95 per year. Intangible asset 100, Amortisation (SLM) : Financial 20%, Tax 25%. Recoverable amount : 45 at the end of year 2; 40 at the end of year 3. Income tax rate 40%.

Statement of Profit andLoss

Year	1		2		3		4		5	
Profit before amortisation		100		85		85		95		95
Amortisation	20		20		15		20		20	
Impairment	–	20	15	35	10	5	–	20	–	20
Accounting Profit		80		50		80		75		75
Tax expense –										
Current tax	30		24		24		28		38	
Deferred tax expense / (liability)	2		(2)		6		2		(8)	
Deferred tax (income) / asset	–	32	(2)	20	2	32	–	30	–	30
Profit for the Period		48		30		48		45		45

Workings **Current Tax**

Year	1	2 and 3	4	5
Profit before amortisation	100	85	95	95
Amortisation allowed	25	25	25	–
Taxable Profit	75	60	70	95
Current Tax @ 40%	30	24	28	38

Deferred Tax Liability / Asset

Year	1		2		3		4		5	
Deferred tax	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset
Opening balance	–	–	2	–	–	2	6	–	8	–
Created	2	–	–	2	6	–	2	–	–	–
Reversed	–	–	(2)	–	–	(2)	–	–	(8)	–
Closing Balance	2	–	–	2	6	–	8	–	–	–

Carrying Amount of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Accumulated amortisation and impairment	20	55	60	80	100
Carrying Amount	80	45	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Amortisation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 13

Profit before amortisation – year 1 : 100, year 2 : 90, year 3 and 4 : 80 per year. Intangible asset 100. Amortisation (SLM) : Financial 20%, Tax 25%. Recoverable amount 40 at the end of year 2 when life is reduced to 4 years. Income tax rate 40%.

Statement of Profit and Loss

Year	1		2		3		4	
Profit before amortisation		100		90		80		80
Amortisation	20		20		20		20	
Impairment	–	20	20	40	–	20	–	20
Accounting Profit		80		50		60		60
Tax expense –								
Current tax	30		26		22		22	
Deferred tax expense / (liability)	2		(2)		–		–	
Deferred tax (income) / asset	–	32	(4)	20	2	24	2	24
Profit for the Period		48		30		36		36

Workings **Current Tax**

Year	1	2	3 and 4
Profit before amortisation	100	90	80
Amortisation allowed	25	25	25
Taxable Profit	75	65	55
Current Tax @ 40%	30	26	22

Deferred Tax Liability / Asset

Year	1		2		3		4	
Deferred tax	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset
Opening balance	–	–	2	–	–	4	–	2
Created	2	–	–	4	–	–	–	–
Reversed	–	–	(2)	–	–	(2)	–	(2)
Closing Balance	2	–	–	4	–	2	–	–

Carrying Amount of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Accumulated amortisation and impairment	20	60	80	100
Carrying Amount	80	40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Amortisation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 14

Profit before amortisation – year 1 : 100, year 2 to 5 : 125 per year. Intangible asset 100, Amortisation (SLM) : Financial 20%, Tax 20%. Fair value 100 at the end of year 1. Income tax rate 40%.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before amortisation	100	125	125	125	125
Amortisation	20	25	25	25	25
Accounting Profit	80	100	100	100	100
Tax expense –					
Current tax	30	42	42	42	42
Deferred tax liability	– 32	(2) 40	(2) 40	(2) 40	(2) 40
Profit for the Period	48	60	60	60	60
Other comprehensive income					
Revaluation surplus (net of tax)	12	–	–	–	–
Total comprehensive income	60	60	60	60	60

Statement of Changes in Equity

Year	1	2	3	4	5
Revaluation surplus					
Opening balance	–	12	9	6	3
Created through Other comprehensive income	12	–	–	–	–
Transferred to retained earnings	–	(3)	(3)	(3)	(3)
Closing Balance	12	9	6	3	–

Workings **Current Tax**

Year	1	2 to 5
Profit before amortisation	100	125
Amortisation allowed	20	20
Taxable Profit	80	105
Current Tax @ 40%	32	42

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	8	6	4	2
Created through other comprehensive income	8	–	–	–	–
Reversed through profit or loss	–	(2)	(2)	(2)	(2)
Closing balance	8	6	4	2	–

Carrying Amount of the Asset

Restated proportionately

Year	1			2	3	4	5
			Revaluation increase				
Gross block	100	→	125	125	125	125	125
Accumulated amortisation	20	→	25	50	75	100	125
Carrying Amount	80	→	100	75	50	25	–

Eliminated against gross carrying amount

Year	1			2	3	4	5
			Revaluation increase				
Gross block	100	→	100	100	100	100	100
Accumulated amortisation	20	→	–	25	50	75	100
Carrying Amount	80	→	100	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Amortisation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Example 15

Profit before amortisation – year 1 : 100, year 2 to 5 : 125 per year. Intangible asset 100.Amortisation (SLM) – Financial 20%, Tax 25%. Fair value 100 at the end of year 1. Income tax rate 40%.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before amortisation	100	125	125	125	125
Amortisation	20	25	25	25	25
Accounting Profit	80	100	100	100	100
Tax expense –					
Current tax	30	40	40	40	50
Deferred tax expense / (liability)	2 32	– 40	– 40	– 40	(10) 40
Profit for the Period	48	60	60	60	60
Other comprehensive income					
Revaluation surplus (net of tax)	12	–	–	–	–
Total comprehensive income	60	60	60	60	60

Statement of Changes in Equity

Year	1	2	3	4	5
Revaluation surplus					
Opening balance	–	12	9	6	3
Created through Other comprehensive income	12	–	–	–	–
Transferred to retained earnings	–	(3)	(3)	(3)	(3)
Closing Balance	12	9	6	3	–

Workings **Current Tax**

Year	1	2 to 4	5
Profit before amortisation	100	125	125
Amortisation allowed	25	25	–
Taxable Profit	75	100	125
Current Tax @ 40%	30	40	50

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	10	10	10	10
Created through –					
profit or loss	2	–	–	–	–
other comprehensive income	8	–	–	–	–
Reversed through profit or loss	–	–	–	–	(10)
Closing balance	10	10	10	10	–

Carrying Amount of the Asset

Restated proportionately

Year	1		2	3	4	5
		Revaluation increase				
Gross block	100 →	125	125	125	125	125
Accumulated amortisation	20 →	25	50	75	100	125
Carrying Amount	80 →	100	75	50	25	–

Eliminated against gross carrying amount

Year	1		2	3	4	5
		Revaluation increase				
Gross block	100 →	100	100	100	100	100
Accumulated amortisation	20 →	–	25	50	75	100
Carrying Amount	80 →	100	75	50	25	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Amortisation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 16

Profit before amortisation – year 1 : 100, year 2 and 3 : 125 per year, year 4 and 5 : 130 per year. Intangible asset 100.Amortisation (SLM) – Financial 20%, Tax 25%. Fair value 100 at the end of year 1 and 60 at the end of year 3. Income tax rate 40%.

Statement of Profit and Loss and Other Comprehensive Income

Year	1		2		3		4		5	
Profit before amortisation	100		125		125		130		130	
Amortisation	20		25		25		30		30	
Accounting Profit	80		100		100		100		100	
Tax expense –										
Current tax	30		40		40		42		52	
Deferred tax expense / (liability)	2	32	–	40	–	40	(2)	40	(12)	40
Profit for the Period	48		60		60		60		60	
Other comprehensive income										
Revaluation surplus (net of tax)	12		–		6		–		–	
Total comprehensive income	60		60		66		60		60	

Statement of Changes in Equity

Year	1	2	3	4	5
Revaluation surplus					
Opening balance	–	12	9	12	6
Created through Other comprehensive income	12	–	6	–	–
Transferred to retained earnings	–	(3)	(3)	(6)	(6)
Closing Balance	12	9	12	6	–

Workings **Current Tax**

Year	1	2 and 3	4	5
Profit before amortisation	100	125	130	130
Amortisation allowed	25	25	25	–
Taxable Profit	75	100	105	130
Current Tax @ 40%	30	40	42	52

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	10	10	14	12
Created through –					
profit or loss	2	–	–	–	–
other comprehensive income	8	–	4	–	–
Reversed through profit or loss	–	–	–	(2)	(2)
Closing balance	10	10	14	12	–

Carrying Amount of the Asset

Restated proportionately

Year	1		2	3		4	5
		Revaluation increase			Revaluation increase		
Gross block	100	→ 125	125	125	→ 150	150	150
Accumulated amortisation	20	→ 25	50	75	→ 90	120	150
Carrying Amount	80	→ 100	75	50	→ 60	30	–

Eliminated against gross carrying amount

Year	1		2	3		4	5
		Revaluation increase			Revaluation increase		
Gross block	100	→ 100	100	100	→ 60	60	60
Accumulated amortisation	20	→ –	25	50	→ –	30	60
Carrying Amount	80	→ 100	75	50	→ 60	30	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Amortisation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 17

Profit before amortisation – year 1 : 100, year 2 and 3 : 110 per year, year 4 and 5 : 95 per year. Intangible asset 100.Amortisation (SLM) – Financial 20%, Tax 25%. Fair value : 100 at the end of year 1, 40 at the end of year 3. Income tax rate 40%.

Statement of Profit and Loss and Other Comprehensive Income

Year	1		2		3		4		5	
Profit before amortisation		100		110		110		95		95
Amortisation		20		25		25		20		20
Accounting Profit		80		85		85		75		75
Tax expense –										
Current tax	30		34		34		28		38	
Deferred tax liability	2	32	–	34	–	34	2	30	(8)	30
Profit for the Period		48		51		51		45		45
Other comprehensive income										
Revaluation surplus (net of tax)		12		–		(6)		–		–
Total comprehensive income		60		51		45		45		45

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	12	9
Created through Other comprehensive income	12	–	–
Transferred to retained earnings	–	(3)	(3)
Reversed	–	–	(6)
Closing Balance	12	9	–

Workings **Current Tax**

Year	1	2 and 3	4	5
Profit before amortisation	100	110	95	95
Amortisation allowed	25	25	25	–
Taxable Profit	75	85	70	95
Current Tax @ 40%	30	34	28	38

Deferred Tax Liability

Year	1	2	3	4	5
Opening balance	–	10	10	6	8
Created through –					
profit and loss	2	–	–	2	–
other comprehensive income	8	–	–	–	–
Reversed through –					
profit and loss	–	–	–	–	(8)
other comprehensive income	–	–	(4)	–	–
Closing balance	10	10	6	8	–

Carrying Amount of the Asset

Restated proportionately

Year	1 Revaluation increase	2	3 Revaluation decrease	4	5
Gross block	100 → 125	125	125 → 100	100	100
Accumulated amortisation	20 → 25	50	75 → 60	80	100
Carrying Amount	80 → 100	75	50 → 40	20	–

Eliminated against gross carrying amount

Year	1 Revaluation increase	2	3 Revaluation decrease	4	5
Gross block	100 → 100	100	100 → 40	40	40
Accumulated amortisation	20 → –	25	50 → –	20	40
Carrying Amount	80 → 100	75	50 → 40	20	–

Tax Base of the Asset

Year	1	2	3	4
Gross block	100	100	100	100
Amortisation allowed	25	50	75	100
Tax Base	75	50	25	–

Example 18

Profit before amortisation – year 1 : 100, year 2 and 3 : 110 per year, year 4 and 5 : 90 per year. Intangible asset 100, Amortisation (SLM) – Financial 25%, Tax 20%.Fair value 90 at the end of year 1.Recoverable amount 20 at the end of year 3. Income tax rate 40%.

Statement of Profit and Loss and Other Comprehensive Income

Year	1	2	3	4	5
Profit before amortisation	100	110	110	90	90
Amortisation	25	30	30	20	–
Accounting Profit	75	80	80	70	90
Tax expense –					
Current tax	32	36	36	28	28
Deferred tax (income) / asset	(2)	(2)	(4)	–	8
Deferred tax liability	– 30	(2) 32	– 32	– 28	– 36
Profit for the Period	45	48	48	42	54
Other comprehensive income					
Revaluation surplus (net of tax)	9	–	(6)	–	–
Total comprehensive income	54	48	42	42	54

Statement of Changes in Equity

Year	1	2	3
Revaluation surplus			
Opening balance	–	9	6
Created through Other comprehensive income	9	–	–
Transferred to retained earnings	–	(3)	–
Reversed	–	–	(6)
Closing Balance	9	6	–

Workings **Current Tax**

Year	1	2 and 3	4 and 5
Profit before amortisation	100	110	90
Amortisation allowed	20	20	20
Taxable Profit	80	90	70
Current Tax @ 40%	32	36	28

Deferred Tax Asset / Liability

Year	1		2		3		4		5	
Deferred tax	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
Opening balance	–	–	2	6	4	4	8	–	8	–
Created through –										
profit and loss	2	–	2	–	4	–	–	–	–	–
other comprehensive income	–	6	–	–	–	–	–	–	–	–
Reversed through –										
profit and loss	–	–	–	(2)	–	–	–	–	(8)	–
other comprehensive income	–	–	–	–	–	(4)	–	–	–	–
Closing Balance	2	6	4	4	8	–	8	–	–	–

Carrying Amount of the Asset

Restated proportionately					
Year	1	Revaluation increase	2	3	Revaluation decrease	4
Gross block	100	→ 120	120	120	→ 80	80
Accumulated amortisation	25	→ 30	60	90	→ 60	80
Carrying Amount	75	→ 90	60	30	→ 20	–
Eliminated against gross carrying amount						
Year	1	Revaluation increase	2	3	Revaluation decrease	4
Gross block	100	→ 90	90	90	→ 20	20
Accumulated amortisation	25	→ –	30	60	→ –	20
Carrying Amount	75	→ 90	60	30	→ 20	–

Tax Base of the Asset

Year	1	2	3	4	5
Gross block	100	100	100	100	100
Amortisation allowed	20	40	60	80	100
Tax Base	80	60	40	20	–

Borrowing Costs (Ind AS 23)

Introduction

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. When interest is paid on funds borrowed to finance the construction of an asset, which takes significant time to complete, it is capitalised, that is, treated as part of the cost of acquiring the asset, until such time that the asset comes into productive use. The objectives of capitalising borrowing costs are to –

- obtain a measure of acquisition cost that reflects the entity's total investment in the asset;and
- charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the periodsbenefitted.

This standard provides two treatments for borrowing costs. Borrowing costs, which can be directly allocated to the acquisition, construction or production of a qualifying asset, become a part of the total cost of that asset whereas other borrowing costs are treated as expenses.

This standard clearly spells out that an entity is not required or rather compelled to apply this Standard to borrowings costs that are directly attributable to the acquisition, construction or production of –

- a qualifying asset measured at fair value, eg, a biological asset; or
- inventories that are manufactured / produced, in large quantities on a repetitive basis.

The expression not required in the above paragraph hints on a choice factor provided to the entity regarding the application of this standard. We will take up this later in this chapter.

The standard also clarifies that borrowing costs do not include the actual or imputed cost of equity, such as preference shares (ie, classified as equity), it only applies to external borrowing. If preference shares are classified as liability, which may be the case as per the provisions of IndAS 32 Financial Instruments : Presentation, then servicing that liability for construction or acquisition of a qualifying asset would fall within this Standardand need to be capitalised as part of the cost of that asset.

Example 1

ABC Ltd began construction of a power generation plant. The construction will take 3 years. The cost of construction is financed with issuances of 12% debentures of 1,000 as well as 1,000 equity shares. The debentures and the equity shares were issued at the beginning of the construction. The cost of issuance of debentures is 3% and that of equity is 5%. The imputed cost of share capital is 15%. The approach that ABC Ltd should follow is–

- construction of power generation plant is a qualifying asset because it would take 3 years to get ready for its intended use; and
- it is not outside the scope of this Standard.

Therefore, ABC Ltd will capitalise its borrowing cost related to the construction of the power plant. The borrowing cost will be capitalised for the 3 years of construction. Each year 2 parts of borrowing cost will be capitalised, i.e., added to the cost of the asset.

Part 1 Interest expense per year on Debentures (12% of 1,000) = 120

Part 2 Issuance cost distributed over a period of 3 years (3% of 1,000) ÷3 = 10

Total borrowing cost capitalised each year for the next 3 years 120 + 10 = 130

The cost of equity should not be included in borrowing cost because it is the owners' money invested in business and not part of external borrowing.

Borrowing costs not only includes interest cost on short term borrowings such as bank overdrafts or long term borrowings such as term loans, but also other associated costs involved with external borrowing such as issuance cost involved in arrangement of borrowing and other ancillary costs. Thus, borrowing costs include –

- Interest expense calculated using effective interestmethod;
- Exchange differences arising from foreign currency borrowing to the extent they are regarded as an adjustment to interest costs;and

- Finance charge in respect of finance leases.

Borrowing costs particularly in relation with interest expense calculated using effective interest method, takes into account 3 parts –

- Interest expense from external borrowings;
- Amortisation of discounts or premiums relating to borrowings; and
- Amortisation of ancillary costs.

Example 2

ABC Ltd has issued 12% debentures of 1,000 for a period of 5 years at a discount of 5% for constructing a qualifying asset. The issuance cost of debentures is 2%. The asset will take 2 years before it is ready for use.

Year		Cash flows			Total
		Issuance Cost	Discount	Interest	
0		20	50	0	70
1		0	0	120	120
2		0	0	120	120
3		0	0	120	120
4		0	0	120	120
5		0	0	120	120
	Total borrowing cost				**670**

- The issuance cost related to the debentures is 20.
- The debentures are issued at a discount which means the initial discount of 50 is also a cost related to the borrowing.
- The interest expense each year amounts to 120.

Therefore, the total borrowing cost over 5 years is 670 (including ancillary cost as well initial discount provided). The effective interest rate is [(670 ÷5) ÷1,000] x 100 = 13.40%.

Till year 2, the borrowing cost will be capitalised @ 13.40% and, thereafter, it will be expensed in Statement of Profit and Loss at the same effective interest rate.

Example 3

Let us take the previous example. The only difference is that the debentures are issued at a premium of 5%.

Year		Cash flows			Total
		Issuance Cost	Premium	Interest	
0		20	-50	0	(30)
1		0	0	120	120
2		0	0	120	120
3		0	0	120	120
4		0	0	120	120
5		0	0	120	120
	Total borrowing cost				**570**

By issuing debentures, there is a gain of 50, which is adjusted against the borrowing costs.

In this case, the total borrowing cost becomes 570 and the effective rate of interest is [(570 ÷5) ÷1,000] x 100 = 11.42%.

Till year 2, the borrowing cost will be capitalised at the rate of 11.42% and, thereafter, it will be expensed in Statement of Profit and Loss at the same effective interest rate.

This standard includes in borrowing costs, exchange differences (for foreign currency borrowing) to the extent they are regarded as an adjustment to interest costs. It is, therefore, very important for an entity to determine the extent to which exchange differences on these borrowings can be capitalised. The adjustment should be as following –

- It should be of an amount which is equivalent to the extent to which the exchange loss does not exceed the difference between the cost of borrowing in functional currency when compared to the cost of borrowing in a foreign currency.

Example 4

ABC Ltd is located in India and its functional currency is C. The borrowing rate for ABC Ltd in India is 11%. ABC Ltd decided to borrow from USA where the cost of borrowing is 2% annually. It borrowed $ 100 at the beginning of the year for a project that would take 3 years to construct. The exchange rate on the date when the loan was taken was $ 1 = C 55.

Carrying amount of the liability at the beginning = $ 100 x C 50 per $ = C 5,000 At the end of year 1,

Interest to be paid = $ 100 x 2% x C 55 per $ = C 110 Carrying amount of liability = $ 100 x C 55 per $ = C 5,500 Therefore, increase in liability = C 5,500 – C 5,000 = C 500

If ABC Ltd had taken the loan in its own country, the interest expense would have been = $ 100 x 50 x 11% = C 550.

In this case, the total exchange loss is C 500, out of that the difference between the cost of borrowing in functional currency and in a foreign currency (C 550 – C 110) C 440 is treated as an adjustment for borrowing cost and the remaining C 500 – C 440 = C 60 is treated as exchange difference as per Ind AS 21.

- When there is an unrealised exchange loss which is treated as an adjustment to interest and subsequently there is a realised or unrealised gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognised as an adjustment should also be recognised as an adjustment to interest.

Lease is like any other external borrowing arrangement including a principal amount as well as the interest expense (the finance charge). The lease rental in case of a lease is, therefore, divided into two parts — finance charge and principal repayment. Therefore, its treatment according to this standard is similar to any other external borrowing.

