ELECTIVE PAPER 6E- GLOBAL FINANCIAL REPORTING STANDARDS

SUGGESTED SOLUTION – CASE STUDY 1

Answers to Descriptive Questions

1. The key areas of differences where accounting or recognition as per IFRS is required vis-a-vis the current accounting practices, as per Indian GAAP, followed by ABC Limited:

(i) Power purchase agreement contains an embedded lease which needs to be evaluated under IFRIC 4.

(ii) The highway project is a service concession arrangement and will be accounted for as an intangible asset as per IFRIC 12.

(iii) The assets and liabilities of financial services constitute a disposal group held for sale as at 31 March 2016 and for the year then ended and will be accounted for as per IFRS 5.

(iv) The renegotiation of terms related to the term loan taken by ABC Ltd. needs to be evaluated to determine whether it constitutes a substantial modification of terms as per IFRS 9 or not.

(v) Class B equity shares will be accounted for as compound financial instruments as per IAS 32. The payment of dividend is dependent upon availability of profits, an event which is considered outside the control of the issuer and hence represents a financial liability. The feature of conversion into a fixed number of equity instruments i.e. Class A equity shares is an equity feature.

(vi) A-ONE Ltd. will be consolidated as a joint venture under IFRS 11 as the shareholders' agreement between ABC Limited and other shareholders of A-ONE Ltd. provides certain substantive rights which are not merely protective.

(vii) Corporate guarantee given by ABC Limited in respect of loan taken by A-ONE Ltd. will be accounted for as a financial guarantee contract as per IFRS 9.

(viii) ABC Limited has an obligation to restore the mine and related area and the estimated cost of fulfilling that obligation will be provided for in accordance with IAS 37, and capitalised to the cost of the mining license.

(ix) The portfolio of car loans will not be derecognised in the books of B-ONE Ltd. and in the consolidated financial statements of ABC Limited.

(x) The interest free loan from ABC Ltd. to B-ONE Ltd. will be initially recognised at its fair value and the difference between the loan amount and the fair value thereof will be accounted for as an investment in the books of ABC Ltd. and as a capital contribution in the books of B-ONE Ltd.

2. **(a)** The key exemptions available to ABCG on 1 April 2015 i.e. from its date of transition to IFRS, are:

i. ABCG may determine whether the PPA with GOP contains a lease on the basis of facts and circumstances existing at 1 April 2015.

ii. If, for the highway project, it is impracticable for ABC Limited to apply IFRIC 12 retrospectively at 1 April 2015, it shall:

(a) recognise the intangible assets that existed at 1 April 2015;

(b) use the previous carrying amounts of those intangible assets (however previously classified) as their carrying amounts as at 1 April 2015; and

(c) test intangible assets recognised at 1 April 2015 for impairment, unless this is not practicable, in which case the amounts shall be tested for impairment as at 1 April 2016.

iii. ABC Limited may elect not to apply IFRS 3 retrospectively to its acquisition of B-ONE Ltd.

(b) As per IFRIC 19, Extinguishing Financial Liabilities with Equity Instruments:

i. When equity instruments issued to a creditor to extinguish all or part of a financial liability are recognised initially, an entity shall measure them at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured.

ii. The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognised in profit or loss, in accordance with paragraph 3.3.3 of IFRS 9. The equity instruments issued shall be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished.

In the present case, the outstanding amount of interest on the term loan has been converted into CCPS. Each CCPS is convertible into one class A equity shares of ₹ 100 each. As the criteria specified in IAS 32 in respect of definition of equity instrument are satisfied, CCPS are concluded as equity instruments.

Accordingly, as per IFRIC 19, the difference between the carrying amount of financial liability i.e. ₹ 100 crores and the fair value of equity instruments shall be recognised as a gain or loss.

It has been mentioned that in January 2017, an investor showed interest in picking up a strategic stake in ABC Limited at a valuation of ₹ 10,000 crores. This demonstrates that the fair value of all equity instruments of ABC Limited is ₹ 10,000 crores.

Further, it has been mentioned that the total number of equity instruments (on fully diluted basis) is 20 crores (Class A equity shares – 10 crores and Class B equity shares – 10 crores). Accordingly, fair value per equity instrument is ₹ 500. It may be noted that Class B equity shares are in the nature of compound financial instruments and hence it is assumed that the fair valuation of all equity instruments (i.e. ₹ 10,000 crores) is after factoring in the liability component of these compound financial instruments.

