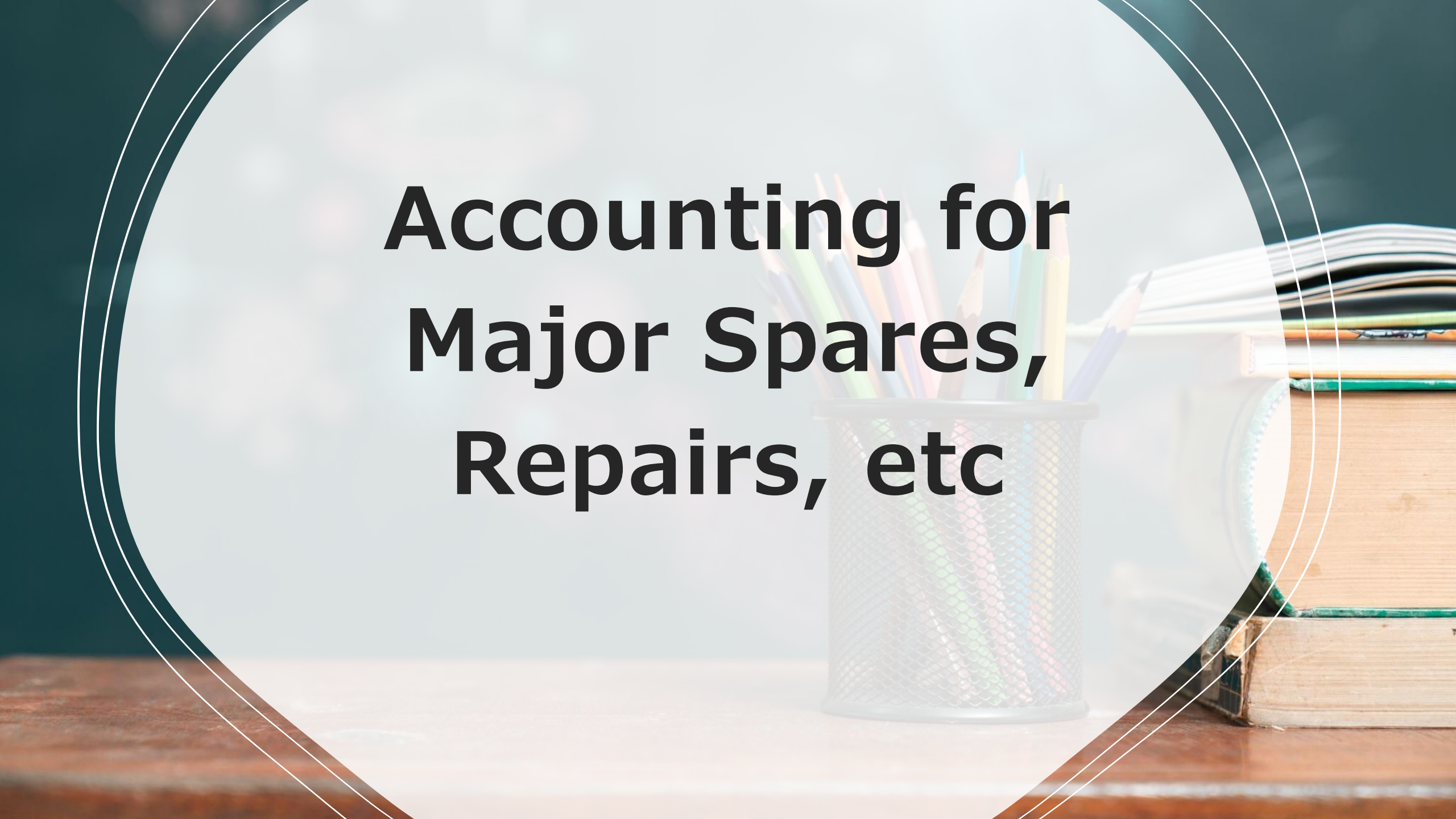


# Addressing complex Financial Reporting Issues

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# **Accounting for Major Spares, Repairs, etc**

# Ind AS 16: Major Spares

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Company has adopted the policy of capitalising the major spares under PPE on purchase and charged depreciation from the date of its use in the main machinery. It had determined the estimated useful life of major spares considering the date of issue and remaining useful life of the intended machine. Management contention -

1. Major spares are deemed to be available for use when the same are fitted in the machinery so as to be capable of operating in the manner intended by the management.
2. Installation and commissioning cost being an important part of PPE (major spares), charging depreciation on cost of spare alone on its procurement (receipt at store) pending capitalisation of commissioning/ installation cost may lead to under valuation of asset and consequential under charging of depreciation.