A **qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.This standard has not defined the expression substantial period of time. Therefore, a period of 12 months can be considered unless, shorter or longer period can be justified on the basis of facts and circumstances. Management judgment requires special consideration at this point. Similarly, the term intended also stresses on the management's intention of whether an asset is a qualifying asset or not.

Example 5

XYZ Ltd acquires a piece of land, which the company intends to develop into an office building. The land can also be sold at a higher price, where XYZ Ltd can make huge profits. Assessing whether the asset is a qualifying asset or not, management's intention should be given prior importance compared to the other usage available. Thus, the land is a qualifying asset because the management intends to develop an office building over substantial period of time.

The following may be qualifying assets :

- Inventories;
- Manufacturing plants;
- Power generation facilities;
- Intangible assets;
- Investment properties.

The following cannot be qualifying assets :

- Financial assets;
- Assetsthatarereadyfortheirintendeduseorsalewhenacquired;
- Inventories that are manufactured or produced over a short period of time.

Inventories require a special mention due to certain complexities in classifying them as qualifying assets. The standard identifies limited circumstances where borrowing costs are included in the cost of inventories. Inventories which are non-standardised (non-repetitive) and require a substantial period of time to produce, can be qualifying assets (such as customised aircraft, construction of bridges and dams). The standard has excluded inventories that are manufactured in large quantities on a repetitive basis because of the difficulty in both allocating borrowing costs to inventories and monitoring those borrowing costs until the inventory is sold.

Example 6

ABC Ltd produces wine. The production of grapes and the conversion of grapes into wine takes considerable period of time. Such assets, therefore, qualify for exemption and the borrowing cost related to the inventories is, therefore, eligible for the choice. The management must choose whether to capitalise borrowing costs or not.

Example 7

ABC Ltd has an owner occupied asset under construction as a qualifying asset and the company follows revaluation model as per IndAS 16. The cost of construction incurred is 700 and borrowing cost is 50. The fair value of the asset still under construction is found to be 1,000. The share capital is 200, borrowing is 500 and revenue for the year is 1,000. The income tax rate is 30%. Since the company has an accounting policy choice as per this standard, it decides not to capitalise borrowing cost.

Statement of Profit and Loss and Other Comprehensive Income

Revenue		1,000
Interest expense		50
Accounting profit		950
Tax expense – Current tax	285	
Deferred tax	–	285
Profit for the Year		665
Other Comprehensive Income		
Revaluation Surplus (Net of tax)		*210
Total Comprehensive Income		875

* [(1,000 – 700) ×70%]

Balance Sheet

Assets		
Non-current		
Property, plant and equipment	1,000	
Add: Borrowing cost	0	1,000
Current		
Cash		*665
Total assets		1,665
Equity and Liabilities		
Equity		
Share capital		200
Retained earning		665
Revaluation Surplus		210
Total equity		1,075
Liabilities		
Non-current		
Borrowing		500
Deferred tax liabilities – 30% of (1,000 – 700)		90
Total equity and liabilities		1,665

* Cash = Revenue – Interest expense – Current tax = 1,000 – 50 – 285 = 665

Example 8

Let us continue with the previous example. The only difference is that ABC Ltd decides to capitalise the borrowing costs. In such a case, the cost of construction and borrowing cost together give the carrying amount of the asset, ie, 700+50 = 750. There will be no charge of borrowing cost in Statement of Profit and Loss. The fair value of the asset is 1,000, same as before and the total cost of the asset under construction (including borrowing cost) is 750. Therefore, the revaluation of the asset will be at 250 (1,000 – 750).

Statement of Profit and Loss and Other Comprehensive Income

Revenue		1,000
Interest expense		0
Accounting Income		1,000
Tax expense –		
Current tax (30% of 950)	285	
Deferred tax expense (30% of 50)	15	300
Profit for the Year		700
Other Comprehensive Income		
Revaluation Surplus (Net of tax)		175
Total Comprehensive Income for the year		875

Balance Sheet

Assets		
Non-current		
Property, plant and equipment	950	
Add: Borrowing cost	50	1,000
Current		
Cash		665
Total assets		1,665
Equity and Liabilities		
Equity		
Share capital		200
Retained earning		700
Revaluation Surplus		175
Total equity		1,075
Liabilities		
Non-current		
Borrowing		500
Deferred tax liabilities (15 ÷ 75)		90
		1,665

Recognition

This Standard prescribes two treatments for borrowing cost –

- Capitalise

  Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of the asset.

- Expense

  Other borrowing costs in the period incurred.

An entity can capitalise its borrowing cost that is directly attributable to the acquisition, construction or production of a qualifying asset, provided the following two criteria are satisfied –

- It is probable that they will result in future economic benefits; and

- The costs can be measured reliably.

Capitalisation of Borrowing costs

The expression directly attributable gives emphasis to the fact that those borrowing costs could have been avoided if the expenditure on the qualifying asset had not been made. When an entity takes a specific loan for a specific qualifying asset it is simple to track the borrowing cost. The difficulty arises when it is hard to track the direct relationship between several borrowings and a qualifying asset. This is a very common problem faced particularly by entities which have a centralised financing activity, ie, borrowing and funding centrally. An entity may be using debentures at different interest rates with different time periods and those funds may be used for various purposes of other entities in a group. Further, if foreign currency loans are taken, the currency fluctuations also need to be adjusted to the borrowing costs. Thus, it is necessary is to differentiate between specific and general borrowings. Specific borrowings are borrowings for a specific asset and, therefore, can be easily identified.

Example 9

ABC Ltd has taken a bank loan for the purpose of building a dam. The dam will take 2 years to build and the total capital required for the project is estimated to be 1,000. ABC Ltd borrowed 1,000 at 15% for 5 years. This is a specific borrowing.

If an entity borrows funds for a specific purpose, it measures the borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income earned on the temporary investment of those borrowings.

Example 10

ABC Ltd has issued bonds for acquisition of a specific qualifying asset. The full amount raised is not required immediately and, therefore, the excess money is invested temporarily in a fixed deposit. This investment income earned need to be deducted while measuring the borrowing cost that will be capitalised.

Example 11

XYZ Ltd is constructing a qualifying asset. The estimated cost of the asset is 20 and the period of construction is 3 years. The company makes specific borrowings for this project from different sources with varying interest rates and different tenure. As per the project planning, excess funds would be invested in securities.

Total cost of construction		20	
Period of construction (years)		3	
Specific Borrowing	**Amount**	**Interest**	**Tenure (years)**
Bank term loan	5	7%	5
Corporate borrowings	5	8%	5
Debentures	10	9%	10
Excess Funds Invested			
Year 1	10	6%	1
Year 2	5	6.5%	1

Total borrowing is 20.

Weighted average cost of funds is determined by

= [{(5 x 7%) + (5 x 8%) + (10 x 9%)} ÷(5 + 5 + 10)] x 100 = 8.25%.

Borrowing cost per year = 20 x 8.25% = 1.65

Excess fund was invested in securities. Therefore, the investment income earned :

Year 1 (10 x 6%)=0.60 **Year 2** (5 x 6.5%) =0.325

These are deducted from the total borrowing cost. Borrowing cost eligible for capitalisation –

Year 1 1.65 – 0.60=1.05 **Year 2** 1.65 – 0.325=1.325 **Year 3** 1.65

An entity should keep it in mind that the amount of borrowing cost capitalised should not exceed the amount of borrowing costs incurred during that period.

Example 12

ABC Ltd is constructing a factory in the backward area. The Government has provided ABC Ltd a loan of 1,000 at 5% interest when the market interest rate was 12%. Though the effective interest rate is 12%, only 50 (1,000 x 5%) can be capitalised.

Often expenditure on a qualifying asset does not take place at one time — it occurs in phases or in bits and pieces. Therefore, a detailed calculation of the expenditure needs to be done to take into account the timing of the expenditure during the period. The complexity increases in companies where the financing activity is coordinated centrally, ie, where a group borrows funds generally and uses them for the purpose of obtaining qualifying assets for other entities within the group.

In such cases, an entity should determine the amount of borrowing costs eligible for capitalisation by using a capitalisation rate to the expenditure on that asset. The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

Example 13

ABC Ltd is constructing a qualifying asset funded by general borrowings. The reporting date is 31 March 2013. The capital outlay in the first year is:

Expenditure on the qualifying Asset

2012	Amount
1 April	1,000
6 September	1,000
1 December	1,000

General borrowings during that period are :

Sl. No.	General Borrowings	Amount	Rate	Period
1	Bank loan	10,000	12%	3 years
2	Bank loan (floating rate)	1,000	6%	3 months
		2,000	6.5%	3 months
3	Tradepayable	1,000	10%	6 months

Weighted average expenditure on the basis of period of investment

2012	Amount	Weights	Weighted average expenditure
1 April	1,000	1.00	1,000
6 September	1,000	0.58	580
1 December	1,000	0.33	330
Total			1,910

Capitalisation rate

Borrowing	Amount (A)	Interest Rate (B)	Interest (A x B = C)	Weighted Average (D)	Borrowing Cost (C x D)	Weighted Borrowing (A x D)
Bank loan	10,000	12%	1,200	1.00	1,200	10,000
Bank loan (floating rate)	1,000	6%	60	0.25	15	250
	2,000	6.5%	130	0.25	32.50	500
Tradepayable	1,000	10%	100	0.50	50	500
Total					**1,297.50**	**11,250**

Capitalisation Rate (Total borrowing cost ÷Weighted average borrowing) x 100

= (1,297.50 ÷11,250) x 100

= 11.53%

Trade payable is also considered as borrowing because it is a financing arrangement and the interest is recognised separately.

Borrowing cost eligible for capitalisation

Weighted average expenditure on the qualifying asset	1,910
Capitalisation rate	11.53%
Period (months)	12
Borrowing cost eligible for capitalisation (1,910 x 11.53%)	220.22

Entities may wish to borrow funds generally rather than for specific qualifying assets. In those situations, it becomes more difficult to identify a relationship between the borrowing and the qualifying asset. Therefore, some judgment is often necessary to determine what to include in borrowing costs and how much to capitalise, as under:

- **Specific**

  Capitalise (borrowing costs minus Investment income on temporary investment of those borrowings)

- **General**

  Determine the capitalisation rate and apply to the weighted average expenditure on the qualifying asset.

Example 14

Let us take the previous example, but it is a combination of specific and general borrowings.

Sl. No.	General and Specific Borrowings	Amount	Interest Rate	Period
1	Bank loan	10,000	12%	3 years
2	Bank loan (floating rate)	1,000	6%	3 months
		2,000	6.5%	3 months
3	Bank loan for another qualifying asset	1,000	12%	5 years
4	Tradepayable	1,000	10%	6 months

The bank loan for another qualifying asset is a specific borrowing.

Borrowing cost eligible for capitalisation

Specific	120.00	(12% x1,000)
General	220.22	(previous example)
Total	**340.22**	

If by capitalising borrowing costs, the carrying amount of the qualifying asset exceeds its recoverable amount or net realisable amount, then the excess borrowing costs (above the recoverable amount) should be written off.

Example 15

XYZ Ltd has an asset whose carrying amount is 50. The recoverable amount of that asset at the end of the reporting period is 55. The borrowing cost related to that asset is 15. The total borrowing cost is capitalised, added to the cost and the excess (50 + 15 – 55), i.e., 10 has to be written off as impairment.

Time period for Capitalisation

The questions that arise are when:

- does an entity commence capitalisation;
- will capitalisation be suspended; and
- will capitalisation be ceased.

Commencement of Capitalisation

An entity should begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first satisfies all of the following conditions:

- It incurs expenditures for the asset;

Example 16

ABC Ltd wants to buy a piece of land and, therefore, has bided for it. In process, certain costs have been incurred.

Expenditure must result in payment of cash, transfers of other assets or the assumption of interest bearing liabilities. In case, any progress payments or grants that are received in association with the asset must reduce the expenditure on the asset.

Example 17

XYZ Ltd is constructing a school in the backward area. The cost of the building so far has been 100. Government has given a cash grant of 20 and ABC Ltd has also provided 10 as a donation. The cost of the asset that will be eligible for capitalisation of borrowing cost is (100 – 20 – 10) = 70. Therefore, if borrowing cost is 10%, then borrowing cost capitalised is (70 x 10%) = 7.

The average carrying amount of the asset during a period (including borrowing costs previously capitalised) is normally a practical approximation of the expenditure to which the capitalisation rate is applied in that period.

- It incurs borrowing costs; and

Example 18

ABC Ltd takes a bank loan for part of the cost of the land.

- It undertakes activities that are necessary to prepare the asset for its intended use or sale.

Example 19

The land is bought and construction of the factory has started. Therefore, preparation of the land for its intended use has started. Had the land been held without any associated development activity, then no borrowing cost could be capitalised.

The phrase activities that are necessary have a much broader connotation than just physical construction of the asset. It also includes obtaining permits, technical analysis, designing activities, administrative jobs, etc.which commence priorto physical construction.

Suspension of Capitalisation

An entity should suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

Example 20

The land is bought and construction of the factory is in progress. Suddenly due to political issues, the construction is halted. The management has no idea when work will resume. Thus, the borrowing costs incurred during this period is not eligible for capitalisation.

However, sometimes an entity is forced to delay their project, because of peripheral reasons which are necessary parts of the process to get the asset ready for its intended use or sale. During such circumstances, capitalisation is not ceased.

Example 21

While building a river bridge, the water level of the river plays a very crucial role. If there is high water level, construction is required to be halted and this delays the process. But even though there is a delay, since such circumstances are expected, capitalisation of borrowing costs should not be suspended.

Cessation of Capitalisation

An entity should cease capitalisation of borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Example 22

XYZ Ltd had completed construction of an office, which it intends to give on rent. The office is ready, but XYZ Ltd has not yet found a tenant. Though the office does not generate any income, but since it is ready for its intended use the capitalization of the borrowing cost ceases.

Often it is found that the physical construction of an asset is complete, but some administrative work or minor modifications or decorations are left to be done. In such cases, capitalisation of borrowing costs ceases even if routine administrative work might continue. However, management judgment needs to be applied to determine whether the ongoing administrative work is routine or significant.

Example 23

The office in the above example was say, intended to be sold. The buyer wants installation of the central airconditioning system, which XYZ Ltd agrees to do. Thus, the office is substantially ready before minor adjustments and so capitalisation should cease.

It also happens, that when an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the company should cease capitalisation of borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

Example 24

There is a business park consisting of 10 buildings. Each building is capable of functioning on its own. If construction of one building finishes and it is capable of operating on its own, while other buildings are still in process, then capitalisation of borrowing costs for the first building ceases, but continues for the rest.

Example 25

A factory has various processes which are all integrated with each other. Though specific parts of the factory might be ready, until all the processes are ready, the factory can not be used for its intended purpose. Therefore, in that case, the company does not cease capitalisation of borrowing costs when one part (which can not be used independently) is complete.

Provisions, Contingent Liabilities and Contingent Assets (Ind AS 37)

Introduction

Provision

A provision is a liability of uncertain timing and amount. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. A provision can be recognised only when all the following conditions are met :

- An entity has a present obligation (legal or constructive) as a result of a past event;
  - Legal obligation

    It is an obligation that derives from –
    - a contract (through its explicit or implicit terms);
    - legislation;or
    - other operation of law

Example 1

When we buy a watch we are given a warranty card, which says in case of any defect in the working of the watch within 6 months, the watch would be repaired free of cost. That piece of paper is like a contract written by the watch manufacturer and given to us as a result of a past event (sale of the watch). This sale of the watch leads to a legal obligation on part of the manufacturer to repair the watch if there is a manufacturing defect.

- Constructive obligation

  It is an obligation that derives from an entity's actions where –
  - by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities;and
  - as a result, the entity has created a valid expectation on the part of those other parties that itwill discharge those responsibilities.

Example 2

ABC Ltd advertises its policy of giving refunds for defective shoes. By publishing its policy, ABC Ltd has created a valid expectation on part of the customers that it refunds money. Thus, ABC Ltd has a constructive obligation as a result of a past event.

Example 3

XYZ Ltd had been giving its retiring employees (who have worked for more than 25 years) 50 over and above all their dues.This has been the practice for the last 5 years. This established pattern of past practice of XYZ Ltd has created a valid expectation among the retiring employees this year that they will also get the extra sum of money (provided criteria satisfied). Thus, XYZ Ltd has a constructive obligation as a result of past practice.

- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, e.g., because the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.

Example 4

In a law suit, it may not be clear whether an enterprise has a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date. In such cases, evidence is provided by external legal experts or legal counsel of the company. An enterprise recognises a provision for that present obligation if the other recognition criteria described above are met. If it is more likely than not that no present obligation exists, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Therefore, a past event is deemed to give rise to a present obligation if, after taking into account all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period. In rare cases, the existence of a present obligation is unclear.

The settlement of a present obligation usually involves the entity giving up resourcesembodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, e.g., by –

- payment of cash;
- transfer of other assets;
- provision of services;
- replacement of that obligation with another obligation;or
- conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

A past event that leads to a present obligation is called an obligating event. An obligating event is an event that created legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. This is the case only–

- where the settlement of the obligation can be enforced by law;or
- in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

Just a decision of the board of directors will not lead to a constructive obligation at the end of the reporting period until and unless the decision has been communicated to those affected by it before the end of the reporting period and has resulted in a valid expectation in them that the entity will fulfill its obligation.

Environmental provisions are recognised if there is an obligation (either legal or constructive) to repair environmental damage. This environmental damage can be either clean up cost or penalties. Thus, there must be an obligating past event in order to recognise a provision. Sometimes, even though there is no immediate obligation, but there may be one at a later date because of changes in law or act of the entity.

Example 5

ABC Ltd causes contamination and operates in a country where there is no environmental legislation in place. Therefore, ABC Ltd has no obligation to remedy the consequences. However, if ABC Ltd had published its environmental policy in which it undertakes to clean up all contamination it causes, then by the act of the entity it has an obligation to clean up and, therefore, a constructive obligation. On the other hand, if there is some changes in the legislation of the country obligating clean-up, then automatically the legal obligation arises. In either of the cases, ABC Ltd can recognise a provision.

An obligation always involves another party to whom the obligation is owed. Third party's presence is very important to justify the obligation; however, the identity is not important. An obligation can be to the people in general, ie, public at large.

Some assets need to be repaired or to have parts to be replaced after every few years or some expenses need to be carried out to operate in a certain manner in the future. Such expenses can be avoided by the entity and, therefore, no present obligation for future expenses exist and thus no provision should be recognised.

Example 6

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 2012. The entity has not fitted the smoke filters.

- At 31 December 2011

  Present obligation as a result of a past obligating event

  There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

  Conclusion

  No provision is recognised.

- At 31 December 2012

  Present obligation as a result of a past obligating event

  An obligation will arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

  An outflow of resources embodying economic benefits in settlement

  Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

  Conclusion

  No provision is recognised. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

An outflow of resources embodying economic benefits refers to the fact that an entity has to sacrifice or give up certain economic resources, such as payment of cash. For an entity to recognise a liability, outflow of economic benefits must be probable, if it is not probable that a present obligation exists, then an entity discloses a contingent liability.

In case, there are a number of similar obligations such as product warranties, the entire classof obligations is clubbed as one.

As per the third recognition criteria for a provision, if reliable estimate is not possible, a provision can not be recognised. However, since estimates are rarely accurate, adjustments or rather changes in estimates require prospective treatment as per Ind AS8 Accounting Policies, Changes in Accounting Estimates and Errors. However, it is very rare that an estimate for a liability can not be arrived at, but if such a situation occurs, a contingent liability is disclosed.

Example 7

ABC Ltd has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so.Its policy of making refunds is generally known. Thus a provision is to be recognised, because of the following:

- The obligating event is the sales, which gives rise to a constructive obligation as the company, by its past actions, created a valid expectation on part of its customers that the company will refund purchases.
- It is also probable that a proportion of goods are returned for refund.
- Best estimate of the cost of refunds can be made from past experience.

Example 8

XYZ Ltd pledges that it will rectify any environmental damage caused by its activities. The company has a record of honouring this policy. There is no environmental legislation in place in the jurisdiction. Recently, the company's mining activities have accidentally polluted the surrounding environment. The company agrees to pay for the cost to clean up the pollution.

- The obligating event is the polluting the surrounding environment, which gives rise to a constructive obligation because of the policy and previous conduct of the company and that has credited valid expectation that the company will clean-up the pollution. It is not necessary, however, to know the identity of the party to whom the obligation is owed — the obligation may be to the general public.
- An outflow of resources embodying economic benefits or service potential in settlement is probable.
- Best estimate of the costs of the clean up can be determined.