Therefore, the fair value of equity instruments to be issued upon conversion of the interest outstanding is: 2,100,000 equity shares x ₹ 500 per share = ₹ 105 crores.

Applying the guidance in IFRIC 19, a loss of ₹ 5 crores will be recognised in the statement of profit or loss.

Next, we need to consider whether the modification of terms of loan to the extent of principal outstanding qualifies as "substantial modification" or not. In order to be able to do that, we refer to guidance in paragraph B3.3.6 of the application guidance of IFRS 9, which provides as below:

"For the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability."

Accordingly, the following computation table has been made:

Year	Cash flow	Present value @ 14%
2018	(88)	(77.19)
2019	(88)	(67.71)
2020	(88)	(59.40)
2021	(88)	(52.10)
2022	(888)	(461.20)
TOTAL		**(717.60)**
PV as % of original loan [(7,176/800) x 100]		**89.70%**

As can be seen from the table above, the present value of the cash flows under the new terms discounted using the original effective interest rate (₹ 717.61 crores) vary from the original financial liability (₹ 800 crores) by 10.30%. Accordingly, the debt restructuring tantamount to substantial modification of terms of the loan.

(c) As per para 7 of IFRS 10 (under the head 'Control'):

"Thus, an investor controls an investee if and only if the investor has all the following:

(i) power over the investee;

(ii) exposure, or rights, to variable returns from its involvement with the investee; and

(iii) the ability to use its power over the investee to affect the amount of the investor's returns"

As per paragraph B3 of application guidance (under the head 'Assessing Control') of IFRS 10:

"Consideration of the following factors may assist in making that determination:

(a) the purpose and design of the investee;

(b) what the relevant activities are and how decisions about those activities are made;

(c) whether the rights of the investor give it the current ability to direct the relevant activities;

(d) *whether the investor is exposed, or has rights, to variable returns from its involvement with the investee; and*

(e) *whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns."*

As per paragraph B12 of application guidance of IFRS 10:

"Examples of decisions about relevant activities include but are not limited to:

(a) *establishing operating and capital decisions of the investee, including budgets; and*

(b) *appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment."*

In the instant case, certain matters cannot be decided by majority of the Board unless there is consent of all the parties. Those matters are evaluated to be relevant activities as per IFRS 10.

This constitutes "joint control" under IFRS 11, which is defined as:

"The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control."

Accordingly, A-ONE Ltd. will be consolidated as a joint venture using the equity method prescribed under IAS 28.

3. (a) In respect of the infrastructure business, ABC Limited is first required to determine its contractual performance obligations. Those obligations are:

- Construction services during Year 1 and 2
- Operation services during Years 3 to 10
- Road surfacing in Year 8

As a consideration of the aforementioned services, ABC Limited is paid a consideration of ₹ 200 crores per annum. Since this represents an unconditional contractual right to receive cash, it is a financial asset recognised and measured as per IFRS 9.

Measurement of revenue

Contract to render construction services and carry out road resurfacing are construction contracts in accordance with IAS 11. The contract to render operation services is accounted for in accordance with IAS 18.

In accordance with paragraph 12 of IAS 11 and paragraph 9 of IAS 18, revenue is measured at the fair value of consideration received or receivable.

(b) Accordingly, revenue to be recognised in respect of these performance obligations are as below:

Particulars	Year	Cost (₹ crores)	Margin	Revenue (₹ crores)
Construction services	1	500	5%	525
	2	500	5%	525
Operation services (per year)	3-10	80 (10 x 8)	20%	96 [(10x120%) x 8]
Road resurfacing	8	100	10%	110
Total		**1,180**		**1,256**

Revenue is recognised at the contract cost plus margin, with a corresponding debit to financial asset in each of the years mentioned above. The same is tabulated in column (A) below.

As the consideration for these performance obligations is received over a period of time, as tabulated in column (B) below, there is an inherent finance income element included in the consideration. In order to determine the same, the formula of IRR is applied on column (C) which represents the net cash flow i.e. creation of financial asset and its realisation.

In the present case, IRR is determined as 6.18%.

Applying the computed IRR of 6.18% on the financial asset balance as at the beginning of the year (i.e. previous year's column (E)), finance income for each of the years is determined.

The table after the next table summarises the net effect of accounting for these transactions as per IFRIC 12.