# Ind AS 16: Major Spares

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## Analysis:

1. The intended use of spare part is to act as a stand-by for replacement of the original part in the plant and machinery in case of its damage/non-functioning/break-down and therefore, normally it is ready for its intended use on its purchase or acquisition
2. An entity recognises in the carrying amount of an item of PPE, the cost of replacing part of such an item when that cost is incurred and the carrying amount of those parts that are replaced is derecognised

# Ind AS 16: Arbitration award

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A capex project of the Company was delayed (order placed 2008, Scheduled date of commissioning 2011, actual date 2014). In 2022, a settlement agreement was signed and amount of Rs. 283.94 crore (excluding prolongation cost) was determined as compensation for various elements (balance amount as per contract + extra price variation claim + extra civil work + additional design engineering cost). A liability for Rs. 153.71 crore was already provided for in respect of above elements in the books on capitalisation of the asset and balance amount of Rs. 130.23 crore was capitalised prospectively.

1. Whether Rs. 130.23 crore should be depreciated retrospectively, i.e., from the original date of capitalization?

# Ind AS 16: Arbitration award

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## Company's contention

1. The additional capitalisation was on account of extra price variation, extra civil work and additional design engineering which has been paid to the contractors due to arbitration award given in their favour.
2. The asset was capitalised in 2014 without considering the aforesaid claims of the contractor because the same was not contractually payable and the claim of the contractor was put to legal scrutiny through various redressal forums.
3. Since the liability arises because of arbitrator's award and not because of provision of contract, the same was capitalised prospectively in accordance with paragraph 5 (a) of the Appendix A, 'Changes in Existing Decommissioning, Restoration and Similar Liabilities' to Ind AS 16, 'Property, Plant and Equipment'.



# Ind AS 16: Arbitration award

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## Analysis

1. Assumption - that all these items of costs pertain to pre-capitalisation period of the plant/asset (i.e. prior to commissioning of the plant in 2014); In other words, these do not include any new item of cost which might have arisen after capitalisation of asset.
2. The cost of the plant includes an element of an estimate of Rs. 153.71 crore towards extra price variation claim, extra civil work, and additional design engineering cost at the time of capitalisation of the asset (Plant) in 2014, actual cost of which got crystallised in 2022 at a higher amount and therefore, the same is a change in estimate of the cost of PPE.
3. Thus, the additional amount incurred should be capitalised prospectively. Further, the depreciation should be charged prospectively.

# Ind AS 16: Restoration/ Replacement

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A company's R washery plant has completed its useful life in the FY 2001-02 and the said plant is still in the operation solely on account of regular maintenance activities. However, the capacity utilisation of said washery plant was very poor. There was also increase in breakdown hours. The Company incurred Rs. 56.19 crore for enhancement of utilisation of plant capacity. As such, according to the management, none of the items qualifies for recognition as PPE.



# Ind AS 16: Restoration/ Replacement

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## Management contention

The Company has recognised the incurred cost in the Statement of Profit and Loss considering the following aspects of the transaction:

As the replacement activities undertaken related to a particular section of an item of PPE i.e. say improvement in particular section of washing section / fine coal section, hence, the probability of future economic benefits associated with the item as whole (i.e. an asset) could not be established. Hence, the reliable estimation of the enhancement of further useful life of whole PPE could also not be technically established.

Further, the useful life of the said washery is already expired. Hence, the suitable option available with the Company is to expense the same in the Statement of Profit and Loss.