Therefore, a provision should be recognised after satisfying all the three recognition criteria.

Example 9

The following are journal entries for recording a provision against an expense as well as its utilisation :

- Initial creation of a Provision

  Related Expense

  Provision

- Future adjustments
  - Full utilisation of provision

    Provision

    Cash
  - Provision recognised initially,now reversed

    Provision

    Related Expense
  - Provision utilised less than created

    Provision

    Cash

    Related Expense

Contingent liability

A contingent liability is a:

- possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- present obligation that arises from past events but is not recognised because–
  - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - the amount of the obligation cannot be measured with sufficient reliability.

Therefore, an entity shall not recognise a contingent liability. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably.

The following is the summary of the main requirements of the standard:

- There is a present obligation that probably requires an outflow of resources
  - A provision is recognised
  - Disclosures are required for the provision
- There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources
  - No provision is recognised
  - Disclosures are required for the contingent liability

- There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote
  - No provision is recognised
  - No disclosure is required

Example 10

ABC Ltd and XYZ Ltd are equal partners. They are jointly and severally liable for 10 for damages resulting from a certain work. A case has been filed against them. ABC Ltd has made a provision for 5 and a contingent liability for 5. The contingent liability discloses that if XYZ Ltd can not pay, then ABC Ltd will be liable for the total claim.

Contingent asset

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. Therefore, an entity shall not recognise a contingent asset. A contingent asset is disclosed, where an inflow of economic benefit is probable.

The following is the summary of the main requirements of the standard :

- The inflow of economic benefits is virtually certain
  - The asset is not contingent
- The inflow of economic benefits is probable, but not virtually certain
  - No asset is recognised
  - Disclosures are required
- The inflow is not probable
  - No asset is recognised
  - No disclosures are required

Example 11

ABC Ltd had an accident in its premises and, therefore, made a claim of 10 compensation against the insurance company. The claim had gone to the court since the insurance company did not agree to pay. According to the legal councel of ABC Ltd, such claims against the same insurance company have gone to court and then been paid. Thus, ABC Ltd decides to treat this claim as a contingent asset. Subsequently, the claim for 10 compensation against the insurance company has been successful. The insurance company has asked for some time to pay and ABC Ltd does not see any risk of default. Therefore, ABC Ltd recognises the compensation as other receivable (asset).

Measurement

Initial measurement

An entity shall measure a liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation – which is the lowest of the:

- estimated present value of the resources required to fulfil the obligation, taking into account the–
  - the expected outflow of resources and the time value of money; and
  - risk that the actual outflows of resources might ultimately differ from those expected.
- amount that the entity would have to pay to –
  - **cancel** the obligation; and
  - **transfe**r the obligation to a third party.

If there is no evidence that an entity could cancel or transfer an obligation for a lower amount, the entity measures the liability at the present value of the resources required to fulfil the obligation, which is the price that the counter party or a third party would demand, plus any costs of cancellation or transfer.

Expected present value technique

The amount or timing of the outflows of resources required to fulfill an obligation might be uncertain. Therefore, the range of outcomes and their effects shall be taken into account by estimating the expected present value of the outflows, which involves:

- identifying each possible outcome;
- making an unbiased estimate of the amount and timing of the outflows of resources for that outcome by–
  - incorporating, in an unbiased way, all available information about the amount, timing and probability of the relevant future outflows.
  - being consistent with observable market prices, if such prices are available.
- determining the present value of these outflows using rates that reflect–
  - current market assessments of the time value of money; and
  - risks specific to the liability (but only if and to the extent that the risks are taken into account by adjusting the discount rate rather than by the other risk adjustment methods).
- making an unbiased estimate of the probability of each outcome.

If the obligation will be fulfilled by making payments to the counterparty, the relevant outflows include –

- payment to the counter party; and
- associated costs, such as external legal fees or the costs of an in-house legal department attributable to that obligation.

If the obligation will be fulfilled by undertaking a service at a future date, the relevant outflows for such obligations are the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf if there is –

- a market for a service, the amount is the price that the entity estimates a contractor would charge at the future date to undertake the service on the entity's behalf.
- not a market for the service, the entity estimate the amount it would charge another party at the future date to undertake the service. The estimates shall include the costs the entity expects to incur and the mark-up it would receive to undertake the service for the other party.

The relevant outflows are measured before tax because Ind AS 12 applies to the tax consequences.

Risk adjustment

For a liability, a risk adjustment is a compensation sought by risk-averse market-participants forbearing the uncertainty inherent in the cash outflows of that liability. It measures the amount, if any, that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk. Therefore, a risk adjustment can be included by–

- adjusting estimates of the future cashflows (i.e., as an increase in the amount of cash outflows);
- adjusting the rate used to discount the future outflows to their present values,

or

calculating the expected present value of the future outflows and adding a risk adjustment to the amount so calculated.

An entity shall ensure that it does not double-count or omit adjustments for risk. Therefore, care is needed to avoid duplicating adjustments for risk with consequent overstatement of theliability.

Example 12

If the estimated cash outflows are increased to take into account the compensation for assuming the risk associated with the obligation, the discount rate should not be adjusted to reflect the risk.

Example 13

If the estimated outflows for a particularly adverse outcome are increased to take account of risk, that outcome is not then also treated as more probable than is realistically the case. Similarly, the discount rate does not reflect risks for which future cash outflow estimates have been adjusted.

Example 14

Using present value techniques for measuring a liability is made under conditions of uncertainty because the cash outflows used are estimates rather than known amounts. In many cases, both the amount and the timing of the cash outflows are uncertain. Even contractually fixed amounts, such as the payments on a loan, are uncertain if there is risk of default.

Subsequent measurement

An entity shall adjust the carrying amount of a liability at the end of each reporting period to the amount that it would rationally pay to be relieved of the present obligation at that date.

Remeasurement of the present value of the resources required to fulfill the obligation takes into account changes in estimates of –

- the expected outflows of resources;
- market assessments of the time value of money; and
- the risk that the actual outflows of resources might ultimately differ from those expected

Changes in estimates

An estimate is an educated guess, ie, a guess made on the basis of facts, good information etc., and so probably fairly accurate. Therefore, it is important not only that estimates faithfully represent conditions at the end of the reporting period, but also that changes in estimates faithfuly represent changes in conditions during the period.

Changes in estimates of the expected outflows of resources could arise from –

- changes in estimates of the amount of the outflows associated with a particular outcome;
- the probability of the outcome occurring.

Changes in the carrying amount of a liability resulting from the passage of time are recognised as a borrowing cost.

Example 15

Facts

An oil production company owns and operates an oil rig. Existing environment laws oblige rig owners to dismantle rigs that have reached the end of their useful lives.

Rig owners can not cancel such obligations, or transfer them to a third party. However, there are contractors in the market that provide dismantling services for rig owners. A contractor would charge 125,000 to dismantle the oil company's rig now, in a way that complies with existing environmental laws.

The rig has an estimated remaining useful life of 10-15 years. The current 10-year and 15-year risk-free rates of interest are respectively 6% and 5.5% per year.

Measurement basis

Since the obligation cannot be cancelled or transferred, the entity measures the liability as the present value (PV) of the resources required to fulfill the obligation.

Outflows of resources

The relevant outflows are the amounts that the entity estimates a contractor would charge at the end of the rig's useful life to dismantle the rig at that time. The entity estimates the amount taking into account the price that a customer would charge to undertake this work now (125,000) and estimates of future price increases (possible market and technological developments). The entity estimates the probability of these developments occurring on the basis of experience, market data, technological information and similar evidence. The estimates

of future prices are based on existing legal requirements. They do not take into account the possibility that the legal requirements will be more onerous at the end of the rig's useful life than they are at present.

The entity identifies 6 outcomes that represent a reasonable estimate of the distribution of possible outcomes. The entity discounts the estimated outflow for each of the 6 outcomes to its present value.

Expected present value of the outflows

The entity estimates that the probability of each outcome occurring. It calculates the probability-weighted average of the present values for the 6 outcomes. This amount is the expected present value of the outflows.

Risk adjustment

The 125,000 that a contractor would charge to dismantle the rig includes a price for risk, but only in respect of uncertainties in the costs that the contractor would incur to dismantle the rig now. It does not take into account the additional risk that arises because of uncertainty about–

- how prices will change between now and the end of the rig's useful life;and
- when the rig will reach the end of its useful life.

The entity estimates that it would rationally pay an additional 5% to be relieved of this risk.

Outcome	Useful life (years)	Estimated outflow	Discount rate	PV of outflow	Probability	Probability weighted present value
1	10	200,000	6%	111,679	5%	5,584
2	10	225,000	6%	125,639	25%	31,410
3	10	275,000	6%	153,559	20%	30,712
4	15	230,000	5.5%	103,025	5%	5,151
5	15	260,000	5.5%	116,463	25%	29,116
6	15	340,000	5.5%	152,297	20%	30,459
Expected present value of outflows						132,432
Add: Risk adjustment (5%)						6,622
The amount the entity would rationally pay at the end of the reporting period to be relieved of the obligation						139,054

Example 16

An entity, at the end of 20x0, tests a cash-generating unit (CGU) for impairment, which has a carrying amount of 3,000 (at depreciated historical cost) and a remaining useful life of 10 years.

The entity decided that the CGU will be restructured at an estimated cost of 100 at the end of 20x3.

At the end of 20x2, the entity becomes committed to the restructuring and accordingly, a provision is recognised for 100. At the end of 20x3, actual restructuring costs of 100 are incurred and paid.

At the end of 20x0

The CGU's recoverable amount is calculated at 2,051. Since this amount is less than the carrying amount, an impairment loss of 949 (3,000–2,051) is recognised. Therefore, the carrying amount of the CGU after impairment loss is 2,051.

At the end of 20x1

There is no indication of impairment.

At the end of 20x2

The CGU's recoverable amount is calculated at 2,162. Since the CGU's recoverable amount is higher than its carrying amount, the entity reverses the impairment loss recognised for the CGU at the end of 20x0, as under:

Carrying amount at the end of 20x0	2,051
End of 20x2	
Depreciation for 20x1 and 20x2 (205x2)	410
Carrying amount before reversal	1,641
Recoverable amount	2,162
Reversal of the impairment loss (2,162–1,641)	521
Carrying amount after reversal	2,162

At the end of 20x3

Summary of the carrying amount of the CGU

End of year	Depreciated historical cost	Recoverable amount	Depreciation charge	Impairment loss	Carrying amount after depreciation
20x0	3,000	2,051	–	(949)	2,051
20X1	2,700	–	(205)	–	1,846
20X2	2,400	2,162	(205)	521	2,162
20x3	2,100	–	(270)	–	1,892

Reimbursement

Sometimes, it might happen that there is an insurance policy that will cover the costs of a law suit. In such a case, the liability which is the provision for law suit and the recovery, which is the insurance policy, should be treated as a separate liability and a separate asset. However, in Statement of Profit and Loss the provision as well as the reimbursement are adjusted against the concerned expenditure.

It should be ensured that the reimbursement should be recognised only when it is virtually certain that reimbursement will be received and that it should not exceed the amount of the provision.

Provision	Reimbursement	Deferred tax asset @ 40%			Deferred tax liability @ 40%
		Created	Reversed	Cancelled	
100	100	40	40	–	–
100	50	40	20	20	–
100	150	40	40	–	20

Though the entity will be reimbursed by a third party, it still remains liable for the full amount in case the third party fails to pay. Thus, the entity should continue to recognise a separate liability.

In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case, the entity has no liability for those costs and they are not included in the provision.

Example 16

Journal

Related Expense	
Provision	
(Provision recognised)	
Reimbursement Asset	
Related Expense (for which a provision is recognised)	
(Reimbursement recognised)	

Use of provision

A provision should be used only for the purpose it was originally created. It should not be the case that a provision is created for a particular expenditure but utilised to satisfy another. If a provision created for a specific expenditure is set against a different expenditure, then the interpretation would be misleading. This is because both the expenditures, for which the provision was created and the one against which it was utilised, are two different events.

Future Operating Losses

An entity prepares its financial statements to show the financial position of the entity at the end of the reporting period and not its possible position in the future. Previously, provisions were recognised for future operating losses on grounds of conservatism, but now no provision can be recognised for future operating losses. They should not be provided because they relate to future events (which the entity can avoid by its future actions) and there is no obligation to third party (no need to know identity of person but involves a commitment to another party). The possibility of future operating losses gives an indication that some related asset is to be impaired as per Ind AS 36.

Onerous contracts

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Therefore, a provision is to be created for an onerous contract which is "lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it."

Generally, when an entity enters into an contract, expected benefits are greater than the cost of entering the contract. Such contracts are also referred to as executory contracts. These are contracts under which neither party has performed any of its obligations, nor have partially performed their obligations to an equal extent. These contracts do not fall under this Standard. At this stage, no provision is recognised. But say with the occurring of some event or under change in circumstances the contract becomes onerous one. In that case, this Standard allows that the present obligation be recognised and measured as a provision.

Example 17

ABC Ltd has a contract to supply a certain product to XYZ Ltd at 2 per unit for 2 years. The price of the product increases to 3 per unit, but ABC Ltd has to supply the product at 2 per unit to maintain the contract. Initially, the contract was a regular contract but later on due to change in circumstances the contract becomes onerous, since the unavoidable cost (3) associated with the contract is greater than the expected benefit (2). Thus, for the present obligation resulting from this onerous contract, a provision can be recognised.

The next question is how to measure such a provision. Expected benefits remain as per contract but the unavoidable cost under the contract is the least of net cost of exiting from the contract, which is lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

Example 18

ABC Ltd estimates that it has to incur a loss of 1 per unit (total units 10) to keep the contract alive or to pay a penalty of 25 to the company for non-performance of the contract. The unavoidable cost here is 10 and not 25. Therefore, the company has to make a provision of 10.

Example 19

A Ltd enters into a sales contract with X Ltd to sell 100 units of a customised product at an agreed price of 5 per unit. The agreement included a penalty of 20 in case of any delay or cancellation of the contract as the delivery is very important to X Ltd. At the end of the period, due to rise in the prices of raw materials, the cost of the product went above the sale price to 5. 10 per unit. The applicable tax rate is 40%. The unavoidable cost of meeting the obligation (Penalty > Cost of fulfilling the contract) is higher than the selling price and, therefore, a provision of 10 (100x0.10) is recognised. The consequent tax effect is also shown.

	Journal	
Cost of goods sold	10	
Provision for onerous contract		10
(Provision recognised)		
Deferred tax asset	4	
Deferred tax income		4
(Tax effect)		

Example 20

Now let us continue with the previous example, but the cost of the product rises to 5.50 and applicable tax rate is 30%.

The cost of fulfilling the contract has increased and the loss on fulfilling the contract is 50, whereas the penalty to cancel the contract is 20. Therefore, a provision of 20 is created (lower between the two).

	Journal	
Cost of goods sold	20	
Provision for onerous contract		20
(Provision recognised)		
Deferred tax asset	6	
Deferred tax income		6
(Tax effect)		

Often a particular contract might have a dedicated asset for it to be performed, in that case before a separate provision for the onerous contract is recognised, an entity recognises any impairment loss that has occurred on the asset dedicated to that contract.

Example 21

ABC Ltd enters into a contract to supply 1,000 aluminium bins for 200 per unit to XYZ Ltd. After the contract was entered, it was found that the cost of aluminium has increased to 210 and the loss in fulfilling the contract is 10,000 whereas the cost of cancelling the order is 15,000. ABC Ltd has a dedicated asset for this contract whose value is 5,000. ABC Ltd should first determine the recoverable amount of the asset and charge impairment loss.

Say the recoverable amount of the asset is 1,500. In that case, ABC Ltd should charge 3,500 as impairment loss and create a provision for 10,000.

Example 22

Let us continue with example 19. The contract also requires a dedicated machine as well which costs 100. The recoverable amount of the machinery at the time provision was created was found to be 95. The applicable tax rate is 30%.

Since, the recoverable amount of the dedicated asset is less than the carrying amount, a impairment loss of (100–95) = 5 is charged to Statement of Profit and Loss and is also deducted from the carrying amount of the asset. A deferred tax asset is also recognised (5 x 30%) = 1.50.

The total probable outflow is 20, and therefore, a provision is recognised for 20 and a corresponding deferred tax asset is also created (20x30%) = 6. Thus, the total deferred tax asset is 1.50+6 = 7.50.

Environmental Provisions

The concept of environmental provisions for clean up costs or decommissioning and restoration cost is either legal obligations or constructive obligations. As per Ind AS 16, the cost of an asset should include the initial estimate of the cost of dismantling and renovating the item and restoring the site on which it is located. This is mostly the case with industrial sites or even when assets are taken with dilapidation clause in them, i.e., the asset has to be returned in the same manner as it was initially received.

Example 23

ABC Ltd is operating in the mining sector. It has an obligation, at the date of installation of the rig, to decommission the mining site at the end of its 10 years' life in accordance with the legislative requirements. The decommissioning cost is estimated to be 50 at the end of 10 years, with a net present value of 19.28, based on the discount rate of10%.

As per Ind AS 16 and Ind AS 37, management of ABC Ltd should include 19.28, the net present value of the decommissioning cost in the carrying amount of the asset at the time of installation of mining rig. Simultaneously, a provision for 19.28 is also created because the obligating event is the installation of the miningrig.

The amount included in the Property, Plant and Equipment will be depreciated with the rest of the cost of the mining rig. The increase in the value of the provision is adjusted through the finance cost.

Example 24

Let us take the previous example. The cost of the asset is 1,000 and the cost of decommissioning is estimated to be 50 to be incurred after 10 years. The discount factor is taken to be 10%.

Step 1

Journal		
Asset	1,000	
Cash		1,000

Step 2

Year	Cost	Discount factor @ 10%	Present value	Finance cost
0		0.39	19.28	–
1		0.42	21.20	1.93
2		0.47	23.33	2.12
3		0.51	25.66	2.33
4		0.56	28.22	2.57
5		0.62	31.05	2.82
6		0.68	34.15	3.10
7		0.75	37.57	3.42
8		0.83	41.32	3.76
9		0.91	45.45	4.13
10	50	1.00	50.00	4.55

Step 3

The provision is created against the asset.

Journal		
Asset	19.28	
Provision for decommissioning		19.28
(Provision created for decommissioning against the related asset)		

Step 4

Statement of Profit and Loss (includes)			
Year	**1**	**2**	**3**
Interest expense	1.93	2.12	2.33
Depreciation *	101.93	101.93	101.93

* (1,000 + 19.28) ÷10 = 101.93

Step 5

Balance Sheet (includes)			
Year	**1**	**2**	**3**
Assets			
Non-current			
Gross Block	1,019.28	1,019.28	1,019.28
Accumulated Depreciation	101.93	203.86	305.78
Net Block	917	815	713
Liabilities			
Non-current			
Provision for decommissioning	21.20*	23.33	25.66

* 19.28 + 1.93 = 21.20 (approximations have been made).

Restructuring

An entity may restructure its business for various reasons. The following are examples of events that may fall under the definition of restructuring –

- sale or termination of a line of business;

- the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
- changes in management structure, e.g., eliminating a layer of management; and
- fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

A restructuring is a program that is planned and controlled by management, and significantly changes either the scope of the business or the manner in which that business is conducted. A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met.

Intention to restructure is not same as restructuring and, therefore, no provision is recognised. A restructuring provision can only be recognised where an entity has a constructive obligation to carry out restructuring.

A constructive obligation to restructure arises only when an entity:

- has a detailed formal plan for the restructuring identifying at least–
  - the business or part of a business concerned;
  - the principal locations affected;
  - the location, function, and approximate number of employees who will be compensated for terminating their services;
  - the expenditures that will be undertaken;and
  - when the plan will be implemented; and
- has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Evidence that an entity has started to implement are structuring plan, e.g., by dismantling plant or selling assets or by the public announcement of the main features of the plan is important. A public announcement of a detailed plan to restructure should be made in such a way and in sufficient detail (i.e., setting out the main featuresof the plan) that it givesrise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

In some cases, an undertaking starts to implement a restructuring plan, or announces its main features to those affected, only after reporting date. In that case, disclosure may be required under Ind AS 10.

Example 25

ABC Ltd's reporting period ends at 31 March. On 20 February 2012, the management of ABC Ltd voted to proceed with 2 reorganisation schemes involving the closure of two factories. ABC Ltd will finalise its financial statements and publish it on 30 June 2012.

Scheme 1 The closure costs will amount to 50. The factory is rented on a short term lease, and there will be no gains and losses arising from this property. The closure will be announced in June and will commence in July.

Scheme 2 The closure costs will amount to 20 (after crediting 35 profit on disposal of some machines). The closure will take place in August, but redundancy negotiations began with staff in March.