₹ *crores*

Year	Financial asset	Cash inflow	Net cash flow	Finance income @ IRR = 6.18%	Adjusted financial asset
	(A)	(B)	(C) = (A) + (B)	(D) = previous year's (E) X 6.18%	(E)= E of previous year + C+D
1	525		525	-	525.0
2	525		525	32.4	1,082.4
3	12	(200)	(188)	66.9	961.3
4	12	(200)	(188)	59.4	832.7
5	12	(200)	(188)	51.5	696.2
6	12	(200)	(188)	43.0	551.2
7	12	(200)	(188)	34.1	397.3
8	122	(200)	(78)	24.6	343.9
9	12	(200)	(188)	21.3	177.2
10	12	(200)	(188)	10.8	0
	1,256	**(1,600)**	**(344)**	**344**	

*Different is due to approximation.

Net effect of accounting under IFRIC 12:

₹ *crores*

Year	Contract cost	Revenue					Net profit
		Construction services	Operation services	Road resurfacing	Finance income	Total	
1	500	525			-	525.0	25.0
2	500	525			32.4	557.4	57.4
3	10		12		66.9	78.9	68.9
4	10		12		59.4	71.4	61.4
5	10		12		51.5	63.5	53.5
6	10		12		43.0	55.0	45.0
7	10		12		34.1	46.1	36.1
8	110		12	110	24.6	146.6	36.6
9	10		12		21.3	33.3	23.3
10	10		12		10.8	22.8	12.8
	1,180	**1,050**	**96**	**110**	**344**	**1,599.9***	**420**

* Difference is due to approximation.

(b) The extract of IFRS balance sheet of ABC Limited is as below:

Particulars	**As at 31 March 2017**	**As at 31 March 2016**	**As at 1 April 2015**
Assets			
Non-current assets			
(a) Property, plant and equipment - Power plant given on operating lease (carried at original cost less depreciation) - Spare parts for power plant with useful life of more than one year			
(b) Investment property – Land with undetermined use (carried at cost)			
(e) Investments - In equity shares of subsidiary (carried at cost as per IAS 27) - In equity shares of unrelated unlisted company (carried at fair value through other comprehensive income) - Equity contribution in respect of interest free loan to B-ONE Ltd.			
(f) Other financial assets - Interest free loan to B-ONE Ltd. (carried at amortised cost) - Loan to employees at discounted rate of interest - Consideration receivable under service concession arrangement			
Sub –total (A)			
Current assets			
(a) Investments - Investments in mutual funds carried at fair value through profit or loss			
(b) Financial assets - Consideration receivable under service concession arrangement			
Sub total (B)			
Total assets (A) + (B)			

Particulars	As at 31 March 2017	As at 31 March 2016	As at 1 April 2015
EQUITY AND LIABILITIES			
Equity			
- Class A equity shares - Equity component of Class B equity shares - Compulsorily convertible preference shares			
Total equity			
Liabilities			
Non-current liabilities			
(a) Financial liabilities			
(i) Borrowings – Loan from Yep Bank Ltd., net of processing fee of 1%			
(ii) Other financial liabilities - Liability component of Class B equity shares - Corporate guarantee contract			
(b) Provisions – Mine restoration provision			
Total			
Current liabilities			
Total			
Total liabilities			
Total equity and liabilities			

Answers to Objective Type Questions

1. Option c. The date of transition to IFRS is 1 April 2015.

2. Option d.

As at the balance sheet date, in the consolidated financial statements of ABC Limited, the assets and liabilities of financial services business undertaken by B-ONE Ltd. shall be measured as below:

- the carrying amounts of any assets and liabilities that are not within the scope of the measurement requirements of IFRS 5, shall be measured in accordance with applicable IFRSs

- the carrying amounts of any assets and liabilities that are within the scope of the measurement requirements of IFRS 5, shall be measured at lower of carrying amount and fair value less costs to sell.

The aggregate of the above shall be compared with the fair value less costs to sell of the financial services business as a whole.

3. Option d.

Class A equity share is classified as "Equity". This is because Class A equity shareholders are entitled to dividend at the discretion of the Board of Directors which implies that they are only entitled to residual interest in the net assets of ABC Limited.

