ELECTIVE PAPER 6E- GLOBAL FINANCIAL REPORTING STANDARDS

SUGGESTED SOLUTION – CASE STUDY 3

I. Answers to descriptive questions

Answer 1

(a) In present case, 13 kms of rail tracks belonging to A Ltd. has been identified as specified asset in the above-mentioned agreement and this asset is required by A Ltd. to fulfil its obligations under the said agreement. There is no other rail track available that connects to Location 2 railway station and enable B Ltd. to transport its cargo to the said station. Hence, it is not practicable for A Ltd. to perform its obligation under this agreement by using alternative railway tracks or any other mode of transport. Accordingly, fulfilment of abovementioned arrangement is dependent on the use of this 13 kms of railway tracks, connecting B Ltd.'s rail tracks to Location 2 railway station. Hence, 13 kms of railway track is a specified asset. In accordance with IFRIC 4 "Determining Whether an Arrangement Contains a Lease", an arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

Technical literature	Analysis
(1) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.	In the present case, B Ltd. has no right over the concerned railway tracks stated in this agreement because of the following factors: • A Ltd. has permitted B Ltd. to run its trains on a portion of A Ltd.'s railway tracks (13 kms out of total 27 kms of rail tracks) leading to Location 2 Railway station. • A Ltd.'s trains shall be given preference over B Ltd.'s trains in movement of cargo over such rail tracks. • B Ltd. shall have no claim on any assets or facilities owned by A Ltd. in respect of railway tracks. • B Ltd. cannot increase number of rake loads without A Ltd.'s prior written approval.

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	• Thus, on reading the above, it can be said that by getting first priority over others and restricting other's traffic, A Ltd. is controlling the rail traffic on its tracks. Hence, it can be concluded B Ltd. has no ability or right to operate these tracks or direct other to operate these tracks.
(2) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset	Considering the facts of the case, it seems that A Ltd. has the right to control physical access to rail tracks and not B Ltd.
(3) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.	B Ltd. shall be paying INR 5.5 per MT of cargo transported on such tracks (both inward and outward movements). This rate is contractually fixed for the entire agreement period of 10 years. Such price is arrived by considering length of tracks that will used and frequency at which such tracks will be used. Hence, the said criteria is also not getting satisfied.

Based on the above analysis, it is clear that the arrangement between A Ltd. and B Ltd. for letting B Ltd. to run its trains on a portion of A Ltd.'s rail tracks, will not be considered to be a lease arrangement.

(b) In the present case, B Ltd. has transferred the ownership of connecting tracks (i.e., from its port to A Ltd.'s rail tracks) to A Ltd. It clearly states that ownership of connecting tracks and facilities built by B Ltd. will belong to A Ltd. and B Ltd. will have no claim over such connecting tracks. In accordance with the principles of IFRIC 18 "Transfers of Assets from Customers", to determine whether an asset exist for an entity that renders service, the right of ownership on that asset is not essential. Even if ownership of an asset is transferred by the customer to an entity (rendering services), but it is still controlled by the customer, then definition of an asset will not be met for the entity rendering services.

IFRIC 18 provides few factors which can help to ascertain as to who has control over the transferred item of property, plant and equipment. These factors have been discussed

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below in the context of the present case to determine whether A Ltd. has control over connecting rail track:

Examples	Whether applicable to present case?
The entity can exchange that asset for other assets	In present case, the asset received is a rail track. Practically, considering the nature of the asset, it can be said that A Ltd. cannot exchange such a track with any other party for other assets.
Employ it to produce goods or services	A Ltd. can run its own trains on such connecting tracks, without paying for usage.
Charge a price for others to use it	A Ltd. has no intention to charge a price for others to use it.
Use it to settle liabilities, hold it or distribute it to owners	A Ltd. cannot use such connecting rail tracks to settle its own liabilities, or distribute it to owners.
It may have the ability to decide how the transferred item of property, plant and equipment is operated and maintained and when it is replaced	Responsibility of operating and maintaining such track is with B Ltd.