For Scheme 1, the obligating event is the announcement of the plan, which would occur in June and, therefore, no provision is recognised.

For Scheme 2, though closure would take place in August, redundancy negotiations had already begun with staff creating a valid expectation and, therefore, a provision would be created for 55 (expected profit on disposal can not be netted-off against the anticipated loss).

No obligation arises for the sale of an operation until there is a binding agreement to the sale. Even when an undertaking has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding agreement. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Ind AS 36.

A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both–

- necessarily entailed by the restructuring;and
- not associated with the ongoing activities of the entity.

A restructuring provision does not include such costs as –

- retraining or relocating continuing staff;
- marketing;or
- investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Example 26

XYZ Ltd decides to reorganise its business and incurs redundancy costs of 20. They also spend 5 on retraining, 10 on new equipment and will also suffer some future operating losses of 3. The restructuring provision will be limited to 20. The cost of retraining, new equipment and future operating losses must be expensed when incurred.

Non-current Assets Held for Sale and Discontinued Operations (Ind AS 105)

Introduction

Non-current assets are assets that include amounts expected to be recovered more than 12 months after the reporting period. Non-current assets are classified as either –

- held and used;or
- held forsale

This Chapter has been divided into two parts. Our first focus would be on accounting for held for sale non-current assets (or disposal groups) and then we would move on to discontinued operations.

Non-current assets (or disposal scrap) held for sale

An asset is called **held for sale** when its carrying amount will be recovered principally through a sale transaction rather than through usage.

Example 1

An entity has a fleet of trucks, which it can use either for its own goods transportation purpose and generate economic benefits from its continuing use or it can sell it to another entity. If the entity decides to recover its value by selling rather than using them, then it is a non-current asset held for sale.

It should be clear that, inventories, which is a current asset that is sold as a main function of a business should not be confused with non-current assets held for sale. Ind AS105 is used when the sale of the asset is not the main activity or function of the business.

A **disposal group** is a group of assets to be disposed of,by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will also be transferred in that transaction. The group can be single cash generating unit or a group of cash generating units or part of a cash generating unit.

Example 2

A disposal group can be a subsidiary or an operating segment and all the assets and liabilities of that subsidiary or operating segment will be classified as held for sale.

If goodwill is allocated to the cash generating unit, then it should also be included within the disposal group.

Classification

A non-current asset (ordisposal group) should be classified as held for sale, if its carrying amount is recovered through sale rather than its continuing usage.

This Standard specifies two requirements to classify a non-current asset (or disposal group) as held for sale provided the –

- asset is available for immediate sale in present condition; and
- sale is highly probable.

The expression **available for immediate sale** means that the non-current asset (or disposal group) should be ready for sale in its present condition subject to terms or customs which are common for any sales transaction and that there is nothing that can materially delay the sale.

Example 3

ABC Ltd has an office building, which it has decided to sell and has taken action to locate a buyer. The company intends to transfer the building to the new buyer only after it vacates the building. The time necessary to vacate the building is standard and customary for such sales. This situation surely satisfies the classification requirement of held for sale.

Example 4

ABC Ltd has an office building, which it has decided to sell and has initiated actions to find a buyer. The company would vacate the building only if it finds a replacement. The delay in timing of the transfer of the building indicates that the building is not available for immediate sale. The classification requirement would be satisfied only after a replacement for the office building is found.

Thus, an asset (office building) is not available for sale, if it is still needed for the entity's ongoing operations.

Example 5

XYZ Ltd plans to sell a piece of plot. The company decides to clean the plot in order to increase its value prior to selling it to a third party. The delay in the timing of the transfer of the plot imposed by the company demonstrates that the property is not yet available for sale.

Example 6

XYZ Ltd is committed to a plan to sell a manufacturing unit and has already initiated actions to locate a buyer. At the plan commitment date, there is a backlog of uncompleted customer orders. The company intends to sell the manufacturing unit with its operations and, therefore, any uncompleted customer orders at the sale date will be transferred to the buyer. The transfer of the uncompleted customer orders at the sale date will not affect the timing of the transfer of the facility and, therefore, the manufacturing unit satisfies the classification criteria.

Example 7

ABC Ltd is committed to sell a manufacturing unit and has already initiated actions to locate a buyer. The company intends to sell the unit, without its operations. On the sale commitment date, there is a backlog of customer orders. ABC Ltd does not intend to transfer the facility to a buyer until it ceases all operations of the facility and eliminates the backlog of uncompleted customer orders.The delay in the timing of the transfer of the facility imposed by the company demonstrates that the unit is not available for immediate sale.

For a sale to be **highly probable** there is no specific requirement regarding a sales transaction and, therefore, judgment is required to determine whether the conditions of the Standard have beenmet.

A decision to sell is not a sale, until and unless, there is a firm purchase commitment. Thus, even if a buyer is identified and the selling plan is reasonably clear, the trigger for held for sale classification is the firm purchase commitment.

In fact, this Standard has defined a firm purchase commitment as an agreement, with an unrelated party, binding on both parties and usually legally enforceable, that –

- specifies all significant terms, including the price and the timing of the transactions, and
- includes a disincentive for non-performance that is sufficiently large to make performance highly probable.

In the absence of the firm purchase commitment, an entity must ensure the following:

1. Management commitment to the sellingplan

   Management refers to people who have the authority and responsibility for planning, controlling and directing the activities of an entity. Therefore, unless the appropriate level of management is committed to the selling plan, the sale is not highly probable. In some cases, it is mandatory to have shareholders' approval as per the law of the land. The probability of the shareholders' approval must also be assessed.

Example 8

ABC Ltd holds 80% interest in a subsidiary, XYZ Ltd. The Board of Directors of XYZ Ltd has approved a plan to sell a few non-current assets to ABC Ltd. The law of the land in which XYZ Ltd operates, provides protection to the minority shareholders of XYZ Ltd, when the value of a transaction exceeds a certain limit. Thus, until XYZ Ltd's minority shareholders' approve, the appropriate level of management commitment to the plan to sell can not be achieved and, therefore, the sale is not highly probable.

2. Active marketing efforts for the asset(s)

   In order to sell, an entity must initiate an active search to locate a buyer and complete the sale transaction. The entity must, therefore, actively market the asset (or disposal group) for it to be known to third parties

that it is being sold off. If an entity outsources an external agent to initiate the process, then that will also be considered as an active marketing effort by the entity.

3. Asset(s) marketed at fair value

The asset (or disposal group) must be marketed at a price that is reasonable to its current fair value.

Example 9

ABC Ltd plans to sell its office building and has started looking for a buyer. The price quoted by the company is 50, whereas th evaluer has valued the building on the basis of market prices at 35. Since the price being asked for the building can not reasonably be compared to the market price, it is unlikely that the entity will sell the building.

4. Completion of the sales transaction expected within 1 year of the classification

The sale transaction is expected to be completed within 1 year period after the asset (or disposal group) has been classified as held for sale.

The only exception to this 1 year time frame arises in certain circumstances which are outside the control of the seller and there is enough evidence that the seller is still committed to the plan of sale, such as:

- at the date an entity commits itself to sell a non-current asset (or disposal group), it reasonably expects that others will impose conditions on the transfer of the asset (disposal group) that will extend the period of sale and:
  - actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained; and
  - a firm purchase commitment is highly probable within 1 year.

Example 10

An entity attempts to sell of its plant to a multinational company. The trade union with the local government's help put a stay order on the sale. The company knows that it will take some time (may be more than a year) to negotiate with the bureaucrats as well as the trade unions. It is expected that once the problem is resolved, firm purchase commitment is obtained (which is expected within 1 year).

Example 11

An entity is committed to a plan to sell a disposal group that represents a major portion of its regulated operations. But sale of such a significant part requires regulatory approval whichwill take some time (extended by 1 year). In order to get the approval, the buyer is to be known and a firm purchase commitment is required. This firm purchase commitment is highly probable, within 1 year and the exception of 1 year requirement is met.

- an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a non-current asset (or disposal group) previously classified as held for sale that will extend the period required to complete the sale, and –
  - timely actions necessary to respond to the conditions have been taken;and
  - a favourable resolution of the delaying factors is expected.

Example 12

An entity wants to sell a group of mines, but the buyer insists on geological and environmental surveys that will take more than a year. The sale will, therefore, be delayed because of the third party.

- during the initial 1 year period, circumstances arise that were previously considered unlikely and, as a result, a non-current asset (or disposal group), previously classified as held for sale, is not sold by the end of that period, and –
  - during the initial 1 year period the entity took actions necessary to respond to the change incircumstances;
  - the non-current asset (or disposal group) is being actively marketed at a price that is reasonable, given the change in circumstances;and

- the two classification criteria are met.

Example 13

ABC Ltd has negotiated with XYZ Ltd to sell a manufacturing unit, but due to XYZ Ltd's financial problems the sale got delayed. Finally, after one year of classifying the disposal group as held for sale, XYZ Ltd went into liquidation and, therefore, the sale transaction could not complete. As a result, ABC Ltd started to look for another buyer and was still committed to the plan to sell.

5. Significant changes or withdrawal of the selling plan unlikely

   If there are indicators (such as an economic downturn) that there will be significant changes to the selling plan or a withdrawal (because of change in businesss trategy) from the selling plan, then the sale should not be considered highly probable and hence the asset (disposal group) should not be classified as held for sale.

It is not necessary that sale of a non-current asset is only for cash; it can also be exchanged for another non-current asset.The only thing that needs to be checked in such a scenario is whether the exchange has commercial substance or not, as per Ind AS 16.

Disposal of Subsidary

An entity that is committed to a sale plan, involving loss of control of a subsidiary, should classify all the assets and liabilities of that subsidiary as held for sale, provided the classification criteria are satisfied, regardless of whether the entity would retain a non-controlling interest in its former subsidiary after the sale. The important point that is to be interpreted here is the expression loss of control. This standard becomes applicable either –

- when the parent-subsidiary relationship comes to an end; or
- the nature of the holding undergoes significant change, i.e., a change in controlling interest or significant influence or joint control.

Example 14

A Ltd is a parent and it has two subsidiaries– B Ltd and C Ltd. It is decided that B Ltd will be sold to C Ltd. This plan of sale will not be classified as held for sale under this Standard. Since A Ltd has control over C Ltd and C Ltd now will have contro lover B Ltd, so indirectly A Ltd still has control over both the entities.

Example 15

A Ltd is a parent, B Ltd its subsidiary and C Ltd is A Ltd's associates (having significant influence). If B Ltd is decided to be sold to the associate C Ltd, then A Ltd loses control over B Ltd and, therefore, this sale plan will fall under this Standard.

Non-current Assets that are to be Abandoned

An abandoned non-current asset (or disposal group) is one, which has been abandoned by the entity with no activity lately. Assets which are to be abandoned should not be classified as held for sale. If non-current assets (or disposal groups) are to be sold, then they are classified as held for sale. But if these assets (or disposal group) are abandoned, then there is no sale transaction and that their carrying amount will be recovered only through continuing use and not by sale. However, if a disposal group to be abandoned meets the criteria of discontinued operation, then the entity should present the result and cash flows of the disposal group as discontinued operations.

Example 16

ABC Ltd in October 2010, decides to abandon the activities of its cotton mill. In the reporting period 31 March 2011, the result and cashflows of the cotton mill are treated as continuing operations. There is no work at the cotton mill during the next year. In the financial statements of 31 March 2012, the result and cash flows of the cotton mill are treated as discontinued operations, the assets of the mill are classified as held for sale disposal group and the required disclosures are made.

An entity should not account for a non-current asset that has been temporarily taken out of use as if it has been abandoned.

Example 17

ABC Ltd stops production because the demand for its product had declined and there is a huge inventory of finished products. The plant is still in workable condition and is expected that it will become operational once demand picks up. This plant is not abandoned, but temporarily stopped.

Other Key Aspects

Entities often purchase assets with the sole objective of subsequent disposal. Such non- current assets should be classified as non-current assets (or disposal group) as held for sale at the acquisition date only, if the classification criteria are satisfied. If the classification criteria are satisfied after the reporting period, but before the authorisation of the financial statements for issue, the entity should not classify the non-current asset (or disposal group) as held for sale but disclose this information in the notes.

Measurement

Once the non-current asset (or disposal group) meets the classification criteria, then the measurement rules of this Standard become applicable.

Measurement of non-current assets held for sale

Step 1 Before classifying a non-current asset as held for sale, the carrying amount of the asset should be measured in accordance with the applicable Ind ASs

Example 18

ABC Ltd accounts for its buildings under revaluation model and decides to sell one of the buildings. Before classifying the building as non-current asset held for sale, the building should be revalued in accordance with Ind AS 16. Any revaluation gain or loss will be accounted for under that standard.

Step 2 It has to be determined whether the asset is within the measurement scope of this standard or not.

The measurement rules of this Standard does not apply to the following either as individual assets or as part of a disposal group.

- Assetsforwhichtheremightbedifficultiesindeterminingtheirfairvalue–
  - Deferred tax assets (Ind AS 12);
  - Assets arising from employee benefits (Ind AS 19); and
  - Contractual rights under insurance contracts (Ind AS 104)
- Assets already carried at fair value with changes in fair value recognised in profit or loss–
  - Financial assets (Ind AS 109);
  - Non-current assets that are–
    - accounted for in accordance with the fair value model (Ind AS 40);
    - measured at fair value less costs to sell (Ind AS 41).

The list above is limited only to the measurement requirements of this standard; the classification and presentation requirements of this Standard apply to all non-current assets. These scoped- outnon-current assets will continue to be measured in accordance with their applicable standards. Now, complexity arises when a disposal group includes both scoped-in and scoped-out non-current assets, we will take this up at a later part.

Step 3 An entity should then determine the fair value less cost to sell of the non-current asset classified as held for sale and measure it at lower of its carrying amount and fair value less cost to sell, where Fair value > carrying amount, there will be no effect on the reported value.

If the sale takes place beyond the 1 year period, then the costs to sell should take into account the time value of money, i.e., the costs to sell should be discounted to its present value and the increase in its value (unwinding of the discount) over subsequent reporting period should be treated as finance cost in profit or loss.

If the fair value less cost to sell (FVLCTS) of the non-current asset is lower than its carrying amount then an impairment loss should be charged to reduce the carrying amount of the asset to its FVLCTS.

Example 19

ABC Ltd decides to dispose of its office building. The held for sale criteria are satisfied and the asset is to be classified as non-current asset held for sale. The measurement procedure is:

Step 1 Initial measurement

Carrying amount 100 and recoverable amount 70. New remeasured carrying amount is 70 and impairment loss charged 30.

Step 2 Office building is within the scope of measurement rules of this standard.

Step 3 Held for sale measurement (Ind AS 105) on reporting date

Carrying amount 70 and FVLCTS 55. The new carrying amount of the non-current asset held for sale is 55 and further impairment loss is15.

Example 20

ABC Ltd has a building whose cost was 100. After 3 years, the accumulated depreciation was 30 and the property was decided to be sold.

Step 1 On initial measurement,no impairment loss was charged.

Step 2 Building is within the measurement scope of this Standard.

Step3 After classifying the asset as held for sale, the carrying amount of the building is 70 and its FVLCTS is found to be 75. Therefore, no impairment loss is recognised, since the asset is measured at lower of its carrying amount and FVLCTS, i.e., the non-current asset classified as held for sale is measured at 70.

Step 4 Once the building is classified as held for sale, depreciation ceases.

Step 5 On subsequent remeasurement, an entity should recognise any–

- impairment loss due to the write-down of the asset to FVLCTS to the extent it has not been recognised earlier;or
- subsequent gain for any increase in FVLCTS but not in excess of the cumulative impairment loss that has been recognised either in accordance with this standard or previously in accordance with Ind AS 36.

Step 6 If the non-current asset held for sale, is a scoped-out asset, then on subsequent measurement it should be measured as per the applicableInd ASs.

Example 21

The cost of the building is 1,000, accumulated depreciation is 300 and impairment loss is 150. Therefore, the present carrying amount of the building is 550.The building is decided to be sold.

Step 1 Initial measurement of the building (before the classification)

The Carrying amount of the non-current asset held for sale is 550 and deferred tax asset is 60.

Step 2 The building is within the measurement scope of this Standard.

Step 3 The FVLCTS of the building is found to be 500. As a result, an impairment loss of 550–500 = 50 is recognised and the non-current asset held for sale is carried at 500. The deferred tax asset is increased to 80.

Step 4 The depreciation of the building ceases.

Step 5 Subsequent measurement

On the reporting date, the building's market value increases and the FVLCTS is found to be 625. Thus, there is a gain of (625–500) = 125 and this is less than the cumulative impairment loss of 150 (at the beginning of the example) +50 (on subsequent measurement) = 200.Accordingly,the non-current asset held for sale is recorded at 625, deferred tax asset reduced to 30; and the gain of 75 is credited to profit or loss.

Thus, if the asset has been impaired prior to classification as held for sale, it is possible that at subsequent measurement there is a gain. It should be ensured that this gain can be used to reverse the earlier impairment loss but not accumulated depreciation.

Example 22

Let us continue with the previous example only. Due to some delay, which is beyond the control of the company, the asset is still not sold.

At the next reporting date, the building's FVLCS increases to 750. There is a further gain of 750–625 = 125, but the cumulative impairment loss available for reversal till that date is 150+50–125 = 75. Thus, the impairment reversal is restricted to 75 and hence the asset is carried at 625+75 = 700, deferred tax asset reduced to zero; and the gain of 45 is credited to profit or loss. Finally, the building is sold at 750 and a gain of 50 is recognised in profit or loss.

Example 23

ABC Ltd has land whose original cost is 100. It is revalued for 200. There valuation reserve in respect of the land has a balance of 100. The company decided to sell the land.

Step 1 At initial measurement, there is a downward revaluation of 50 and, in effect, the carrying amount of the land is 200–50 = 150. And, this 50 reduces the revaluation reserve balance to 50. The land as well as the related revaluation reserve is classified as held for sale.

Step 2 Land is within the measurement scope of this Standard.

Step 3 FVLCTS of the land was found to be 150 only and, therefore, there is no change as the measurement rule of this Standard.

Step 4 Land is not to be depreciated.

Step 5 On the reporting date, the land was not yet sold and its FVLCTS was found to be180. There is a gain of 180–150 = 30, but since there has been no impairment loss that is charged to the land as per this Standard or previously in accordance with IndAS 36, no subsequent gain is recognised and the land is continued to be carried at 150 only. There valuation reserve balance of 50 would be reduced on further downward revaluation (ifany) or would be transferred to retained earnings on the final sale of the land.

Example 24

Now let us take the previous example with some changes. We continue from Step 3.

Step 3 The FVLCTS of the land is found to be 80. Therefore, the asset is to be measured at lower of its carrying amount and FVLCTS. Thus, change in value is 150–80 = 70. 50 is used to reduce the revaluation reserve balance and the remaining 20 is charged as impairment loss in profit or loss.

Step 4 Same as before

Step 5 On subsequent remeasurement, the FVLCTS of the land was found to be 200. There is gain of 200–80 = 120. But as per this Standard, a subsequent gain can be recognised but only to the extent of cumulative impairment loss. In this case, the previous impairment loss is 20 and, therefore, impairment reversal is also limited to 20 only. The new carrying amount of the asset is 80+20 = 100.

Example 25

ABC Ltd has a building whose cost price is 1,000 and has residual value of nil. The useful life of the asset is 10 years. Therefore, depreciation per year is 1,000÷10 = 100.

After 2 years, the asset's carrying amount is 1,000 – 100 – 100 – 200 (impairment loss in 2nd year) = 600.

The depreciation in the 3rd year is (600 ÷8) = 75. Therefore, carrying amount of the asset at the end of 3rd year is (600 – 75) = 525. The building is decided to be sold and classified as held for sale.

Step 1 The recoverable amount of the building is found to be 325 and, therefore, an impairment loss of 525–325 = 200 is recognised.

Step 2 Building is within measurement scope of this Standard.

Step 3 The FVLCTS of the building is found to be 325. Therefore, the non-current asset held for sale is carried at 325.

Step 4 Depreciation of the building ceases.

Step 5 The FVLCTS is found to be 725 at the reporting date. The cumulative impairment loss till date has been 200+200 = 400. Impairment reversal is allowed to the extent of 400. The change in value is 725–325 = 400. The value of the building is recognised at 725 and an impairment reversal of 400 is recognised in profit or loss.

If an entity has classified a non-current asset (or disposal group) as held for distribution to owners, even then the same rules apply, i.e., it should be measured at lower of its carrying amount and fair value less cost to distribute (incremental costs directly attributable to the distribution, excluding finance costs and income tax expense).

