Case Study - 3

A Ltd. is an automotive supplier and is in the business of manufacturing components and parts to be used by various automotive companies.

It has a registered office in New Delhi and is listed on the Bombay Stock Exchange (BSE). It is considering the possibilities of listing its securities at London Stock Exchange for which it needs to submit its financial statements prepared under International Financial Reporting Standards (IFRS).

The Accountant of A Ltd. is facing certain issues while preparing its financial statements based on IFRS. The company approached ABHI & Co. Chartered Accountants. Mr. Harsh of ABHI & Co. Chartered Accountants was given the assignment to deal with the client A Ltd. and help the company in the preparation of financial statements based on IFRS. Harsh has approached CFO of A Ltd. to discuss the issues.

The CFO of A Ltd. gave brief facts about the transactions entered into by the company to Harsh and wants an advice on the below accounting matters:

(a) Railways is an important mode of transport for A Ltd., which is used for transporting various components to its depots and customers located in different cities across India. Considering the size of each consignment that it supplies, A Ltd. prefers to transport it by rail, which is cost effective, time saving and relatively less risky. Accordingly, A Ltd. has laid down railway tracks of 27 kms connecting its factory in Location 1 to Location 2 railway station, where these railway tracks are connected to main railway network operated by the Central Railways, with the help of which the inventory of A Ltd. can be transported to different parts of the country. These railway tracks were laid down during the period 1982-1985 and have been in use by A Ltd. under a private siding agreement executed with the Central Railways on 11 January 2007. Maintenance work for these railway tracks is undertaken by Railway authorities for an agreed price. B Ltd. had approached A Ltd. and the Railway authorities for letting them use A Ltd.'s tracks, so that they can transport their cargoes from their port/ factory to Location 2 railway station, using rail tracks of A Ltd. and from there on to other parts of the country via Location 2 railway station. Pursuant to private siding agreement entered into between A Ltd. and Central Railways as stated above, Railway authorities can permit other entities to use these railway tracks, subject to issuance of non-objection certificate by A Ltd.

B Ltd. is engaged in the business of construction of jetty and operation of port at Location 3 and have built jetty for import of cargo such as coal, rock phosphate, sulphur, etc. and is carrying out business of barging for import-export cargoes. B Ltd. laid down railway tracks from Location 3 Jetty to A Ltd.'s railway tracks (distance being 2 kms) at its own cost and uses A Ltd.'s 13 kms of railway tracks to reach to Location 2 railway station.

For the abovementioned arrangement, A Ltd. entered into an agreement with B Ltd. Following is the synopsis of agreement between A Ltd. and B Ltd.:

Particulars	**Details**
Date of agreement	12 October 2011
Lessor	A Ltd.
Lessee	B Ltd.
Tenure	10 years and can be extended by parties as mutually decided
Length of railway tracks	13 kms
Purpose	To allow B Ltd. to use 13 kms of railway tracks of A Ltd.
Compensation	B Ltd. to pay INR 10 crores being one time lump-sum non-refundable amount towards grant of permission by A Ltd. to use its railway tracks. The amount of INR 10 crores has been recognised as 'miscellaneous income' in the year of receipt.
	B Ltd. shall share revenue from its operations which is computed @ INR 5.5 per metric tonne (MT) of inward and outward movement of cargo on A Ltd.'s railway tracks. Quantities of cargo will be ascertained from railway receipts issued by Railways to B Ltd. Such price is arrived by considering length of tracks that will used and frequency at which such tracks will be used.