IFRIC 18 further states that an entity receiving the item of property, plant and equipment should consider all relevant facts and circumstances when assessing control over that transferred item. Accordingly, following factors may also be considered while assessing control over connecting rail tracks laid down by B Ltd.:

- These connecting rail tracks (of 2 kms) were laid down by B Ltd. at its own costs.
- Responsibility of maintaining such connecting rail tracks lies with B Ltd., i.e., they have to maintain these connecting rail tracks. However, A Ltd. has right to access to the connecting tracks without paying for usage.
- After expiry of the said agreement, connecting rail tracks will belong to B Ltd. only. Hence, ownership of rail tracks is for 10 years only and not for entire life of the asset.

From the above factors, it can be said that, although ownership of connecting tracks has been transferred to A Ltd. and A Ltd. can have access to such tracks, it does not have substantial control over connecting rail tracks. Also, no future economic benefits are expected to flow to A Ltd. from such connecting rail tracks laid down by B Ltd. Hence, it

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can be concluded that provisions of IFRIC 18 will not be applicable and A Ltd. cannot recognise connecting rail tracks in its books as an asset.

(c) The agreement between A Ltd. and B Ltd. was entered into with the purpose of allowing B Ltd. to use A Ltd.'s 13 kms of rail tracks for a fixed period of 10 years. There is no transfer of significant risk and rewards incidental to ownership of such tracks to B Ltd. As per the available information, the permission given to B Ltd. is a license given solely for the purpose of hauling traffic and B Ltd. does not have any right over such assets (i.e., rail track). On that basis, we can conclude that there is no sale of rail tracks to B Ltd since INR 10 crores is against permission granted to use A Ltd.'s tracks. As regards sharing of revenue @ INR 5.5 per MT, it is paid for inward and outward movement of cargo on A Ltd.'s railway tracks. Sharing of revenue @ INR 5.5 per MT were agreed between both the parties, based on two factors namely the length of rail tracks to be used and frequency of usage of such tracks. Hence, there is no connection between upfront payment of INR 10 crores and sharing of revenue @ INR 5.5 per MT. INR 10 crores were levied on B Ltd. because A Ltd. wanted to recover some amount against their initial investments made on such rail tracks. As per the agreement, INR 10 crores paid is non-refundable, hence, there is no obligation on A Ltd. to repay back the said amount, irrespective of usage of such tracks by B Ltd. Based on above facts, it can be concluded that such arrangement does not involve sale of assets. The payment is for giving a right to an external party to use an entity's assets over a fixed period. Considering the general principles of para 13 of IAS 18, upfront consideration of INR 10 crores should be treated as a deferred revenue and should be recognised in the statement of profit and loss over the period of 10 years on a straight-line basis.

Answer 2

In accordance with IFRS 9, a financial guarantee contract meets the definition of an insurance contract and if an issuer applies accounting to such contracts which is applicable to insurance contracts, in such a case issuer may elect to apply either the requirements of IFRS 4 or IFRS 9 to such financial guarantee contracts.

A Ltd. in its Indian GAAP financial statements has disclosed the contract as corporate guarantees under contingent liabilities. Hence, the criteria of previous assertion of this contract as an insurance contract is not met. Hence, as provided above, since the criteria of insurance contract is not met, the said transaction will be covered under IFRS 9 and not under IFRS 4 and the company needs to measure the financial guarantee given by at its fair value.

Measurement of financial guarantee under IFRS 9

Evaluation is required with regards to guarantee given by A Ltd., i.e., whether it is an integral part of the loan or not.

Guarantee is an integral part of the loan if the guarantee provided to the lender forms part of the overall terms of the loan (i.e., if the loan were to be assigned by the lender to a third party, the guarantee would transfer with it). If the guarantee is provided to the lender separate and apart from the original borrowing such that it does not form part of the overall terms of the loan (i.e., if

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the loan were to be assigned by the lender to a third party, the guarantee would not transfer with it), then such guarantee is a separate unit of account.

I. Accounting in the books of A Ltd.

The same will not affect the recognition in the books of A Ltd. The recognition of financial guarantee is independent to the fact whether the guarantee is a separate unit of account or is not a separate unit of account. Therefore, irrespective of whether the guarantee is considered a separate unit of account, A Ltd. recognises the fair value of the financial guarantee in its separate financial statements as follows:

Investment in subsidiary A/c	Dr.	INR 2 crores
Financial guarantee obligation A/c	Cr.	INR 2 crores

II. Accounting in the books of F Ltd.

With respect to the recognition of financial guarantee contracts, F Ltd. has an accounting policy choice to be applied consistently:

(a) View I- Guarantee is not an integral part of the loan and F Ltd. should perform mirror accounting of what has been done by A Ltd. in its separate financial statements.