Measurement of Disposal Group Held for Sale

The measurement rules for disposal groups are similar to individual assets, but complexity arises when disposal groups include assets which are scoped-out from measurement rules as well as scoped-in assets.

Let us consider the entire process once again for a disposal group.

Step 1 Before classifying the disposal group as held for sale, an initial measurement of all the individual assets (scoped-in or scoped-out) and liabilities in the disposal group is done on the basis of their applicable Ind ASs.

Step 2 The scoped-in and scoped-out non-current assets within the disposal group held for sale are to be identified.

Step 3 Then, the FVLCTS of the entire disposal group held for sale, is determined.

If the FVLCTS of the disposal group is lower than the aggregate carrying amount of the disposal group, then an impairment loss is recognised in profit or loss.

In case of an impairment loss, the loss is allocated to the assets within the disposal group on the basis of same rules as per Ind AS 36, i.e.,

- any impairment loss is first allocated in its entirety to the disposal group's goodwill;
- the remaining loss (if any) is then allocated on a pro-rata basis to the remaining assets (scoped-in assets) in the disposal group.

Step 4 Interest and other expenses attributable to the liabilities of a disposal group continue to be recognised, whereas depreciation or amortisation of the non-current assets within the disposal group ceases.

Step 5 On subsequent remeasurement, the scoped-out assets within the disposal group held for sale are first measured on the basis of their applicable Ind ASs and then the carrying amount of the entire disposal group is adjusted accordingly.

Step 6 Thereafter, the FVLCTS of the entire disposal group is again (subsequent remeasurement) determined.

If the carrying amount of the disposal group is greater than its FVLCTS, then further impairment loss is charged and allocated among the scoped-in assets only on a pro-rata basis. And, in case, the FVLCTS of the disposal group on subsequent measurement exceeds its carrying amount, then a subsequent gain is also recognised to the extent it was not recognised on initial measurement, but not in excess of the cumulative impairment loss that has been recognised either in accordance with this Ind AS or previously in accordance with Ind AS 36.

Example 26

ABC Ltd has decided to dispose of a group of assets, which form the disposal group. After the classification criteria are satisfied, the assets in the disposal group are immediately remeasured according to the applicable Ind ASs.The FVLCTS of the entire disposal group is determined to be 2,300.

Disposal Group	Carrying amount at the end of reporting period before classification as held for sale	Change in value on initial measurement before classification
Goodwill	1,000	–
Other intangible assets	600	–
Property, plant and equipment	1,000	(400)
Investment property	700	(100)
Deferred tax asset	500	(100)
Trade receivables	400	–
Financial assets	300	–
Aggregate	**4,500**	**(600)**

Step 1 Once the decision to sale is taken, all individual assets (scoped-in or scoped-out) within the disposal group are remeasured according to their respective Ind ASs. The carrying amount of the disposal group after initial measurement is 3,900 (4,500– 600). The disposal group is then classified as held for sale.

Step 2 The assets, within the disposal group held for sale, that are scoped-out of the measurement rule of this Standard are deferred tax asset, trade receivables and financial assets. Trade receivables are type of financial assets and, therefore, outside the measurements cope of this Standard.

Step 3 As per this Standard, a disposal group classified as held for sale should be measured at lower of its carrying amount (3,900) and FVLCTS (2,300). There is clearly an impairment loss of 3,900–2,300 = 1,600, which needs to be allocated among the individual as sets (scoped-in assets) within the disposal group.

For assets recovered partly through use and partly through sale, measuring the resulting deferred taxes will require a blended measurement approach as different tax rates and tax bases will apply.

Disposal group	Carrying amount before classification	Change in value on initial measurement before classification	Carrying amount on initial measurement before classification	Allocation of impairment loss	Carrying amount after held for sale classification
Goodwill	1,000	–	1,000	(1,000)	–
Other intangible assets	600	–	600	(200)*	400
Property, plant and equipment	1,000	(400)	600	(200)*	400
Investment property (at cost)	700	(100)	600	(200)*	400
Deferred tax asset	500	(100)	400	–	400
Trade receivables	400	–	400	–	400
Financial assets	300	–	300	–	300
Aggregate	**4,500**	**(600)**	**3,900**	**(1,600)**	**2,300**

*(Carrying amount of asset ÷ Sum of carrying amount of assets among which loss to be allocated) x (Remaining impairment loss after charging to goodwill) = [(600 ÷1,800) x (1,600 – 1,000)] = 200

First, the goodwill in the disposal group is reduced to Nil and, therefore, the loss allocated to goodwill is 1,000. Remaining loss (1,600–1,000) = 600 is allocated to the remaining assets (which are within the scope of measurement of this standard) on pro-rata basis. Allocation of remaining impairment loss is–

- Other intangible assets [600 ÷(600 + 600 + 600)] x 600 = 200
- Property, plant and equipment [600 ÷(600 + 600 + 600)] x 600 = 200
- Investment property [600 ÷(600 + 600 + 600)] x 600 = 200

The left out assets are outside the scope of measurement of this Standardand, therefore, no impairment loss is allocated to those assets.

Example 27

Let us continue with the previous example. The disposal group is not sold till the next reporting period and, therefore, needs to be remeasured.

Step 5 The assets that are outside the measurement scope are measured on the reporting date as per the applicable Ind ASs, ie, Deferred tax asset 350; Trade receivables 200; Financial assets 400.

The change in fair value of the scoped-out assets from previous carrying amount is (— 50 — 200 + 100) = (—) 150.

The aggregate carrying amount of the disposal group after remeasuring the scoped-out assets on reporting date is 2,150 (2,300—150).

Step 6 The FVLCTS of the entire disposal group is found to be 2,000 on the reporting date and, therefore, further impairment loss of 2,150–2,000 = 150 needs to be allocated among the remaining assets (other intangible assets, property, plant and equipment and investment property at cost) of the disposal group on a pro-rata basis.

Disposal group	On reporting date	After measuring the scoped-out assets	Allocation of further impairment	Carrying amount on reporting date
Goodwill	–		–	
Other intangible assets		400	(50)	350
Property, plant and equipment		400	(50)	350
Investment property		400	(50)	350
Deferred tax asset	350	350	–	350
Trade receivables	200	200	–	200
Financial assets	400	400	–	400
Aggregate		**2,150**	**(150)**	**2,000**

Example 28

Let us continue with the example 26, the FVLCTS of the entire disposal group on the reporting date was found to be 3,000.

Disposal group	On reporting date	After measuring the scoped-out assets (A)	Impairment reversal	Allocation of subsequent gain allowable (B)	Carrying amount on reporting date (A + B)
Goodwill		–	–	–	
Other intangible assets		400	283.33	200	600
Property, plant and equipment		400	283.33	350	750
Investment property (at cost)		400	283.33	300	700
Deferred tax asset	350	350	–	–	350
Trade receivables	200	200	–	–	200
Financial assets	400	400	–	–	400
Aggregate		**2,150**	**850**		**3,000**

Step 5 The scoped-out assets are measured as per their applicable Ind ASs and the carrying amount of the entire disposal group is found to be 2,150.

Step 6 On reporting date, the FVLCTS (3,000) is found to be greater than the carrying amount (2,150) of the disposal group held for sale. There is a subsequent gain and thus, a requirement for impairment reversal of 3,000–2,150 = 850.

Impairment loss on goodwill is never reversed. Therefore, it remains at Nil.

The increase in value should have been allocated to the scoped-in assets on a pro-rata basis –

- Other intangible assets [400 ÷(400 + 400 + 400)] x 850 = 283.33.
- Property, plant and equipment [400 ÷(400 + 400 + 400)] x 850 = 283.33.
- Investment property [400 ÷(400 + 400 + 400)] x 850 = 283.33.

But, for impairment reversal there is a check point, i.e., subsequent gain should be recognised to the extent of cumulative impairment loss charged in prior period(s).Therefore–

- Other intangible assets Cumulative impairment loss 200, so impairment reversal allowed to the extent of 200 only and not 283.33. Remaining gain for impairment reversal is to be allocated between the remaining two scoped-in assets (850– 200) ÷2 = 325.

- Investment Property at cost Cumulative impairment loss 100+200 = 300, so impairment reversal is allowed to the extent of 300 only. Remaining gain for impairment reversal is to be allocated to the remaining scoped-in asset
- Property, plant and equipment Cumulative impairment loss 400+200 = 600, so impairment reversal is allowed for the remaining 350.

Example 29

Let us continue with example 27 only with a different FVLCTS in Step 6.

Step 6 The FVLCTS determined on the reporting date is 4,100.

Disposal group	On reporting date	After measuring the scoped-out assets (A)	Impairment reversal	Allocation of subsequent gain allowable (B)	Carrying amount on reporting date (A + B)
Goodwill	–	–	–	–	
Other intangible assets	–	400	650	200	600
Property, plant and equipment	–	400	650	600	1,000
Investment property (at cost)	–	400	650	300	700
Deferred tax asset	350	350	–	–	350
Trade receivables	200	200	–	–	200
Financial assets	400	400	–	–	400
Aggregate		**2,150**	**1,950***	**1,100**	**3,250**

*4,100 – 2,150 = 1,950

The final aggregate carrying amount of the disposal group on the reporting date is 3,250 whereas the fair value less cost to sell is 4,100. Thus, it is clear that the FVLCTS of the disposal group need not be the same as the actual carrying amount at the end of the subsequent measurement, the reason being the impairment reversal check point.

An entity should present any adjustment for gain or loss on remeasurement of a non-current asset(ordisposalgroup)classifiedasheldforsale,inStatementofProfitandLossfromcontinuing operations. A gain or loss that was not recognised before the date of sale of the non-current asset (or disposal group) should be recognised at the time of derecognition (disposal).

Changes to a plan of sale

If due to some changes in circumstances, a non-current asset (or disposal group) held for sale does not satisfy the classification criteria any more, then an entity needs to reclassify them. The entity should remeasure the non-current asset (or disposal group) that ceases to be classified as held for sale at lower of its–

- carrying amount before the non-current asset (or disposal group) was classified as held for sale, adjusted for any depreciation, amortisation or revaluation that would have been recognised had the asset (or disposal group) not been classified as held for sale; and
- recoverable amount at the date of the subsequent decision not to sell.

Example 31

An entity had the following disposal group classified as held for sale :

Disposal group	Carrying amount		Impairment Loss charged
	before held for sale classification	as per this standard	
Goodwill	10	0	(10)
Property, Plant and equipment	15	10	(5)
Trade receivable	10	3	(7)
Aggregate	**35**	**13**	

The depreciation of property, plant and equipment during the period it was classified as held for sale was 2, but as per this Standard depreciation was ceased.

The management of the entity changed its intention regarding the disposal group and, therefore, ceases to classify the disposal group as held for sale and measures it at lower of its–

- carrying amount before the disposal group was classified as held for sale, adjusted for any depreciation not been classified as held for sale; and
- recoverable amount at the date of the subsequent decision not to sell.

The recoverable amount of the disposal group is found to be 40. The carrying amount of the disposal group, before held for sale classification was 35. The depreciation that would have been recognised was 2. Therefore, the adjusted carrying amount would have been 35–2 = 33 if the disposal group was not classified as held for sale. As per the measurement rule of changes of plan of sale, the disposal group is measured at lower between the 2, ie, 33.

If an individual asset or liability is to be removed from a disposal group classified as held for sale, then the remaining assets or liabilities should be continued to be measured as a group only if the classification criteria are met. Otherwise–

- the remaining non-current assets of the group that individually meet the criteria to be classified as held for sale should be measured individually at lower of their carrying amount and FVLCTS; and
- any non-current asset that cease to be classified as held for sale should be reclassified.

Presentation

Non-current assets (or disposal group) classified as held for sale and any associated liability with the disposal group (if any) needs to be presented separately in Balance Sheet. The non-current assets (or disposal group) classified as held for sale should be presented under a separate heading on the assets side of Balance Sheet. The associated liabilities of a disposal group classified as held for sale should also be presented separately from other liabilities in Balance Sheet.

The non-current assets and liabilities of a disposal group classified as held for sale should not of-set each other and be presented as single amount.

A detailed analysis of the amounts presented against non-current assets (or disposal groups) and associated liabilities (if any) classified as held for sale is required either on the face of Balance Sheet or in notes.

In case, there is any cumulative income or expense recognised in Other Comprehensive Income relating that non-current asset (or disposal group) classified as held for sale, it should be also presented separately.

An entity is not required to reclassify or represent amounts presented for non-current assets (or for the assets and liabilities of disposal groups classified) as held for sale in Balance Sheet for prior periods to reflect the classification in Balance Sheet for the latest period presented.

Example 31

The layout below shows how the items will be presented:

XYZ Ltd
Balance Sheet as on 31 March

Assets	**2016**	**2015**
Non-current assets		
Current assets		
Non-current assets (or disposal group) classified as held for sale		
Equity		
Retained earning		
Other components of equity		
Reserves associated with non-current asset (or disposal group) classified as held for sale		
Liabilities		
Non-current liabilities		
Current liabilities		
Liabilities directly associated with disposal group classified as held for sale		

The line item reserve associated with non-current asset (or disposal group) classified as held for sale refers to the cumulative income or expense that is recognised in Other Comprehensive Income relating to a non-current asset such as a property, plant or equipment that has previously been revalued.

Discontinued Operations

A discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale and –

- represents a separate major line of business or geographical area of operations;
- is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations;or
- is a subsidiary acquired exclusively with a view to resale.

Example 32

An entity has two lines of business, one is retail and the other is hospitality. It decides to cease the activities of its hospitality business and continue and concentrate on its departmental stores (retail business). Thus, the activities of the company's separate major line of business (hospitality business) have been ceased and its assets and related liabilities have been classified as held for sale.

The phrase component of an entity refers to operations and cash flows that can clearly be distinguished, operationally and for financial reporting purposes, from the rest of the entity.

Simply put, discontinued operation is a part of business that is to be discontinued. Its accounting significance is that, its contribution should be removed from profit seeking continuing activities to discontinued activities because otherwise that will mislead investors.

A lot of judgment is required to decide whether a disposal corresponds to a discontinued operation or a disposal group. The facts and circumstances of each transaction should be assessed and significant elements of operations should be studied.

Certain operations of a business that are to be disposed of are classified as discontinued operations. These discontinued operations result in gain or losses that are separately presented in Statement of Profit and Loss. However, gains or losses relating to non-current assets held for sale or disposal groups are presented as part of continuing operations.

If a group of assets (and liabilities) satisfies the classification criteria for held for sale and is also part of a major operation, then a situation of both disposal group and discontinued operation arise.

Example 33

ABC Ltd is operating in 3 busines ssegments namely toy manufacturing, electronic equipments and bicycle manufacturing. The company has purchased a new centralised computer system in order to keep track of all the 3 segments. After 6 months of the new computerised system, the management decided to sell the toy manufacturing segment and want to concentrate on the other two. The disposal of an entire segment will be accounted for as a discontinued operation. However, the new computer system can not be part of the disposal group because for that it must be available for immediate sale in its presentcondition. Therefore, the company should not allocate the overall cost incurred on the new computer system to thesegment disposed of.

Example 34

The following are some cases in order to understand the relationship between discontinued operations and held for sale assets:

Cases	An entity	Whether	
		discontinued operation?	**non-current assets held for sale?**
1	disposes of a certain operation by selling the underlying assets. The sales transaction is still in progress on the reporting date.	Yes	Yes
2	has stopped activities that meets the definition of discontinued operation but has not yet decided to sell off the assets.	Yes	No
3	has stopped activities and already sold of the underlying assets at the reporting date.	Yes	No
4	has not discontinued any activity, but will sell off some assets.	No	Yes

A subsidiary that has been exclusively acquired with a view to resale should be considered as discontinued operation. The result of such a transaction – buying a subsidiary in order to resale is presented as a discontinued operation.

Accounting Policies, Changes in Accounting Estimates and Errors (Ind AS 8)

Introduction

Accounting policies

These are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Example 1

The initial measurement of property, plant and equipment is at cost, but subsequent measurement can be done on the basis of 2 measurement bases–cost model or there valuation model. An entity might choose either of these 2 accounting models as its accounting policy.

Selection and application of accounting policies

If there is a particular Ind AS that applies to a specific transaction, event or condition, then the accounting policy or policies to that item should be determined by applying that Ind AS only.

The standards have some appendices for assistance in applying the requirements. These appendices provide implementation guidance. Some of these appendices are an internal part of the standard and, therefore,are mandatory.

Some specific issues or items are often discussed in much detail in the Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC) and, therefore, accounting policies for treatment of such issues are determined by those Interpretations.

In the absence of a standard or interpretation, an entity should use judgment in developing and applying an accounting policy that results in information that is relevant and reliable.

Example 2

ABC Ltd receives credits for emissions from the government as a result of its country's emission trading schemes.The credits are received annually and, in return, the company must remit rights equal to its actual emissions. Now, there is no specific standard that guides emission credit rights accounting. There was an IFRIC 3 Emission Rights but it was withdrawn in July 2005 and there is presently no guidance available. In the absence of a standard or interpretation, the company developed its own accounting policy that is relevant and reliable. It decided to adopt the net liability approach whereby a provision is recognised in case actual emissions exceed the emission rights granted.

Management should also refer to and consider the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework for Financial Reporting.

The pronouncement by other standard setting bodies that have similar framework for developing accounting standards, other accounting literature and accepted industry practices, could also be considered, provided they do not conflict with the Conceptual Framework for Financial Reporting, and Ind ASs.

Consistency of accounting policies

An entity should select and apply its accounting policies consistently for similar transactions, events or conditions in order to enable users of financial statements to compare the financial statements of an entity, over time, to judge its performance and identify trends.

Example 3

Ind AS 16 allows an entity to choose as its accounting policy, either the fair value model or the cost model. The Standard has clearly stated that changing from one policy to another should be done only if it provides more relevant and reliable information to the users.

If categorisation is permitted or required by an Ind AS, then an appropriate accounting policy can be selected and applied consistently to a category.

Example 4

Ind AS 16 allows an entity to choose either the cost model or the revaluation model as its accounting policy and it should be applied to an entire class/category of property, plant and equipment. A class of property, plant and equipment is basically grouping of assets of similar nature and use in an entity's operations, such as land, land and building, machinery, motor vehicles etc. Therefore, an entity can choose revaluation model for land, and land and buildings category, whereas apply cost model to machinery and motor vehicles. But once chosen, an entity should be consistent in applying those policies.

Changes in Accounting Policies

A change in an accounting policy means that an entity has exchanged one accounting policy for another.

Example 5

A change in inventory valuation as per Ind AS 2 Inventories from FIFO to Weighted Average would be a change in accounting policy. A change in accounting for borrowing costs as per Ind AS 23 Borrowing Costs from capitalisation to immediate expensing is also a change in accounting policy.

In the preparation of financial statements, there is an underlying presumption that an accounting policy, once adopted, should not be changed, but rather should be uniformly applied in accounting for events, transactions or conditions of a similar type. This presumption may be overcome, only, if the entity justifies the use of an alternative acceptable accounting policy on the basis, that it is preferable under certain circumstances.

A change in accounting policy should be made only if either of the following is satisfied –

- It is required by an Ind AS; or
- The change results in the financial statements providing more reliable and relevant information about the effects of transactions, other events or conditions on financial position, performance and cash flows.

It should be ensured that the following are not changes in accounting policies –

- The application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring;

Example 6

ABC Ltd had acquired a machine under a finance lease and therefore Ind AS 17 Leases was applicable. The company purchased another machine, leased it to another party for considerable period and then leased it back from that party for a shorter time period. In such a case, the entity has entered into a series of transactions that involves the legal form of a lease. Therefore, the entity must evaluate the substance of such transactions as per SIC 27 Evaluating the Substance of transactions involving the legal form of a Lease and, therefore, this interpretation becomes applicable and is not a change in accounting policy.

and

- The application of a new accounting policy for transactions, events or conditions that did not occur previously or were immaterial

Example 7

ABC Ltd generally purchases property such as land, building, motor vehicle etc. outright and, therefore, applies Ind AS 16. Now, the company has decided to acquire the right to use a building through leasing and, therefore, Ind AS 17 Leases becomes applicable. This is a new transaction different from previously occurring ones and, therefore, application of a particular accounting policy is not a change in accounting policy.

Example 8

ABC Ltd had a building which it used for its business purposes and a small part of it was sublet. But since it was not a significant part, the company applied Ind AS 16 to that entire building. Later the company acquired another huge property which was let out and, therefore, Ind AS 40 Investment Property became applicable and even the small part of the other building that was sublet previously, is also covered under this standard.