	However, minimum guaranteed amount of INR 35 lacs per annum shall be paid by B Ltd. to A Ltd.
Maintenance costs	B Ltd. to pay estimated amount in advance to A Ltd. at the beginning of the year with final adjustment taking place at year end as per the actual cost incurred.
	A Ltd. and B Ltd. to pay equal maintenance pertaining to railway tracks. In case any other party is included in this arrangement, then maintenance costs shall be shared equally among all the parties from the date of granting such permission. All the parties shall bear in equal portion, maintenance costs for entire 27 kms of railway tracks, i.e., from A Ltd. to Location 2 station.
Capital additions	B Ltd. and A Ltd. shall equally share the cost of capital additions incurred for on 13 kms of railway tracks of A Ltd.
Ownership of connecting tracks	B Ltd. to lay down connecting rails and other facilities to connect their railway tracks at Location 3 with rail tracks of A Ltd. at its own cost. However, the ownership of connecting rails and other facilities provided shall rest with A Ltd. and B Ltd. shall not have any claim on the said connecting facilities. A Ltd. shall have unrestricted rights to use the connectivity facilities of B Ltd. including loop lines without paying any compensation to B Ltd. for such usage.
Assets installed on railway tracks	Assets installed, i.e., signalling cabins, facilities, etc. on B Ltd.'s rail tracks shall be at the cost of B Ltd. Similarly, any such assets installed on A Ltd.'s tracks, shall be constructed and maintained by B Ltd. at its own cost. The cost of additional installation and maintenance shall be solely on account of B Ltd. and shall not be shared by A Ltd. or any other party. In addition to railway tracks, a cabin has been constructed near A Ltd.'s rail tracks, for managing rail traffic. It's a small non-AC cabin occupied by the personnel of A Ltd.

Other relevant conditions

- 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 the number of rake loads without A Ltd.'s prior written approval.
- A Ltd. cannot use such connecting rail tracks to settle its own liabilities, or distribute it to owners.
- After expiry of the said agreement, connecting rail tracks will belong to B Ltd.
- B Ltd. clearly understands that the permission to use the A Ltd.'s rail track is a license given solely for the purpose of hauling the traffic and shall not bestow any right to sell, mortgage, alienate, create liabilities or any encumbrance on the same.
- Also, A Ltd. has no intention to charge a price for others to use rail tracks.

As per the above understanding among the parties, cost of maintenance of A Ltd.'s 27 kms rail tracks, will be borne by both parties equally. As informed, every year, Central Railways charge INR 4 crores towards maintenance of rail tracks to A Ltd. A Ltd. in turn issues debit notes to B Ltd. to recover its share of maintenance costs of INR 2 crores.

(b) F Ltd. (subsidiary of A Ltd.) had entered into a loan agreement with UV Bank on 18th December 2014 to borrow a sum of INR 100 crores at the rate of 12% per annum compounded monthly. As per the agreement, A Ltd. had provided a guarantee to the bank in respect of the loan facility extended by the bank to F Ltd. for which no consideration was charged by A Ltd. from its subsidiary. F Ltd. has defaulted on repayment of an instalment to UV Bank pending on 31 March 2016, however, as explained by the management of F Ltd. and as per the communication with UV Bank, F Ltd. has made good the default on loan after payment of penal interest and there has been no financial impact on the guarantee extended by A Ltd. A Ltd. in its financial statements based on Indian GAAP has disclosed the guarantee given as 'contingent liability'. Fair value of financial guarantee obligation is INR 2 crores.

(c) Besides manufacturing plants, A Ltd. has various other assets, not used for operational activities, e.g., freehold land, townships in different locations, excess of office space rented to ABC, etc. Also, A Ltd. has some land, which are kept vacant as per the government regulations which require that a specified area around the plant should be kept vacant.

The details of these assets are as under:

Property	Details
A Ltd.'s office building (registered office)	A Ltd.'s registered office in Delhi, is a 15 storey building, of which only 3 floors are occupied by A Ltd., whereas remaining floors are given on rent to other companies. These agreements are usually for a period of 3 years. 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.
Flats in Township located in location 1	As regards township in Location I, there are approximately 2,000 flats in the said township. It was built primarily for A Ltd.'s employees, hence, approximately 80% of the flats are allotted to employees and remaining flats are either kept vacant or given on rent to other external parties. A lease agreement is signed between A Ltd. and an individual party for every 12 months being 1 April to 31 March. The lease entered is a cancellable lease (cancellable at the option of any of the parties). Also, besides monthly rent, additional charges are levied by A Ltd. on account of electricity, water, cable connection, etc. According to A Ltd., there is no intention of selling such excess flats or allotting it to its employees.
Flats in township located in location 2	There are 1,000 flats in location 2 township, of which: • 400 flats are given to employees for their own accommodation. • 350 flats are given on rent to Central Government and State Government for accommodation of their employees. Average lease period being 12 months with cancellable clause in lease agreements. • 250 flats are kept vacant.