(b) View II- Guarantee is an integral part of the loan

If the guarantee is integral to loan, the subsidiary is not required to recognise the value of guarantee separately, instead it will be included in the loan liability. However, if the guarantee is not an integral part of the loan, then the subsidiary is required to recognize the value of guarantee separately as a capital contribution.

A. **If the guarantee is an integral part of the loan:** If the guarantee provided to the lender forms part of the overall terms of the loan (i.e., if the loan were to be assigned by the lender to a third party, the guarantee would transfer with it), F Ltd. should recognise the liability at fair value, including the value of the guarantee provided by the parent (INR 100 crores) as follows:

Cash A/c	Dr.	INR 100 crores
Loan liability A/c	Cr.	INR 100 crores

B. **If the guarantee is not an integral part of the loan:** If the guarantee is provided to the lender separate and apart from the original borrowing such that it does not form part of the overall terms of the loan (i.e., if the loan were to be assigned by the lender to a third party, the guarantee would not transfer with it), F Ltd. should recognise the liability at fair value without the guarantee (assumed INR 98 crores) with the difference being recognised as a capital contribution, as follows:

Cash A/c	Dr.	INR 100 crores
Loan liability A/c	Cr.	INR 98 crores
Capital contribution A/c	Cr.	INR 2 crores

III. <u>Accounting in the consolidated financial statements</u>

Irrespective of whether the guarantee is considered a separate unit of account, the financial guarantee is not separately recognised in the consolidated financial statements of A Ltd.

In consolidated financial statements, the entry passed in separate financial statements of the parent will be reversed.

Financial guarantee obligation A/c	Dr.	INR 2 crores
Investment in subsidiary A/c	Cr.	INR 2 crores

The consolidated group incurred a financial liability with a fair value of INR 100 crores (due to the guarantee of the parent) and therefore, the consolidated statement of financial position includes only that liability, measured on an amortised cost basis.

In case F Ltd. (subsidiary) has accounted the loan considering the guarantee as not an integral part of the loan, then in consolidated financial statements, besides reversal of the entry passed by the parent company, the entry passed in F Ltd. (subsidiary company) with respect to capital contribution by A Ltd. for INR 2 crores shall be eliminated by transferring the same to loan liability as follows:

Capital contribution A/c	Dr.	INR 2 crores
Loan liability A/c	Cr.	INR 2 crores

Answer 3

Property	Classification of properties not held for operational purpose
A Ltd.'s office building (registered office)	Excess portion of office space has been given on lease to earn rental income. Out of 15 storey building, only 3 floors are occupied by A Ltd. Such excess office space was constructed for the purpose of letting it out. According to A Ltd., such excess office space will continue to be let out on lease to external parties and have no plans to occupy it, at least in near future. Further, office space given on rent, although in same building, is separately identifiable from other owner occupied portion and hence can be sold separately (if required). Hence, the excess space will qualify to be an investment property.

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Flats in Township located in location 1	Excess flats have been given on lease to earn rental income. According to A Ltd., there is no intention of selling such excess flats or allotting it to its employees. Further, flats given on rent, can be sold separately from flats occupied by A Ltd.'s employees as they are separately identifiable. A Ltd. also charges its lessees on account of ancillary services, i.e., water, electricity, cable connection, etc., but the monthly charges in such cases are generally not significant as compared to rental payments. Hence flats given on rent should qualify to be an 'investment property'. With regard to the flats kept vacant, A Ltd. has to evaluate the purpose of holding these flats, i.e., whether these would be kept for earning rentals or will it be allotted to its future employees. In case they are held for earning rentals, it would be classified as an investment property; and if they are held for allotment to future employees, it would form part of property, plant and equipment.
Flats in township located in location 2	350 flats are given on lease to earn rental income and assuming that management intends to let out these flats on rent in future, such flats should be classified as an 'investment property. With regard to the flats kept vacant, A Ltd. has to evaluate the purpose of holding these flats, i.e., whether these would be kept for earning rentals or will it be allotted to its future employees. In case they are held for earning rentals, it would be classified as an investment property; and if they are held for allotment to future employees, it would form part of property, plant and equipment.
Hostel located in location 1	Rooms in a hostel have been let out to G Ltd. to be used by its personnel. A Ltd. also charges G Ltd. on account of ancillary services, i.e., water, electricity, cable connection, etc., but the monthly charges in such cases are generally not significant as compared to rental payments. Hence, it should be classified as an 'Investment property'.
Land in location 1	Although management has not determined a use for the property after the park's development takes place, yet in the medium-term the land is held for capital appreciation. As per IAS 40, if an entity has not determined that it will use the land either as owner-occupied property or for short term sale in the ordinary course of business, then it will be considered as land held for capital appreciation. Therefore, management should classify the property as an investment property.
Land in location 1	Since the land is held with an intention of giving it on lease and earning capital appreciation over a period of time, it should be classified as 'Investment property'.