The initial application of a policy to revalue property, plant and equipment as well as intangible assets is a change in accounting policy. However, it would be dealt with as per the revaluation model of Ind AS 16 and Ind AS 38 respectively, and not according to this Standard. Therefore, though a change from cost model to revaluation model is a change in accounting policy, no retrospective application is required in case of initial application of a revaluation model.

Example 9

ABC Ltd had been following cost model for its land valuation for 10 years. Then, it decided to change its accounting policy for the measurement of land to revaluation model. The company appointed an independent valuer to determine the fair value of the land. Though, the company has changed its accounting policy from cost to revaluation model for land, it is exempt from any kind of retrospective application.

However, a change from revaluation model to cost model should be treated as a change in accounting policy, requiring retrospective treatment.

A change in accounting policy, which is made on the adoption of an Ind AS standard, should be accounted for as per the following –

- in accordance with the specific transitional provisions in that standard;

Example 10

In the last example, when ABC Ltd first applies the standard Ind AS 40 Investment Property, it follows the transitional provisions related to that standard included in Ind AS 101 First-Time Adoption of International Financial Reporting Standards.

or

- if no transitional provisions are provided then the change should be accounted for retrospectively.

It should be kept in mind that early application of an Ind AS (before it has become effective) is not a voluntary change in accounting policy.

Example 11

In most of the cases, standards are issued first but they become effective at a later date. However, there is always a provision, whereby an entity can go for early application of that standard. In that case, it is not a voluntary change in accounting policy and, therefore, comparative figures need not be presented.

A voluntary change in accounting policy should be applied retrospectively. **Retrospective application**, is applying a new accounting policy to transactions, other events and conditions, as if that policy had always been applied. In retrospective application, an entity should adjust the–

- opening balance of each affected component of equity for the earliest prior period presented; and
- the other comparative amounts disclosed for each prior period presented;

as if the new accounting policy had always been applied.

Example 12

ABC Ltd and XYZ Ltd have a jointly controlled entity PQR Ltd. ABC Ltd was accounting for PQR Ltd under equity method. Then, ABC Ltd decided to account for PQR Ltd under the proportionate consolidation method. This is a change in accounting policy, from equity method to proportionate consolidation method and, therefore, retrospective application needs to be done.

Example 13

ABC Ltd provided the following information :

Reporting Period	**2012**	**2011**	**2010**	**2009**
Revenue	15,000	12,000	9,000	6,000
Cost of goods sold	9,000	7,000	6,000	4,000
Share Capital				10,000
Property, plant and equipment				10,000
Borrowing cost	800	600	500	500
Operating expenses	600	700	450	550

The company was producing an item that would take 4 years to get ready for sale and, therefore, it decided to capitalise the related borrowing costs. The inventory cost incurred in 2009–5,000; 2010–1,000; 2011–1,000 and 2012–1,000. Then, the company decided to go for immediate expensing from 2012. In effect, there is a change in accounting policy.

The income tax rate is 30% and opening cash balance was 10,000 in 2009.

First, the Statement of Profit and Loss of 2009 and 2010 (prior periods) when borrowing costs were capitalised are prepared.

Statement of Profit and Loss

Reporting period	**2010**	**2009**
Revenue	9,000	6,000
Less: Cost of goods sold	6,000	4,000
Gross profit	3,000	2,000
Operating expenses	450	550
Operatingprofit	2,550	1,450
Finance costs	–	–
Accounting Profit	2,550	1,450
Tax expense –		
Current tax	615	285
Deferred tax expense	150* 765	150* 435
Profit for the period	1,785	1,015

*Since borrowing cost was capitalised, a deferred tax expense is created 500 x 30% = 150. Then, the financial statements for 2011 and 2012 are prepared.

Statement of Profit and Loss

Reporting Period	**2012**	**2011** Restated
Revenue	15,000	12,000
Less: Cost of goods sold	9,000	7,000
Gross profit	6,000	5,000
Operating expenses	600	700
Operatingprofit	5,400	4,300
Finance costs	800	600*
Accounting profit	4,600	3,700
Tax expense (@ 30%)	1,380	1,110
Profit for the period	3,220	2,590

*Borrowing costs was capitalised, but here they are restated as if they have been expensed.

Balance of Retained earnings on 1April 2010 : 1,015 + 1,785 = 2,800.

Effect of change in accounting policy from capitalisation to immediate expensing of borrowing cost [(500+500)x70%] = 700.

Deferred tax reversed through equity [(500+500)x30%] = 300.

Statement of Changes in Equity

Particulars	Share Capital	Retained earnings	Total
Balance on 1 January 2010	10,000	2,800	
Effect of change in accounting policy from capitalisation			
to immediate expensing of borrowing cost		(700)	
Profit		2,590	
Balance on 31 December 2011	10,000	4,690	14,690
Profit		3,220	3,220
Balance on 31 December 2012	10,000	7,910	17,910

Balance Sheet

Reporting period	2012	2011 Restated	2010	2009
Assets				
Current				
Inventories	8,000	7,000	7,000	5,500
Cash and cash equivalents	11,290	8,800	6,715	5,950
Total assets	19,290	15,800	13,715	11,450
Equity and liabilities				
Equity attributable to owners				
Share capital	10,000	10,000	10,000	10,000
Retained earnings	7,910	4,690	2,800	1,015
Total equity	17,910	14,690	12,800	11,015
Liabilities				
Non–current				
Deferred tax liabilities	–	–	300	150
Current				
Current tax liabilities	1,380	1,110	615	285
Total liabilities	1,380	1,110	915	435
Total equity and liabilities	19,290	15,800	13,715	11,450

Inventories

2009 5,000 + 500 = 5,500 (borrowing costcapitalised)

2010 5,500 + 500 = 6,000 (borrowing cost capitalised) + 1,000 =7,000

2011 7,000 – 1,000 = 6,000 (borrowing cost capitalised earlier is reduced – effect of retrospective application)+ 1,000 = 7,000

2012 7,000 + 1,000 =8,000

Cash and cash equivalent

2009 Opening balance + Profit before tax – Borrowing cost (paid in cash) – Cost of Inventory
= [10,000 + 1,450 – 500 – 5,000] = 5,950

2010 Opening balance + Profit before tax – Borrowing cost – Current tax (previous year) – Cost ofInventory
= [5,950 + 2,550 – 500 – 285 – 1,000] = 6,715

2011 6,715 + 3,700 (profit before tax after borrowing cost expensed) – 615 – 1,000 =8,800

2012 8,800 + 4,600 – 1,110 – 1,000 =11,290

Example 14

ABC Ltd had been using the completed–stage method for its construction business. The company decided to voluntarily change its accounting policy to the percentage of completion method from 2012. The details are given below:

Reporting period	**2012**	**2011**	**Prior periods**
Profit before tax	1,000	800	
Retained earnings at the beginning		500	
Difference in income due to change in policy	100	150	600

The applicable income tax rate is 30%.

Statement of Profit and Loss

Reporting period	**2012**	**2011 Restated**
Profit before tax	1,000	950*
Income tax expense	300	285
Profit	700	665

* 800 + 150 = 950

Statement of Changes in Equity

Particulars	**Share Capital**	**Retained earnings**	**Total**
Balance on 1 January 2011	1,000	500	1,500
Effect of change in accounting policy from completed			
stage method to percentage of completion method	–	420*	420
Profit	–	665	665
Balance on 31 December 2011	1,000	1,585	2,585
Profit	–	700	700
Balance on 31 December 2012	1,000	2,285	3,285

* 600 x 70%

Applying a requirement is **impracticable**, when the entity cannot apply it, after making reasonable efforts to do so. For a particular prior period, it is impracticable to apply a change retrospectively because of the following—

- The effects of the retrospective application are notdeterminable;
- The retrospective application requires assumptions about what management's intent would have been in that period; or
- The retrospective application requires significant estimates of amounts.

Therefore, in cases, where it is impracticable to ascertain the period-specific effects or the cumulative effect of change, the entity should alter the comparative information to apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and should make a corresponding adjustment to the opening balance of each affected component of equity for that period.

Example 15

ABC Ltd had been charging borrowing cost as an expense and now it decides to change its accounting policy to capitalising borrowing costs.There was a fire in the company's office building 4 years ago. As a result, all data prior to that is unavailable. Therefore, adjustments are limited to the last 4 years, since it is impracticable to adjust the opening balance of the effective component of equity for the earliest prior period.

Also, if it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity should adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

Changes in Accounting Estimates

Uncertainty is inherent in business environment and, therefore, estimation and assumptions become part and parcel of accounting. Estimation necessitates judgment based on the latest available information.

Example 16

An estimate is a guess at the size of something. An estimate often comes out a little larger or a little smaller than the actual size. In accounting, it is a judgment of the value of a quantity which can not accurately be determined. Estimate is an integral part of accounting.

A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. A change in accounting estimate resultsfrom new information or new development and they should not be mistaken as corrections of errors. The effect of a change in an accounting estimate should be recognised prospectively by including it in profit or loss in the period of–

- change , if the change affects that period only; or
- the change and future periods, if the change affects both.

Example 17

ABC Ltd has a building whose present carrying amount is 1,000 and its remaining useful life is 5 years. Its receivables are standing at 500 and provision for doubtful debt is 25. Now, with new information available, ABC Ltd decides to keep its provision for doubtful debt at 10% for the current year. The company also decides to change the estimate of useful life of its building from 5 to 8 years. Now, let us look at the implications of these changes in estimates.

Provision for doubtful debts (previous carrying amount) 25

After change in estimate, Provision is 10% of receivables 10% x 500 = 50

Journal

Other expenses	25	
Provision for doubtful debts		25

Next year, the company would again decide whether to keep the provision at 10% or change it. So, this change in estimate affects only the current period's profit or loss and, therefore, is recognised in the current period only.

The building had a carrying amount of 1,000 and remaining useful life 5 years, so depreciation should have been 1,000÷5=200.

But due to change in estimate of the useful life to 8 years, the new depreciation charge for the present as well as the future periods would be 1,000÷8=125. Thus, a change in the estimated useful life has changed the expected pattern of consumption of the future economic benefits embodied in, affecting the depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, however, the effect of change relating to the current period are recognised as expense in the current period and the effect on future periods is recognised in those future periods.

If a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognised by adjusting the carrying amount of the related asset, liability, or equity item in the period of change.

Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate.

Example 18

ABC Ltd provided the following information :

Reporting period	**2012**	**2011**	**2010**
Revenue	1,500,000	1,200,000	1,000,000
Cost of goods sold	900,000	700,000	550,000
Share capital			1,000,000
	Cost	**Useful life (years)**	**Revised useful life remaining (years)**
Building	150,000	15	20
Property, Plant and Equipment	100,000	10	7
Furniture	35,000	7	5

The assets have been purchased on 1 January, 2010. The useful lives of the assets are revised on 1 January 2012 and the applicable income tax rate is 30%.

Accumulated Depreciation Schedule

Particulars	**Building**	**Property, Plant and Equipment**	**Furniture**	**Total**
Balance on 1 January 2010	–	–	–	–
Depreciation	10,000	10,000	5,000	25,000
Balance on 31 December 2010	10,000	10,000	5,000	25,000
Depreciation	10,000	10,000	5,000	25,000
Balance on 31 December 2011	20,000	20,000	10,000	50,000
Depreciation	6,500*	11,429**	5,000***	22,929
Balance on 31 December 2012	26,500	31,429	15,000	72,929

* (150,000 – 20,000) ÷20 = 6,500

** (100,000 – 20,000) ÷7 = 11,429

*** (35,000 – 10,000) ÷5 = 5,000

Statement of Profit and Loss for the period ended on 31 December

Reporting period		**2012**		**2011**		**2010**
Revenue		1,500,000		1,200,000		1,000,000
Less: Cost of goods sold		900,000		700,000		550,000
Gross profit		600,000		500,000		450,000
Depreciation		22,929		25,000		25,000
Accounting profit		577,071		475,000		425,000
Tax expense –						
Current tax	172,500		142,500		127,500	
Deferred tax expense	621*	173,121	–	142,500	–	127,500
Profit for the period		403,950		332,500		297,500

*Difference in depreciation charged 25,000 – 22,929 = 2,071

Therefore, corresponding deferred tax 2,071 x 30% = 621

Balance Sheet as on 31 December

Reporting period	2012	2011	2010
Assets			
Non–current			
Property, plant and equipment	212,071	235,000	260,000
Current			
Cash and cash equivalents	1,995,000	1,537,500	1,165,000
Total assets	2,207,071	1,772,500	1,425,000
Equity and liabilities			
Share capital	1,000,000	1,000,000	1,000,000
Retained earnings	1,033,950	630,000	297,500
Total equity	2,033,950	1,630,000	1,297,500
Liabilities			
Non–current			
Deferred tax liabilities	621	–	–
Current			
Current tax liabilities	172,500	142,500	127,500
Total liabilities	173,121	142,500	127,500
Total equity and liabilities	**2,207,071**	**1,772,500**	**1,425,000**

Cash and cash equivalent

2010 1,000,000 – 285,000 (Cost of PPE) + 450,000 =1,165,000

2011 1,165,000 – 127,500 (Previous year's tax paid) + 500,000 =1,537,500

2012 1,537,500–142,500+600,000=1,995,000

Example 19

ABC Ltd provided the following information :

Reporting period	2012	2011	2010
Revenue	150,000	120,000	100,000
Cost of goods sold	90,000	70,000	55,000
Share capital			100,000
	Cost	**Useful life (years)**	**Scrap Value**
Property, Plant and Equipment	100,000	10	10,000

On 1st January 2012, it was found that the revised scarp value of the plant and machinery is 25,000 (Tax rate 30%).
Depreciation –

2010 (100,000 – 10,000) ÷10 =9,000

2011 (100,000 – 10,000) ÷9 =9,000

2012 [(100,000 – 18,000) – 25,000] ÷8 =7,125

Statement of Profit and Loss

Reporting period	2012		2011		2010	
Revenue		150,000		120,000		100,000
Less: Cost of goods sold		90,000		70,000		55,000
Gross profit		60,000		50,000		45,000
Depreciation		7,125		9,000		9,000
Accounting profit		52,875		41,000		36,000
Tax expense –						
Current tax	15,300.00		12,300		10,800	
Deferred tax expense	562.50	15,862.50	–	12,300	–	10,800
Profit for the period		37,012.50		28,700		25,200

Balance Sheet as on 31 December

Reporting period	2012	2011	2010
Assets			
Non–current			
Property, plant and equipment	74,875	82,000	91,000
Current			
Cash and cash equivalents	131,900	84,200	45,000
Total assets	206,775	166,200	136,000
Equity and liabilities			
Share capital	100,000	100,000	100,000
Retained earnings	90,912.50	53,900	25,200
Total equity	190,912.50	153,900	125,200
Liabilities			
Non–current			
Deferred tax liabilities	562.50	–	–
Current			
Current tax liabilities	15,300	12,300	10,800
Total liabilities	15,862.50	12,300	10,800
Total equity and liabilities	2,06,775	1,66,200	136,000

Occasionally, it might be difficult to distinguish between changes in accounting policies and changes in accounting estimates. A change, in the measurement basis applied, is a change in an accounting policy (such as cost or revaluation model) and is not a change in an accounting estimate. In such cases of confusion, the change is treated as a change in estimate.

Errors

Errors are unintentional misstatements or omissions or disclosures in financial statements. They include mistakes in gathering, processing of data or accounting of data from which the financial statements are prepared. Errors can also result from incorrect accounting estimates arising from oversight or misinterpretation of facts and mistakes in the application of accounting principles relating to accounting classification, manner of presentation or disclosure.

The general principle in this standard is that an entity must correct all material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

- restating the comparative amounts for the last period(s) presented in which the error occurred;

Example 20

It was found while auditing that the travelling expenses were inflated hugely by producing fabricated bills in the last financial year. The comparative figures must be then restated to correct this error.

or

- If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equityfor the earliest prior period presented.

Example 21

In 2012, it was found that in 2005 the company had purchased a machine, but recorded it as revenue expenditure in stead of an on– current asset. The machine had a useful life of 10 years. The company has to restate the opening balances of assets, liabilities and equity for the earliest period presented and adjustments thereafter.

Example 22

ABC Ltd provided the following information :

Reporting Period	**2012**	**2011**
Revenue	150,000	120,000
Cost of goods sold	90,000	70,000
Share capital		100,000

An expense of 5,000 was wrongly capitalised in 2011. The error was corrected in the next year. The corporate tax rate is 30%.

Statement of Profit and Loss

Reporting period	**2012**	**2011 Restated**	**2010**
Revenue	150,000	120,000	120,000
Less: Cost of goods sold	90,000	75,000	75,000
Gross Profit	60,000	45,000	45,000
Expense	–	5,000	–
Accounting profit	60,000	40,000	45,000
Tax expense	18,000	12,000	13,500
Profit for the period	42,000	28,000	31,500

Balance Sheet

Reporting period	**2012**	**2011 Restated**	**2010**
Assets			
Non–current			
Advertisement Suspense		–	5,000
Current			
Cash and cash equivalents	188,000	140,000	140,000
Total assets	188,000	140,000	145,000
Equity and liabilities			
Share capital	100,000	100,000	100,000
Retainedearnings	70,000	28,000	31,500
Total equity	170,000	128,000	131,500
Liabilities			
Non–current			
Deferred tax liabilities			1,500
Current			
Current tax liabilities	18,000	12,000	12,000
Total equity and liabilities	188,000	140,000	145,000

Cash and cash equivalents

2011 100,000 + 45,000 – 5,000 =140,000

2012 140,000 + 60,000 – 12,000 =188,000

However, if it is impracticable to determine the period–specific effects of an error on comparative information for one or more prior periods presented, the entity should restate the opening balances of assets, liabilities and items of equity for the earliest period for which retrospective restatement is possible (which might be the current period).

Further, if it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity should restate the comparative information to correct the error prospectively from the earliest date practicable.

Example 23

ABC Ltd has been selling investments and recording it under sale for the last 10 years. When the error was identified, it was found that information for the last 5 years is only available and, therefore, rectification of error could be done only for the last 5 years.

Correction of errors should be distinguished from changes in accounting estimates.

- Errors
  - Mistakes
  - Needs to be corrected whenever identified
- Estimates
  - Approximations
  - Needs to be updated with new information or development.

Accounting for Government Grants and Disclosure of Government Assistance (Ind AS 20)

Introduction

Government grants are assistance by Government (e.g., Government, Government agencies and similar bodies whether local, national or international) in the form of transfer of resources to an entity in return of past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of Government assistance which cannot reasonably have a value placed upon them and transactions with Government which cannot be distinguished from the normal trading transactions of the entity. Grants are often called by other names like subsidies, subventions or premiums.

The purpose of assistance is to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided by the government. For example, an entity is promised a grant from the Government if it sets up a factory in a backward region which suffers from unemployment problems. Since the Government has a social responsibility of providing employment opportunities, it includes the entity to set up the factory in that region. For the receipt of Government assistance, an entity has to–

- select an appropriate method of accounting if the resources have been transferred; and
- disclose to the extent to which the entity has been benefitted from such assistance.

Government grants

Government grants, both monetary and non-monetary grants at fair value, are to be recognised only when there is reasonable assurance that–

- the entity will comply with the conditions attaching to them; and
- the grants will bereceived.

This is because, mere receipt of a grant does not warrant that the conditions attached to the grant have been or will be fulfilled. By reasonable assurance, it means that there should be a sufficient degree of certainty. A grant is accounted for in the same manner irrespective of the way how a grant is received — whether it is received in cash or as a reduction of a liability.

Forgivable loan

These are loans which the lender undertakes to waive repayment of under certain prescribed conditions. An entity would treat a forgivable loan as a government grant when there is reasonable assurance that the entity would meet the conditions for forgiveness of the loan.

Example 1

An entity received loan amounting to 15 from the government for setting up a power plant. The government agreed to forgive the loan if the entity created 500 jobs to the nearby residents within a period of 3 years. The entity has estimated that this new project would require a lot of man power and has reasonable assurance that the conditions attached to the forgiveness of the loan will be fulfilled. Therefore, the entity recognises the amount of forgivable loan as a grant.

Government loan at a below market rate of interest

Sometimes, the government might extend a loan to an entity at a rate of interest that is lower than the market rate of interest or simply the entity does not have to pay any amount of interest.Such a benefit derived from the Government is to be treated as a Government Grant.

Example 2

An entity receives a loan from the government of 2,000 at 5% rate of interest on 1 January when the prevailing market rate of interest is 10%. The term of the loan is 5 years. It is assumed that the reporting date is 31 December every year.