Hostel located in location 1	60 rooms in the hostel have been let out to G Ltd., for giving accommodation to their personnel. Lease agreement is prepared for every 11 months and renewable thereafter. Besides the monthly rent amount, some charges are levied towards water, electricity and other amenities, e.g., cable connection, etc.
Land in location 1	In 2017, A Ltd. purchased a plot of land on the outskirts of a major city. The area has mainly low-cost public housing and very limited public transport facilities. The government has plans to develop the area as an industrial park in 5 years' time and the land is expected to greatly appreciate in value if the government proceeds with the plan. A Ltd. has not decided what to do with the property.
Land in location 1	A portion of land has been leased out to C Ltd. for its manufacturing operations. Land has been given on lease on a lease rental of INR 10 lacs p.a. with a lease term of 25 years.
Land in location 2	A portion of the land has been given on rent to D Ltd. who has constructed a petrol pump on such land. It has been leased since 1970, for a period of 40 years and renewed for a further period of 40 years.

(d) A Ltd. has 10,000 units of a raw material inventory on hand at 31 March 2018 with a carrying amount of INR 100 each. The current market value of that raw material is INR 95 each. A Ltd. intends to use the raw material to manufacture a component to be used by an automotive company. A Ltd. estimates costs to completion and sale of INR 50 each and a selling price for the component is estimated to be INR 160 each.

(e) An item of equipment X was acquired by A Ltd. on 1 April 2016 for INR 100,000 having an estimated useful life of 10 years, with a residual value of zero. The asset is depreciated on a straight line basis. The asset was revalued to INR 104,000 on 31 March 2018.

(f) A Ltd. has an investment property on 6^{th} floor of a building in New Delhi with a floor area of 5,000 square feet. A Ltd. has adopted a fair value policy for its investment property. Similar properties in the same locality have been sold at prices which amount to INR 12,500, INR 12,550, INR 12,600, INR 12,700 and INR 12,900 per square feet during the past month.

(g) One of the plant of A Ltd. is situated in north-east India and the State Government provides interest-free loans for 3 years to aid investment in the region. On April 1, 2017, A Ltd. received an interest-free loan of INR 50 lacs for the project. The fair value of the loan is INR 40 lacs.

(h) On 1 July 2017, A Ltd. was engaged in the development of a property in Rajasthan, which is expected to take five years to complete, at a cost of INR 600 lacs. For this purpose, a bank loan of INR 600 lacs with an effective interest rate at 10% was taken out on 1 July 2017. The amount of loan was fully drawn from the bank. However, during the year2017-18, the construction was not in full swing. Therefore, A Ltd. invested its surplus fund from such loan for the time being. Interest income earned on the unapplied funds during the period 2017-18 was INR 14,00,000.

(i) A Ltd. acquired a customer portfolio from XYZ Ltd. at a price of INR 13 lacs. There are no legal contracts with customers to protect the interest of A Ltd. However, exchange transactions for similar non-contractual customer relationships (other than as part of a business combination) exist in the market.

(j) On 31st March 2018, A Ltd. has given a loan to V Ltd. with low credit standing, but still at an acceptable level for A Ltd.

(k) A Ltd. has accepted INR 10 crores share application money from PQR Ltd. Shares will be issued to PQR Ltd. based on the future fair market value.

(l) A Ltd. acquired 60% of MN Ltd. on 1 January 2018 for INR 1,00,000 cash payable immediately and INR 1,21,000 after two years. The fair value of net assets of MN Ltd. at acquisition amounted to INR 3,00,000. Cost of capital of A Ltd. is 10%. Non-controlling interest is measured at the proportionate share of identifiable net assets.