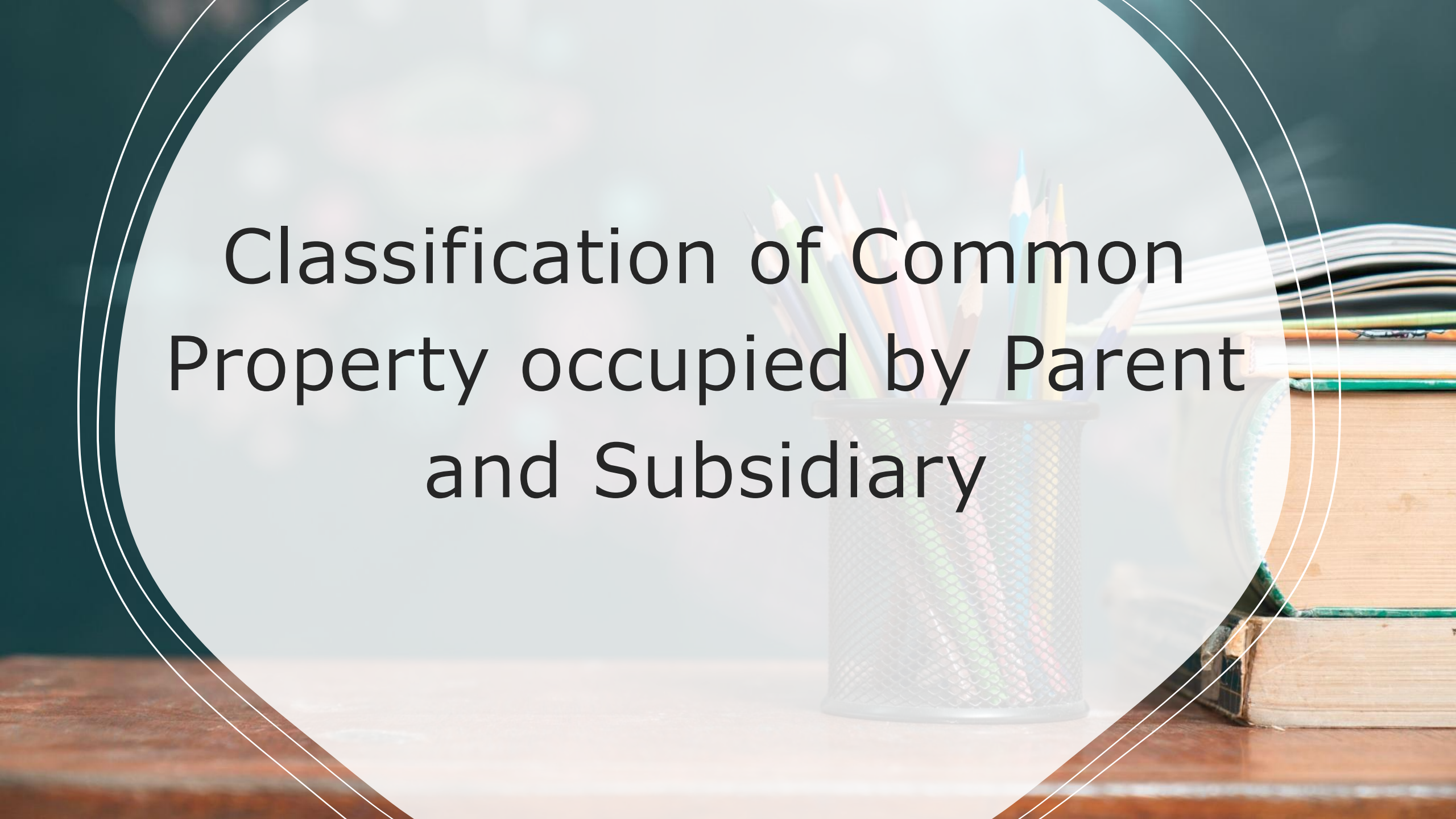
# Ind AS 16: Restoration/ Replacement

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## Analysis

The activity of repairing is undertaken basically to improve the operation of the washery and enhance its capacity. Therefore, it will lead to future economic benefits in terms of improvement in operations and capacity of the washery plant. Further, since the cost incurred can be reliably measured, the recognition criteria under paragraph 7 of Ind AS 16 are met and hence, the Company should capitalise such expenditure as cost of the washery plant.