Fair value of the loan

The loan received should be recognised in Balance Sheet at its fair value which is the present value of the future cash flows relating to the transaction. The effective rate used to discount the future cash flows of the loan is the market interest rate of 10%.

Computation of present value

Year	Cash flows	Discount factor	Present value
1	100	0.909	91
2	100	0.826	83
3	100	0.751	75
4	100	0.683	68
5	2,100	0.620	1,304
		Present value of the loan	1,621

The difference between the actual amount of loan received and its present value is 379 (2,000–1,621) is a benefit from the government which is accounted for as a government grant for which a 'deferred income' of 379 is recognised in Balance sheet.

Journal

Cash	2,000	
Loan		1,621
Deferred income		379

Amortisation schedule

The loan amount of 1,621 will keep on increasing through out the term of the loan period till it becomes 2,000.

Computation of loan amount at each year end

Year	Opening balance (A)	Interest @ 10% (B)	Interest paid (C)	Closing balance
				[A + B – C)]
1	1,621	162	100	1,683
2	1,683	168	100	1,751
3	1,751	175	100	1,826
4	1,826	183	100	1,909
5	1,909	191	100	2,000

The interest payable will be recognised in Statement of Profit and Loss as 'Finance Cost'.

Journal

FinanceCost	162	
Cash		100
Loan		62
(Journal for the first year)		

Recognition of the government grant

The amount of government grant of 379 is reduced at the end of each year by the difference between interest payable and actual interest paid. The resulting amount is recognised in Statement of Profit and Loss. The amounts for the 5 years are –

Year	Difference
1	62 (162 – 100)
2	68 (168 – 100)
3	75 (175 – 100)
4	83 (183 – 100)
5	91 (191 – 100)

Journal

Deferred income	62	
Other income		62

(Journal for the first year)

Presentation of the amounts in the financial statements

Statement of Profit and Loss

Year	1	2	3	4	5
Revenue					
Cost of sales					
Gross Profit					
Other gains and losses	62	68	75	83	91
Operating profit					
Finance cost	162	168	175	183	191
Accounting Profit					
Tax expense					
Profit for the period					

Balance Sheet

Year	1	2	3	4	5
Non-current liabilities					
Borrowings	1,683	1,751	1,826	1,909	–
Deferred income : Government Grant317	249	174	91	–	
Current liabilities					
Borrowings					2,000*

*A liability that is expected to be settled within the next 12 months is classified as current.

Contingent assets andcontingent liabilities

Once an entity has recognised a government grant, any amount of contingent asset or contingent liability should be disclosed as per Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets. The disclosure enables faithful representation of the substance of the transaction.

Example 3

An entity received a grant from the government of 150 to construct a factory building, on a condition that the construction should be complete within the next 2 years, the failure of which would require the entity to repay one-third of the grant amount. The entity at the time of recognising the grant discloses an amount of 50 as a contingent liability.

Example 4

An entity is promised by the government a grant of 300 if it constructs and develops research institutes in 3 different locations. The entity has purchased 3 plots of land and started working for the development of the research institutes. The entity is sure that the objective would be fulfilled and they would receive the grant. It discloses the fact as a contingent asset along with the financial statements since the receipt of the grant is virtually certain.

Recognition of agovernment grant

Any amount of government grant shall be recognised in Statement of Profit and Loss on a systematic basis over the periods in which the entity recognises the relatedcosts for which the grants are intended to compensate

Example 5

The government has agreed to pay 60% of the staff training costs that an entity is supposed to incur for installing advanced machinery. The training costs for the first and second year are 50 and 40 respectively. The grant of 30 (60% of 50) will be recognised in the first year and 24 (60% of 40) will be recognised in the second year in Statement of Profit and Loss.

There are two approaches to accounting for government grant :

Capital approach

As per this approach, the amount of government grant is supposed to be recognised outside profit or loss meaning that it should be credited to the shareholder's equity. It does not approve the recognition of the government grants in Statement of Profit and loss to offset the items of expense that is financed by the grant.

Income approach

According to this approach, the amount of the grant should be recognised in Statement of Profit and Loss on a systematic basis over the periods in which the entity recognises the related costs that are compensated by the grant. This approach stresses on the fact that the entity receiving the grant has to fulfill the terms and conditions attached to the receipt of the grant. So, in a way the grants received are earned.

This standard favours the income approach of accounting for government grants.

Grants are always recognised as income either immediately or deferred whether it is received in cash, a non-monetary asset or as a reduction of a liability. Recognition of the government grants will not be as per the accrual basis as stated in Ind AS 1 Presentation of Financial Statements. This method would be acceptable only when there is no basis existing for allocating the grant to the periods other than the one in which it was received.

Grants related to specific expenses are recognised in Statement of Profit and Loss in the same period as the relevant expenses. This is possible because in most of the cases the periods over which the costs compensated by the grant are readily ascertainable.

Example 6

An entity receives annual grants for a period of 3 years which is 80% of the costs of R&D activities. The entity would allocate the grant over the period of 3 years in Statement of Profit and Loss, when it would simultaneously recognise the expenses relating to those R&D activities.

Grants related to depreciable assets such as plant, machinery, equipment etc. are usually recognised in Statement of Profit and Loss over the periods and in proportions in which the depreciation expense on those assets are recognised.

Example 7

An entity receives a grant for the acquisition of its new office building, which is expected to have a useful life of 40 years. The government grant would be allocated in Statement of Profit and Loss over 40 years.

Grants require fulfillment of certain obligations. In the case of grants relating to non-depreciable assets such as land, the amount is allocated in profit or loss over the periods that the entity bears the costs of meeting those obligations.

Example 8

An entity purchases a plot of land for 60 on 1 January, 2012 for which it receives a grant of 50. The condition attached to such a receipt is the construction of labour quarters for the employees. The construction will take 2 years to complete. The useful life of the labour quarters is estimated to be 20 years. The entity would allocate the grant over the useful life of the labour quarters starting from the date the labour quarters are brought into the condition for its intended use.

Grants are sometimes received as a part of a package of financial or fiscal aids which requires an entity to comply with a number of conditions. This requires componentisation of the grant received and evaluation of the grant in order to determine how the entity would earn the various components of the grant.

Example 9

An educational institution receives a consolidated grant of 80 and is supposed to use two fifth of it in acquisition of land for the construction of accommodation for students. The building is expected to have a useful life of 20 years. One tenth is expected to be utilised for the purchase of furniture. Another one fifth would be used for scholarships and the rest would be used as waivers of tuition fees for underpriviledged students.

Apportionment of the amount of the consolidated grant into identifiable components :

- Non-depreciable asset (land) 32(2/5X80).
- Depreciable assets (furniture) 8(1/10X80).
- Specific expenditure for–
  - scholarships16(1/5X80).
  - waivers of tuition fees 24(80–32–8–16).

Recognition of the grants in Statement of Profit and Loss

Recognise the grants in Statement of Profit and Loss on a systematic basis over the periods that the entity recognises as expenses the related costs for which the grant is intended to compensate.The grant–

- relating to land will initially be recognised for an amount of 32 and will be allocated over the life of the building. Since the land is not a depreciable asset, the useful life of the building becomes the basis for allocation of the grant amount.
- of 8 relating to the purchase of furniture will be allocated over the useful lives of these assets.
- of 16 received for scholarships and 24 which is intended as tuition fee waiver will be recognised as and when the expenses relating to them are recognised in Statement of Profit and Loss.

Grants are sometimes received by an entity as an immediate financial support from the government rather than as an incentive to undertake specific expenditures. In effect, there are no future related costs. In this case, the entity is required to recognise the grant in Statement of Profit and Loss of the period in which it becomes receivable. This should be supported with disclosures in order to make the users understand its commercial effect.

Example 10

An entity, which is in deep financial crisis due to a sharp fall in the demands for its products, receives a grant of 100 for continuing its business.There is no future costs related to this grant. The entity has to recognise the amount of the grant directly in profit or loss, and disclose the fact in the notes to financial statements for the portrayal of its commercial effect.

An entity might receive a government grant as compensation for expenses or losses incurred in previous period(s). In this case too, the government grant will be recognised in Statement of Profit and Loss of the period in which it becomes receivable. This also requires enough disclosures to helpusers understand its commercial effect.

Example 11

An entity suffered a loss of 500 after a cyclone hit the place where its factory was located. The government agrees to pay a 80% compensation for this loss. The entity recognises the grant of 400 in profit or loss since the grant amount becomes receivable.

Non-monetary government grants

A non-monetary grant is the transfer of a non-monetary asset for the use of the entity. Non- monetary assets refer to the assets which do not have a fixed exchange value in terms of cash rather their values depend on economic conditions, e.g., land, plant and equipment etc. The normal way of recording such a grant is at fair value of the non-monetary asset received.

Journal

Property, plant and equipment
    Deferred income — Government grant

Example 12

An entity receives a grant in the form of a plot of land. On the basis of the condition attached to the receipt of such a grant, the entity is supposed to recognise the grant over a period of 10 years. The fair value of the plot of land was found to be 250. The entity recognises the grant as well as the asset for the same amount in Balance Sheet.The grant is recognised for an amount of25 (250÷10) in profit or loss for a period of 10 years.

Grants related to Assets

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held. Normally the purchase of assets and receipt of related grants involve major cash flows. Therefore, in order to show the gross investment in assets, they are disclosed as separate items in Statement of Cash Flows.

Statement of Cash Flows

Operating activities	
Investing activities	
Purchase of an asset	(XXX)
Financing activities	
Receipt of a government grant	XXX

Example 13

An entity purchases a machine at a cost of 1,250 on 1 January 2012 with an estimated useful life of 10 years. The entity receives a grant of 1,000 for this purpose. The machinery does not have any residual value. The entity follows SLM of depreciation and the reporting period ends on 31 December each year. The grant will be recognised in profit or loss over the useful life of the asset.

Balance Sheet

Non-current assets		
Machinery	1,250	
Less: Provision for depreciation (1,250 ÷10)	(125)	1,125
Non-current liability		
Deferred Income – Government grant	1,000	
Less: Transfer to profit or loss (1,000 ÷10)	(100)	900

Statement of Profit and Loss

Depreciation on machinery	(125)
Other Income – Government grant	100

Grants related to income

Grants related to income are government grants other than those related to assets.

If an entity presents the components of profit or loss in a separateincome statementas per Ind AS 1 Presentation of Financial Statements, grants related to income would be presented inthat separate income statement.

Those entities that present the grant and the expenses separately believe that it is not appropriate to net the grant income with the expense it intends to compensate. Separation of the grant item from the expense facilitates comparison with other expenses not affected by the grant. However, the entities that deduct the grant amount from its related expense believe that the expenses might not have occurred in the absence of the grant. The separate presentation of the expense might be misleading without offsetting the grant. Whichever method an entity chooses to present the grant amount is acceptable. In order to ensure a proper understanding of the financial statements, disclosure of the effect of the grants on any item of income or expense is appropriate.

Example 14

ABC Ltd is reimbursed by the government to the extent of 80% for the expenses it incurs on staff training costs which were 120. The grant will be presented as follows–

- Separate presentation of grant and expense

Statement of Profit and Loss

Staff training costs	(120)
Other Income – Government grant (80% on 120)	96

- Deduction from related expense

Statement of Profit and Loss	
Staff training costs (120 – 96)	(24)

Repayment of government grants

A government grant that becomes repayable shall be accounted for as a change in accounting estimate (as per Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors). Repayment of a grant related to income shall be applied first against any unamortised deferred credit recognised in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment shall be recognised immediately in profit or loss. Repayment of a grant related to an asset shall be recognised by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised in profit or loss to date in the absence of the grant shall be recognised immediately in profit or loss.

Circumstances giving rise to repayment of a grant related to an asset may require consideration to be given to the possible impairment of the new carrying amount of the asset.

Example 15

An entity received a grant of 1,500 for staff recruitment which is supposed to be recognised in profit or loss for a period of 5 years. At the end of the third year, the entity was entitled to repay 800 for not fulfilling all the conditions, when, Deferred Income stands at 600 [1,500 – (1,500 ÷5 x3)].

Balance Sheet		
Non-current liability		
Deferred Income	600	
Less: Repayment of government grant	(600)	–

Statement of Profit and Loss	
Repayment of government grant (800 – 600)	(200)

Example 16

An entity had received a government grant of 1,200 for the acquisition of a machinery, which cost 2,000 to the entity. After 2 years, an amount of 1,000 became repayable as the entity did not comply with the obligations of the grant. The entity had been allocating the grant amount over the useful life of the asset, ie, 10 years.

The amount of deferred income transferred to profit or loss is 240 (1,200÷10X2). Therefore, balance of deferred income standing in the books at the end of second year is 960 (1,200–240).

Balance Sheet		
Non-current liabilities		
Deferred Income–Government grant	960	
Less:Repayment of Government grant	(960)	–

Statement of Profit and Loss	
Repayment of government grant (1,000 – 960)	(40)

The carrying amount of the asset will not be changed as a result of this transaction.

Government Assistance

Government assistance is an action by the government designed to provide an economic benefit to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as provision of infrastructure in development areas or the imposition of trading constraints on competitors.

The definition of a government grant states that assistance in the form of resources in return for a past or future compliance with certain conditions relating to the operating activities of the entity is to be accounted for as a grant. The general requirement to operate in certain regions or industry sectors in order to qualify for the government assistance constituted such a condition in the definition of the government grant. Therefore, government assistance meets the definition of government grant even if there is no condition specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors.This becomes yet another reason why grants should not be credited directly to the shareholder's equity as per the capital approach.

However, forms of assistance which cannot reasonably have a value placed upon them such as free technical or marketing advice and the provision of guarantees shall not be dealt as government grants. But, the impact of these assistance on an entity's economy may be significant. In this case, the significance of the benefit (nature, extent and duration of the assistance) is to be disclosed in the notes to financial statements.

Example 17

An entity is in agreement with the government where in the latter is responsible for 60% of the entity's total sales. In this case, the assistance can not be distinguished from the normal trading transactions of the entity. Any attempt to segregate the trading activities from the government assistance may be arbitrary, even though the benefit from such assistance is unquestioned. To make the users understand their position, the entity discloses the fact in the notes to the financial statements.

However any government assistance does not include the provision of infrastructure by way of improved transport, better communication network, provision of irrigation and water reticulation, etc. Therefore, these facilities are not dealt with in this standard.

Income Tax Implications

When, for the purpose of presentation of government grants, a 'deferred income' is set up in Balance Sheet of an entity, the difference between its carrying amount and tax base of nil is a deductible temporary difference. As per Ind AS 12 Income Taxes, a deductible temporary difference calls for the recognition of deferred tax asset. However, the entity is not required to do so since it is excluded from the scope of this standard.

The Effects of Changes in Foreign Exchange Rates (Ind AS 21)

Introduction

Foreign currency is a currency other than the functional currency of the entity. Functional currency is the currency of the primary economic environment in which the entity operates, which is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency :

- the currency–
  - that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and
  - of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
- the currency that mainly influences labour, material and other costs of providing goods or services (that will often be the currency in which such costs are denominated and settled).

The following factors may also provide evidence of an entity's functional currency: The currency in which –

- funds from financing activities (i.e.,issuing debt and equity instruments)are generated.
- receipts from operating activities are usually retained.

Foreign operation is an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity. The following additional factors are considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity (i.e., the parent) –

- whether the activities of the foreign operation are carried out as an extension of the reporting entity (e.g., when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it), rather than being carried out with a significant degree of autonomy (e.g., when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency).
- whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.
- whether cash flows from the activities of the foreign operation –
  - directly affect the cash flows of the reporting entity and are readily available for remittance to it.
  - are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

When the above indicators are mixed and the functional currency is not obvious, management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Example 1

ABC Ltd (located in UK – currency £) has a subsidiary XYZ Ltd (located in USA – currency $)

Scenario 1

ABC Ltd manufactures and sells goods to XYZ Ltd, which sells these in USA at a selling price determined by ABC Ltd. XYZ Ltd has a long-term loan from ABC Ltd. All profits made by XYZ Ltd are remitted back to ABC Ltd.

Scenario 2

XYZ Ltd has been given complete autonomy as far as its operations are concerned. XYZ manufactures its own product, incurs its own expenses and reinvests the profit made for further growth. ABC Ltd is entitled to dividends only.

Scenario 3

ABC Ltd sells some material to XYZ Ltd. XYZ Ltd then utilises some locally sourced materials with those purchased from ABC Ltd and assembles an entirely new product. All goods are sold to PQR Ltd–a UK based company. The selling price, however, is determined by ABC Ltd. XYZ Ltd has taken a loan from a bank in France (currency•).

The functional currency of XYZ Ltd, in all the 3 scenarios can be determined using the following table :

Indicators	Scenario		
	1	2	3
● Selling price determined in	£	$	£
● Salesmarket	USA	USA	UK
● Expenses	£	$	£ & $
● Financing	£	–	•
● Intra group transactions	High	–	Low
Functional currency	£	$	Judgement

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include–

- pensions and other employee benefits to be paid in cash;
- provisions that are to be settled in cash; and
- cash dividends that are recognised as a liability.

Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include–

- amounts prepaid for goods and services (e.g., prepaid rent);
- goodwill, intangible assets, inventories, property, plant and equipment; and
- provisions that are to be settled by the delivery of a non-monetary asset.

Example 2

ABC Ltd bought goods worth 10 on credit to be paid after 6 months. On the date of payment, the prices of the goods increased by 10%. But, ABC Ltd had to pay 10 only and not 11 (100x110%), since it is a monetary item.

Example 3

On 1 January 20x1, an entity bought a machine costing 10, whose useful life is 10 years. The entity follows straight–line method of depreciation. At the end of the reporting period on 31 December 20x1, the entity finds the recoverable amount of the machine to be 7. The entity has to charge depreciation of 1 and impairment loss of 2, since it is a non-monetary item.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation. An entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

The entity that has a monetary item receivable from or payable to a foreign operation may be any subsidiary of the group.

Example 4

An entity has 2 subsidiaries, A and B. Subsidiary B is a foreign operation. Subsidiary A grants a loan to Subsidiary B. Subsidiary A's loan receivable from Subsidiary B would be part of the entity's net investment in Subsidiary B if settlement of the loan is neither planned nor likely to occur in the foreseeable future. This would also be true if Subsidiary A were itself a foreign operation.

Presentation Currency is the currency in which the financial statements are presented.

A reporting entity (parent) may comprise a number of individual entities and some of them may be foreign operations. If the foreign operations have their own functional currency (different from the reporting entity's currency), then their results and financial position need to be translated to the presentation currency of the parent.

This standard permits the presentation currency of a reporting entity to be any currency (s). Therefore, a stand-alone entity preparing financial statements or an entity preparing separate financial statements in accordance with Ind AS 27 may present their financial statements in any currency (s) and it is possible that their presentation currency differs from their functional currency.

Reporting foreign currency transactions in the functional currency

Initial recognition

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity –

- buysorsellsgoodsorserviceswhosepriceisdenominatedinaforeigncurrency;
- borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;or
- otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreigncurrency.

A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

- Exchange rate

  It is the ratio of exchange for 2 currencies.

- Spot exchange rate

It is the exchange rate for immediate delivery.

Example 5

ABC Ltd has functional currency $ and it imported goods from XYZ Ltd costing £ 100. The spot exchange rate on that date was: $ 1.25 = £ 1. Therefore, ABC Ltd would recognise this foreign exchange transaction at $ 125.

The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with Ind ASs.

Example 6

ABC Ltd (functional currency £) buys inventory from USA for $ 100. The date of the order was 1 January 2013, the date of shipping was 15 January 2013, the date of the invoice was 20 January 2013, the date when the inventory was received was 25 January 2013 and the date when the invoice was paid was 31 January 2013.

The date that risks or rewards of ownership pass will essentially be the date of the transaction. In this case, the date of the transaction is likely to be the date of shipping or date of receipt, depending on when the risks or rewards of ownership pass and, in effect, who will suffer loss if the inventory was damaged or lost in transit.

For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used,e.g.,an average rate for a week or a month might be used fo rall transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

Reporting at the ends of subsequent reporting period

At the end of each reporting period –

- foreign currency monetary items shall be translated using the closing rate;
  - Closing rate

    It is the spot exchange rate at the end of the reporting period.
- non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and
- non- monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was measured.

Example 7

ABC Ltd (functional currency $) purchased a machinery from another country (functional currency £) on 1 July 2012 at £ 120. The useful life of the machine is 5 years and ABC Ltd follows straight-line method of depreciation. As per the agreement, ABC Ltd will pay for the machine on 31 March 2013. The reporting period of ABC Ltd ends on 31 December each year.