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Land in location 2	Since the land is held with an intention of giving it on lease and earning capital appreciation over a period of time, it should be classified as ‘Investment property’.

II. Answers to Objective type questions

1. Option (c) : INR 10,00,000

Hint

Net realisable value of one unit of raw material = Sale price - cost to completion and sale

= INR 160 – INR 50 = INR 110

Carrying value of raw material = INR 100

Inventory of raw material will be kept at lower of costs and net realisable value. Thus, inventory of raw material will be kept at INR 100 per unit, i.e., total of INR 10,00,000 for 10,000 units.

2. Option (c) : Annual depreciation charge will be INR 13,000 and an annual transfer of INR 3,000 may be made from revaluation surplus to retained earnings.

Hint

The annual depreciation charge for years 3 to 10 will be INR 13,000 (i.e. 104,000/ 8). The amount that may be transferred from revaluation surplus to retained earnings in accordance with para 41 of IAS 16 will be the difference between the depreciation expense based on historic cost (i.e., INR 10,000), and the depreciation expense based on the revalued amount (i.e., INR 13,000). So an annual transfer of INR 3,000 may be made from revaluation surplus to retained earnings as the asset is used by an entity.

3. Option (a) : INR 6,35,00,000

Hint

The mid-value is 12,700 per square feet [12,500 + 12,900) x ½]. This would value the property at INR 6,35,00,000 (12,700 x 5,000).

4. Option (a)

Bank A/c	Dr.	INR 50 lacs
Loan A/c	Cr.	INR 40 lacs
Government grant (deferred income) A/c	Cr.	INR 10 lacs

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5. Option (d) : INR 31,00,000

Hint
Total interest charge for the year ended 31 March 2018 is INR 45,00,000 (600 lacs x 10% x 9/12). Amount to be capitalised is INR 31,00,000 (i.e., INR 45,00,000 – 14,00,000).

6. Option (a) : A Ltd. should recognise it as an intangible asset.

Hint
A Ltd. should recognise the customer portfolio as an intangible asset considering the below guidance under para 16 of IAS 38: An entity may have a portfolio of customers or a market share and expect that, because of its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (eg portfolio of customers, market shares, customer relationships and customer loyalty) to meet the definition of intangible assets. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.

7. Option (b) : 12-month expected credit losses

Hint
Under the general model of IFRS 9, all assets need to have a loss allowance. Allowance covers either 12-month or lifetime expected credit losses depending on whether the asset's credit risk has increased significantly. Since the loan has just been granted and there has not been a **significant increase in credit risk**, an allowance equal to 12-month expected credit losses is appropriate.

8. Option (d) : Financial liability to be measured at fair value

Hint
The amount of application money is fixed, i.e., INR 10 crores. However, number of shares are variable based on the future fair market value. Therefore, A Ltd. must treat this application balance as a financial liability and measure it at fair value.

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9. Option (a) : INR 20,000 of goodwill

Hint

Cost of investment	1,00,000 + (1,21,000/ 1.21)	INR 2,00,000
Non-controlling interest	(40% x 3,00,000)	INR 1,20,000
		INR 3,20,000
Less: Net assets of MN Ltd.		INR 3,00,000
Goodwill		**INR 20,000**

10. Option (c) : A Ltd. should recognise a provision as on 31 March 2018.

Hint

The communication of management's decision to customers and employees on 25 March 2018 creates a valid expectation that the division will be closed, thereby giving rise to a constructive obligation from that date. Accordingly, a provision should be recognised at 31 March 2018 for the best estimate of the costs of closing the division.

Note: Alternative answers may be possible for certain questions of the case study, depending upon the view taken.

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