4. Option d.

Class B equity shareholders are entitled to a fixed dividend of 10% subject to availability of profits in that year and distributable cash as on balance sheet date of relevant year. ***Therefore, it is a financial liability.*** (Refer paragraph 25 of IAS 32)

5. Option (a)

Class A equity shares are classified as equity instruments of ABC Limited. Accordingly, the journal entry will be as below:

Bank Dr.	₹ 400 crores	
To Class A equity shares		₹ 400 crores
(Being issuance of Class A equity shares to CeeDee)		

6. Option (c)

The fair value of liability component of financial instrument is determined as the present value of cash outflow obligations of ABC Limited. In order to determine that, the cash flows are laid out below:

												₹ in crores
	Particulars	**For the year ending 31 March**										
		2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**Total**
(a)	Opening cash and cash equivalents	100	85	16	8	2	8	26	48	74	104	
(b)	Profit / (loss) as per IGAAP financial statements	(20)	(75)	(15)	(13)	(2)	10	13	18	23	28	
(c)	Depreciation as per IGAAP	5	6	7	7	8	8	9	8	7	7	
(d)	Impact on profit / loss due to IFRS conversion	8	10	(4)	5	7	(12)	6	1	0	(2)	
(e)	Dividend @ 10%	100	100	100	100	100	100	100	100	100	100	

	Dividend (w,e,less (a), (b) or (e))	Nil	Nil	Nil	Nil	Nil	8	13	18	23	25	
	Present value @ 13% p.a.	Nil	Nil	Nil	Nil	Nil	3.8	5.5	6.8	7.7	7.4	**31.2**

As computed above, the present value of dividend obligation is ₹ 31.2 crores. Accordingly, the liability component is ₹ 31.2 crores and the equity component of Class B equity shares is determined as ₹ 568.8 crores.

7. Option (c) i.e. The PPA with GOP contains an embedded lease arrangement

As per paragraph 6 of IFRIC 4, *"Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:*

(a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and

(b) the arrangement conveys a right to use the asset."

In the present case, the PPA with GOP can be fulfilled by the use of the power plant which is a specific asset. Accordingly, condition (a) above is satisfied.

Since

- The entire output of power plant is consumed by the purchaser i.e. GOP
- The price paid by GOP includes an element of capacity charge which makes the price for the output variable.

the PPA with GOP contains an embedded lease arrangement.

8. Option (b)

Continuing the rationale to the above MCQ i.e. the PPA with GOP contains an embedded lease arrangement, next, in order to determine if the lease arrangement is an operating lease or a finance lease, one can refer to paragraph 10 of IAS 17. On assessing the situations given therein, it may be concluded that situations

(a) Not fulfilled, as the ownership is not transferred to GOP.

(b) Not fulfilled, as GOP doesn't have an option to purchase the power plant.

(c) Not fulfilled, as the PPA is for 10 years whereas the useful life of the power plant is 15 years

(d) Not fulfilled. Refer computation below.

(e) Not fulfilled, as the asset is not specialised in nature.

The computation required for the purpose of (d) above is given below:

Contract year	Capacity charges	Total capacity charges	Present value @ 12%
	₹ / kwh	₹ Crores	
1	1.10	491.4	438.8
2	1.10	491.4	391.7
3	1.10	491.4	349.8
4	1.10	491.4	312.3
5	1.10	491.4	278.8
6	0.78	348.5	176.6
7	0.78	348.5	157.6
8	0.78	348.5	140.7
9	0.78	348.5	125.7
10	0.78	348.5	112.2
			2,484.30

[Total capacity charges above have been calculated as: 85% availability **X** 600 MW **X** 1,000 kw/MW **X** 24 hours **X** 365 days/year **X** Rate in ₹ per kwh]

Hence, present value of the minimum lease payments (₹ 2,484.30 crores) amounts to only 62% of the fair value (₹ 4,000 crores) of the leased asset.

Based on the evaluation above, the answer to this question is Option b i.e. “Property, plant and equipment under an operating lease arrangement”.

9. Option (d)

ABC Limited needs to recognise a provision for site restoration in accordance with the terms of the mining license granted to it. The provision is determined based on the best estimate of outflow of economic benefits to satisfy the contractual obligation, discounted to its present value using an appropriate rate determined in accordance with IAS 37.

10. Option (a)

In accordance with paragraphs 3.2.3, 3.2.4 and 3.2.5 of IFRS 9, the financial asset is not derecognised by ABC Limited as it does not constitute a transfer.

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