(m) The board of directors of A Ltd. decides on 11 March 2018 to close down one of its manufacturing divisions. On 25 March 2018, a detailed plan for closure was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

Harsh requires your assistance on the above issues to arrive at the conclusion

I. Descriptive Questions

1. The management of A Ltd. wishes to enquire the following with regard to arrangement with B Ltd.:

(a) Considering the guidance under IFRS, determine whether abovementioned arrangement contains a lease?

(b) Whether rail tracks constructed by B Ltd. at its cost, should be recognised as an asset in the books of A Ltd.?

(c) What accounting treatment should be given for lump-sum consideration received from customer for granting them permission to use rail tracks of A Ltd.?

2. What should be the accounting treatment of corporate guarantees in the separate financial statements of A Ltd. and F Ltd. and consolidated financial statements of group prepared under IFRS?

3. Determine the classification of properties referred to in (c) above which are not held for operational purposes, with appropriate justification in the financial statements of A Ltd. considering the principles of IFRS.

II. Objective Type Questions

(Select the most appropriate answer from the options given for each question.)

1. At what amount 10,000 units of raw material referred to in (d) above be carried at on 31 March 2018?

(a) INR 9,50,000

(b) INR 11,00,000

(c) INR 10,00,000

(d) INR 16,00,000

2. What will be the annual depreciation charge on equipment X for years 3 to 10 and the amount of the revaluation surplus that can be transferred to retained earnings annually?

   (a) Annual depreciation charge will be INR 10,000 and an annual transfer of INR 3,000 can be made from revaluation surplus to retained earnings.

   (b) Annual depreciation charge will be INR 10,000, however, annual transfer from revaluation surplus to retained earnings is not permitted.

   (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.

   (d) Annual depreciation charge will be INR 13,000, however, annual transfer from revaluation surplus to retained earnings is not permitted.

3. What will be the fair value of the 6^{th} floor investment property in a building in New Delhi if A Ltd. wishes to compute the fair value using mid-value approach within a bid-ask spread?

   (a) INR 6,35,00,000

   (b) INR 6,32,50,000

   (c) INR 6,30,00,000

   (d) INR 6,27,50,000

4. What would be the accounting for recognition of interest free loan of INR 50 lacs from State Government?

(a)	Bank A/c	Dr.	INR 50 lacs
	Loan A/c	Cr.	INR 50 lacs

(b)	Bank A/c	Dr.	INR 40 lacs
	Loan A/c	Cr.	INR 40 lacs

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

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

5. What should be the amount of interest to be capitalised on the development of property in Rajasthan for year ended 31 March 2018 under IFRS?

   (a) INR 46 lacs

   (b) INR 60 lacs

   (c) INR 45 lacs

   (d) INR 31 lacs

6. How should customer portfolio acquired by A Ltd. should be recognised in its IFRS financial statements?

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

   (b) A Ltd. should recognise it as an expense.

   (c) A Ltd. should recognise it as a goodwill.

   (d) A Ltd. should recognise it as a separate tangible asset.

7. What loss allowance should be recognised by A Ltd. in its financial statements in relation to loan given to V Ltd.?

   (a) No loss shall be recognized by A Ltd.

   (b) 12-month expected credit losses

(c) Lifetime expected credit losses

(d) A Ltd. has a choice between option (b) and (c) above

8. How A Ltd. should classify the share application money received from PQR Ltd.?

(a) Equity to be measured at cost

(b) Equity to be measured at fair value

(c) Financial liability to be measured at cost

(d) Financial liability to be measured at fair value

9. What should be the amount of goodwill/ capital reserve arising on acquisition of MN Ltd.?

(a) INR 20,000 of goodwill

(b) INR 80,000 of capital reserve

(c) INR 41,000 of goodwill

(d) INR 1,00,000 of capital reserve

10. Which of the following statement is correct with regard to the accounting implication of the board's decision to close one of the manufacturing division of A Ltd.?

(a) No provision should be recognised as on 31 March 2018. Also, there is no requirement to disclose a contingent liability in this regard.

(b) No provision should be recognised as on 31 March 2018. However, A Ltd. should disclose a contingent liability in this regard.

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

(d) A Ltd. may recognise a provision as on 31 March 2018.