The exchange rate on 1 July 2012 was £1=$1. 25 and on 31 December 2012 was £1=$1. 20 On the date of the transaction, the following entry is passed:

Machine	150(120x1.25)	
Liability for machine		150

On the reporting date, the following adjustments are to be made:

Machine at historical cost	150
Depreciation (for 6 months)	151
Carrying amount of the machine	35

Liability for machine is: $ 144 (120 x 1.20)

The carrying amount of an item is determined in conjunction with other relevant Standards, e.g., property, plant and equipment, which may be measured in terms of fair value and historical cost in accordance with Ind AS 16. Whether the carrying amount is determined on the basis of historical cost or on the basis of fair value, if the amount is determined in a foreign currency it is then translated into the functional currency in accordance with this Standard.

The carrying amount of some items is determined by comparing 2 or more amounts, e.g., the carrying amount of inventories is the lower of cost and net realisable value in accordance with Ind AS2.Similarly,in accordance with Ind AS 36, the carrying amount of an asset for which there is an indication of impairment is the lower of its carrying amount before considering possible impairment losses and its recoverable amount. When such an asset is non-monetary and is measured in a foreign currency, the carrying amount is determined by comparing the –

- cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e., the rate at the date of the transaction for an item measured in terms of historical cost); and
- net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (e.g., the closing rate at the end of the reporting period).

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency, or vice versa.

Example 8

ABC Ltd, an Indian Company (functional currency C) purchased some inventory and machinery from USA (functional currency$). The cost of the inventory is $5 and that of the machinery is $10. The exchange rate on the date of transaction was $1=C50. The exchange rate at the end of the reporting period (when net realisable value for inventory and recoverable amount for the machinery were determined) was $ 1 = C52.

At the end of the reporting period –

- The net realisable value of the inventory was found to be $6.
  - The cost translated at the exchange rate when the amount was determined is :$5 x C 50 per $=C 250.
  - The net realisable value is translated at the exchange rate at the date when the value was determined :$6 x C 52 per $=C 312.

The lower of the above 2 becomes the carrying amount and, therefore, at the reporting date the carrying amount of inventory is C 250.

- The recoverable amount of the building was found to be $8.
  - The cost translated at the exchange rate at the date when the amount was determined : $10 x C 50 per $=C 500.
  - The recoverable amount is translated at the exchange rate at the date when the value was determined :$8 x C 52 per $ = C 416.

The lower of the above 2 becomes the carrying amount and, therefore, at the reporting date the carrying amount of the machinery is C416. If ABC Ltd has charged C50 as depreciation, then an impairment loss of C34 (450–416) is to be recognised in profit or loss.

Example 9

ABC Ltd (a USA based company – functional currency $) acquired a plot of land in India (functional currency C) at a cost of C1,500 when exchange rate was $1=C50. The land was measured at historical cost in accordance with Ind AS16. At the end of the reporting period, there was an indication of impairment of this land. Consequently, an impairment test was conducted in accordance with Ind AS 36 and the recoverable amount of the land was found to be C1,400. The exchange rate as that date was $1=C51.

The cost translated at the exchange rate on the date of transaction was :$30(C 1,500@C 50 per $). The recoverable amount translated at the exchange rate on the reporting date is: $27.45(C 1,400@C 51per $).

By comparing the cost of the land with its recoverable amount, it is clear that there is an impairment loss of C 100 (C 1,500 –C 1,400) in terms of foreign currency and an impairment loss of $ 2.55 ($ 30 – $ 27.45) in terms of functional currency.

But, if the exchange rate at the reporting date was $1=C 46, then the recoverable amount would be: $30.43 (C 1,400@C 46 per$). It is clear that, though there is an impairment loss of C 100(C 1,500–C 1,400) in terms of foreign currency, there is no impairment loss in terms of functional currency. This is because, the recoverable amount $30.43 exceeds cost $30 in terms of functional currency. Therefore, no impairment loss is to be recognised for the land.

Example 10

ABC Ltd (an Indian company–functional currency C) purchased a machine from XYZ Ltd (a USA based company–functional currency $) at a cost of $ 30, when the exchange rate was $ 1 = C 50.

Scenario 1 (Impairment loss recognised both in functional currency and foreign currency)

Recoverable amount $28; Exchange rate at the reporting date $1=C 53

	Asset	**Rate**	**Value**
Cost	$ 30	$ 1 = C 50	C 1,500
Recoverable amount	$ 28	$ 1 = C 53	C 1,484
Impairment loss	$ 2		C 16

Scenario 2 (Impairment loss recognised in foreign currency but not in functional currency)

Recoverable amount $ 28; Exchange rate at the reporting date $1 = ‘ 54

	Asset	Rate	Value
Cost	$ 30	$ 1 = C 50	C 1,500
Recoverable amount	$ 28	$ 1 = C 54	C 1,512
Impairment loss	$ 2		Nil

Scenario 3 (Impairment loss recognised in functional currency but not in foreign currency)

Recoverable amount $31; Exchange rate at the reporting date $1='47

	Asset	Rate	Value
Cost	$ 30	$ 1 = C 50	C 1,500
Recoverable amount	$ 31	$ 1 = C 47	C 1,457
Impairment loss	Nil		C 43

Recognition of exchange differences

Exchange difference is the difference resulting from translating agiven number ofunits of one currency into another currency at different exchange rates. Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit and loss in which they arise.

When monetary items arise from a foreign currency transaction and there is a change in the exchange rate between the transaction date and the date of settlement, an exchange difference results. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period.

Example 11

ABC Ltd (functional currency$) purchases inventory for •150 on 1 December 2012, when the exchange rate was $1=•2. ABC Ltd also sold goods for •105 on 15 December 2012, when the exchange rate was $1=•1.75. At the end of the reporting period on 31 December 2012, the amounts have not been paid and the exchange rate was $1=•1.5.

At initial recognition, the following entries are passed –

(1)	Purchases	75		(150 ÷2)
	Accounts Payable		75	
(2)	Accounts receivable	60		(105÷1.75)
	Revenue		60	

At the end of the reporting period, the following entries are passed –

(1)	Foreign exchange loss	25		[(150 ÷ 1.5) – 75]
	Accounts payable		25	
(2)	Accounts receivable	10		[(105 ÷ 1.5) – 60]
	Foreign exchange gain		10	
(3)	Profit or loss	25		
	Foreign exchange loss		25	
(4)	Foreign exchange gain	10		
	Profit or loss		10	

Example 12

The reporting period of ABC Ltd (functional currency$) ends on 31 December each year. On 1 October 2012, its old goods to XYZ Ltd (functional currency £) for £10, when the exchange rate was £1=$1.50.

At initial recognition, ABC Ltd would pass the following entry:

Accounts receivable	15		(10 x1.5)
Revenue		15	

Scenario 1

The amount is settled on 30 November 2012, when the exchange rate was £ 1 = $ 1.60. The following entries are to be passed:

(1)	Accounts receivable	1		[10 x (1.60 – 1.50)]
	Foreign exchange gain		1	
(2)	Cash	16		
	Accounts receivable		16	
(3)	Revenue	15		
	Foreign exchange gain	1		
	Profit or loss		16	

Scenario 2

The amount is settled on 31 October 2012, when the exchange rate was £ 1 = $ 1.40. The following entries are to be passed:

(1)	Foreign exchange loss	1		[10 x (1.50 – 1.40)]
	Accounts receivable		1	
(2)	Cash	14		
	Accounts receivable		14	
(3)	Revenue	15		
	Profit or loss		15	
(4)	Profit or loss	1		
	Foreign exchange loss		1	

Scenario 3

The amount is not settled within the reporting period which ends on 31 December 2012, when the exchange rate was £ 1 = $ 1.70. The following entries are to be passed:

(1)	Account receivable	2		[10 x (1.70 – 1.50)]
	Foreign exchange gain		2	
(2)	Revenue	15		
	Foreign exchange gain	2		
	Profit or loss		17	

Scenario 4

The amount is not settled within the reporting period which ends on 31 December 2012, when the exchange rate was £ 1 = $ 1.30. The following entries are to be passed:

(1)	Foreign exchange loss	2		[10 x (1.50 – 1.30)]
	Accounts receivable		2	
(2)	Revenue	15		
	Profit or loss		15	
(3)	Profit or loss	2		
	Foreign exchange loss		2	

Scenario 5

The amount is settled on 1 February 2013. The exchange rates were:

31 December 2012	£ 1 = $1.60
1 February 2013	£ 1 = $1.40

The following entries are to be passed:

2012

(1)	Accounts receivable	1		[10x(1.60–1.50)
	Foreign exchange gain		1	
(2)	Revenue	15		
	Foreign exchange gain	1		
	Profit or loss		16	

2013

(1)	Foreign exchange loss	2		[10 x (1.60 – 1.40)]
	Accounts receivable		2	
(2)	Cash	14		
	Accounts receivable		14	
(3)	Profit or loss	2		
	Foreign exchange loss		2	

Scenario 6

The amount is settled on 1 March 2013. The exchange rates were:

31 December 2012	£ 1 = $1.40
1 March 2013	£ 1 = $1.60

The following entries are to be passed:

2012

(1)	Foreign exchange loss	1		[10 x (1.50 – 1.40)]
	Accounts receivable		1	
(2)	Revenue	15		
	Profit or loss		15	
(3)	Profit or loss	1		
	Foreign exchange loss		1	

2013

(1)	Accounts receivable	2		[10 x (1.60 – 1.40)]
	Foreign exchange gain		2	
(2)	Cash	16		
	Accounts receivable		16	
(3)	Foreign exchange gain	2		
	Profit or loss		2	

Example 13

On 1 April 2012, an Indian Company (functional currencyC) borrows $100 for 3 years @ 2% simple interest per annum, to be paid semi-annually. The loan is adjusted for exchange rate changes at every 6 months. The exchange rates during the reporting period were as follows:

1 April 2012: $ 1 = C 10; 30 September 2012: $ 1 = C 9; 31 March 2013: $ 1 = C 11

Average rate for first 6 months: $1=C9.20; Average rate for last 6 months: $1=C10.10 1

April 2012

(1)	Cash	1,000		(100 x10)
	Loan payable		1,000	

30 September 2012

(1)	Loan payable	100		[100 x (10 – 9)]
	Foreign exchange gain		100	
(2)	Interest expense	9.20		(100 x 1% x 9.20)
	Foreign exchange gain		0.20	(9.20 – 9.00)
	Cash		9.00	(1 x 9)

31 March 2013

(1)	Foreign exchange loss	200		[100 x (11 – 9)]
	Loan payable		200	
(2)	Interest expense	10.10		(100 x 1% x 10.10)
	Foreign exchange loss	0.90		(10.10 – 9.20)
	Cash		11.00	(1 x 11)

The foreign exchange net loss for the year C100.70(100+0.20–200–0.90) is recognised in profit or loss.

When a gain or loss on a non-monetary item is recognised in –

- other comprehensive income, any exchange component of that gain or loss shall be recognised in other comprehensive income.
- profit or loss, any exchange component of that gain or loss shall be recognised in profit orloss.

Other Ind ASs require some gains or losses to be recognised in other comprehensive income, e.g.,Ind AS16 requires some gains or losses arising on a revaluation of property, plant and equipment to be recognised in other comprehensive income. When such an asset is measured in a foreign currency, this standard requires the revalued amount to be translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognised in other comprehensive income.

Example 14

ABC Ltd (functional currency C) had acquired some land and a building in USA (functional currency $). The cost of land was $100 and that of the building was $60 with a useful life of 6 years (depreciation under straight-line method). The entity follows the revaluation model for land and the cost model for the building as per Ind AS16. The income tax rate is 40%. The exchange rate on the date of acquisition was $1=C25. At initial recognition the following entry is passed:

Land	2,500		(100 x25)
Building	1,500		(60 x25)
Cash		4,000	

At the end of the reporting period, the fair value of the land was found to be $120, where as the building was tested for impairment and its recoverable amount was found to be $35. At the reporting date (which is same as the date of determining the fair value and the recoverable amount), the exchange rate was $1=C30

Land

- Had the exchange rate remained the same on the date of transaction and also on the date when the fair value was determined, the fair value of the land would have been C3,000(120x25). Thereby, a revaluation gain arises (without considering the exchange difference) at C500(3,000–2,500).
- The fair value of the land is $120 and the foreign exchange rate on that date clearly signifies that there is an increase in valuation of the foreign exchange by C5(30–25). Therefore, there is a gain in foreign exchange C600(120x5).
- After revaluation, the carrying amount of the land is C3,600(120x30). Therefore, the increase in the carrying amount of land is C 1,100 (3,600 – 2,500).
- The following entry is to be passed–

Land	1,100		
Foreign exchange gain		360	(60% of600)
Revaluation surplus		300	(60% of500)
Deferred tax liability		440	[40% of (600 +500)]

- Foreign exchange gain, revaluation surplus and deferred tax liability are to be recognised in other comprehensive income.

Building

The cost of the building is C1,500 and depreciation charged is C250(1,500÷6). Therefore, the carrying amount of the land is C1,250 (1,500–250) and the recoverable amount (as given) is $35.

- Had the exchange rateremained the same on the date of transaction and also the date when the recoverable amount was determined, the recoverable amount of the building would have been C875(35x25). Thereby, an impairment loss arises (without considering the exchange difference) at C625(1,500–875). Out of this, depreciation is C250 and impairment loss isC375(625– 250).
- The recoverable amount of the building is $35 and the foreign exchange rate on that date clearly signifies that there is an increase in valuation of the foreign exchange by C5(30–25). Therefore, there is a gain in foreign exchange C175(35x5).
- After impairment, the carrying amount of the building is C1,050(35x30). Therefore, the decrease in the carrying amount of the building is C450(1,500–1,050).

  The following entry is to be passed –

• Depreciation	250		(1,500 ÷ 6)
Impairment	375		[(25 x 25) – 250]
Foreign exchange gain		175	(35 x 5)
Accumulated depreciation and impairment		450	(1,500 – 1,050)
• Deferred tax asset	150		(375 x40%)
Deferred tax income		150	

- Depreciation and impairment are to be recognised in profit or loss. The foreign exchange gain is to be recognised in other comprehensive income.

• Foreign exchange gain	70	
Deferred tax liability		70

Change in functional currency

An entity's functional currency reflects the underlying transactions, events andconditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and condition, e.g., a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency.

When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change. In other words, an entity translates all items into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost.

Translation to the presentation currency

An entity may present its financial statements in any currency(s). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency.

Example 15

When a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements can be presented.

The results and financial position of an entity shall be translated into a different presentation currency using the following procedures:

- assets and liabilities for each Balance Sheet presented (ie, including comparatives) shall be translated at the closing rate at the date of that Balance Sheet;
- income and expenses for each statement presenting profit or loss and other comprehensive income (i.e., including comparatives) shall be translated at exchange rates at the dates of the transaction; and

  For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, eq, an average rate for the period is often used to translate income and expense items. However, if exchange rates fluctuate significantly, the use of average rate for a period is inappropriate.
- all resulting exchange rates shall be recognised in other comprehensive income.

  The exchange differences result from translating—

  - income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate.
  - the opening net assets at a closing rate that differs from previous closing rate.

These exchange differences are not recognised in profit and loss because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations. The cumulative amount of the exchange differences is presented in a separate component of equity until disposal of the foreign operation.

Example 16

ABC Ltd (functional currency $) commenced business on 1 January 2012.

Balance Sheet as on 31 December 2012

Particulars	$	$
Share capital		20
Retainedearnings		6
		26
Accounts payable		2
Total equity and liabilities		**28**
Machinery at cost	10	
Less: Accumulated depreciation	2	8
Inventories		2
Accounts receivable		4
Cash		14
Total assets		28

Statement of Profit and Loss for the period ended 31 December 2012

Particulars	$	$
Revenue		20
Cost of sales –		
Purchases	6	
Expenses	2	
Depreciation	2	10
Accounting profit		10
Tax expense (40%)		4
Profit for the period		6

ABC Ltd wishes to present its financial statements on 31 December 2012 using the • as its presentation currency. The exchange rates during 2012 were–

1 January: $ 1 = • 1; 31 December: $ 1 = • 2; Average: $ 1 = • 1.5

Balance Sheet as on 31 December 2012

Particulars	•	•
Share Capital (20 x 2)		40
Retained earnings		9
Exchange difference (60% of 3)		1.8
		50.8
Deferred tax liability (40% of 3)		1.2
Accounts payable (2 x 2)		4
Total equity and liabilities		56
Machinery at cost	20 (10 x 2)	
Less: Accumulated depreciation	4 (2 x 2)	16
Inventories (2 x 2)		4
Accounts receivable (4 x 2)		8
Cash (14 x 2)		28
Total assets		56

Statement of Comprehensive Income for the period ended 31 December, 2012

Particulars	•	•
Revenue	(20 x 1.5)	30
Cost of sales –		30
Purchases	9 (6 x 1.5)	
Expenses	3 (2 x 1.5)	
Depreciation	3 (2 x 1.5)	15
Accounting Profit		15
Tax expense (40%)		6
Profit for the period		9
Other comprehensive income		
Exchange difference (net of tax)		1.8
Total comprehensive income		10.8

Tax effects of all exchange differences

Ind AS 12 states that certain exchange differences to be recognised as income or expense but does not specify where such differences should be presented in the Statement of Comprehensive Income. Accordingly, where exchange differences on deferred foreign tax liabilities or assets are recognised in the Statement of Comprehensive Income, suchdifferences may be classified as deffered tax expense (income) if that presentation is considered useful.

Example 17

ABC Ltd (functional currency∈) made an investment in foreign operations on 1 January 20x1 for $1,000, when the exchange rate was $1=∈1.50. Profit ∈1,000 per year. Ordinary income tax rate 30%. If the investment is sold for more than cost, tax law specifies tax rate of 40% on sale proceeds in excess of cost.

Fair value

- $1,200 on 31 December 20x1, when the exchange rate was $1=∈1.60.
- $1,300 on 31 December 20x3, when the exchange rate was $1=∈1.70.

The investment was sold for $ 1,400 on 31 December 20x5, when the exchange rate was $1 = ∈1.80.

Statement of Comprehensive Income

Year	20x1		20x2		20x3		20x4		20x5	
Accounting Profit	1,000		1,000		1,000		1,000		1,000	
Tax expense –										
Current tax	300		300		300		300		708	
Deferred tax liability	–	300	–	300	–	300	–	300	(408)	300
Profit for the Period (before reclassification adjustment)		700		700		700		700		700
Exchange difference reclassified from other comprehensive income to profit or loss		–		–		–		–		252
Profit for the period (after reclassification adjustment)		700		700		700		700		952
Other comprehensive income										
Item that will not be reclassified to profit or loss										
Revaluation surplus	300		–		150		–		150	
Income tax relating to the above	(120)	180	–	–	(60)	90	–	–	(60)	90
Item that may be reclassified to profit or loss										
Exchange difference	120		–		140		–		160	
Income tax relating to the above	(48)	72	–	–	(56)	84	–	–	(64)	96
Exchange difference reclassified from other comprehensive income to profit or loss		–		–		–		–		(252)
Total comprehensive income		952		700		874		700		886

Statement of Changes in Equity

Year	20x1	20x2	20x3	20x4	20x5
Revaluation Surplus					
Opening balance	–	180	180	270	270
Created through other comprehensive income	180	–	90	–	90
Transferred to retained earnings	–	–	–	–	(360)
Closing balance	180	180	270	270	–
Exchange difference					
Opening balance	–	72	72	156	156
Created through other comprehensive income	72	–	84	–	96
Reclassified to profit or loss	–	–	–	–	(252)
Closing balance	72	72	156	156	–

Workings	**Current Tax**				
Year	20x1	20x2	20x3	20x4	20x5
Profit	1,000	1,000	1,000	1,000	1,000
Gain from disposal of foreign operation	–	–	–	–	1,020
Taxable Profit	1,000	1,000	1,000	1,000	2,020
Current tax	300	300	300	300	708
Deferred Tax Liability					
Year	20x1	20x2	20x3	20x4	20x5
Opening balance	–	168	168	284	284
Created through other comprehensive income –					
Revaluation surplus	120	–	60	–	60
Exchange difference	48	–	56	–	64
Reversed through profit or loss	–	–	–	–	(408)
Closing balance	168	168	284	284	–
Foreign Operation					
Year	20x1	20x2	20x3	20x4	20x5
Carrying amount	1,920	1,920	2,210	2,210	2,520
Tax base	1,500	1,500	1,500	1,500	1,500
Deferred tax liability	168	168	284	284	408

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