Further, the vendor has committed to provide operation and maintenance for 4 years under defect liability period, which indicates that the improved asset will atleast be operational for 4 years after the expenses incurred on enhancement/improvement.

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# Classification of Common Property occupied by Parent and Subsidiary

# Ind AS 40: Investment property

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Child Ltd. and Parent Ltd. acquired adjacent pieces of land from State Development Authority (SDA) on perpetual lease, accounted for as ROU asset. On the land, a multistorey office complex was constructed on the amalgamated plots comprising two towers (Tower B - Child Ltd. and Tower A - Parent Ltd.) of 5 floors each with common basements and ground floor. Accordingly, the ownership of the building is shared by Child Ltd. and Parent Ltd.

Out of the five floors in Tower B pertaining to Child Ltd., two floors were being occupied by Parent Ltd. for its official use since first occupation and remaining three floors were used by Child Ltd. for its official use. The said property had been classified under the head PPE.

Whether Child Ltd. was required to classify the said two floors as investment property in its financial statements?

# Ind AS 40: Investment property

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## Management contention

1. Two floors out of five floors of the Company's office building at Tower B, intended for the Company's administrative use, were presently being used by the Parent Ltd. for its official use for which consideration was being charged from the parent company. The arrangement of charging consideration was incidental and ancillary to beneficial use of the said portion by Parent Ltd. and was done to ensure that the transaction, being a related party transaction, was at arm's length terms.
2. The said property has been classified under the head PPE as the intention of the Company in respect of this property was not to earn rentals or holding for capital appreciation.
3. The primary criterion as per the provisions of Ind AS 40 is the purpose or intention with which the owner is holding the property. Capital appreciation may occur even in the case of owner-occupied property forming part of PPE.

# Ind AS 40: Investment property

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## Analysis

Classification of a property depends on the purpose or intent of the entity for which the property is held; for example, to earn rentals or capital appreciation or both or for use in production or supply of goods or services or for administrative purpose; or for sale in the ordinary course of business, etc.

Since the Company in the extant case was claiming that its intention to hold the said portion of the building was not to earn rentals or for capital appreciation and had not classified the same as investment property, it is indicative that the Company after exercising its judgment based on the criteria used by it to classify the investment property had assessed that the said portion is not an 'investment property'.

Even if it is considered that the building of Tower B pertaining to Child B is being held for dual use (assuming that each of these floors cannot be sold separately or separately leased out under a finance lease), since the three floors out of five floors are being used by the Company for its own use, which cannot be considered as insignificant, the building or the property cannot be classified as investment property.





**Other areas**



# Cost incurred during force majeure period

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A company was jointly operating an overseas under-development oil & gas project. In April 2021, **force majeure** (FM) was declared by the Operator in the Project due to security situations in the vicinity of project site. As a result, the in-situ development activities in the Project remained suspended during the FY 2021-22.

Moreover, due to such FM situation, the following incremental expenditures were incurred in respect of the Project:

- **Stoppage costs** (such as demobilisation, termination or cancellation fees and one-off settlement) and
- **Standby and support costs** (such as storage and asset preservation)

Whether these costs are 'exceptional items'?

# Cost incurred during force majeure period

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## Management contention

In the present case, the Company has contended that FM is a common phenomenon for businesses. It is more so in case of the Company engaged in oil and gas industry with global presence, which is more vulnerable to geopolitical and operations risks and security concerns. In case of the Company, there has been a history of occurrences of force majeure situations in several projects. Presently also, another major project of the Company is under force majeure situation.

Hence, it is not an exceptional item

# Cost incurred during force majeure period

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## Analysis

Exceptional items are only those items which meet the twin tests of 'materiality' and 'incidence'.

Although in general, FM conditions are not frequent and therefore, the consequent costs arising due to such conditions may meet the test of 'frequency or incidence' for presentation as 'exceptional items'; however, considering the specific facts and circumstances of the Company, having global presence in oil and gas sector and its past experience, the test of 'frequency or incidence' does not appear to be met. Hence, it is not an exceptional item.

However, since these are 'material', the Company should disclose their nature and amount separately, as per paragraph 97 of Ind AS 1 and may also present these items by disaggregating, headings and subtotals under their respective heads in the Statement of Profit and Loss.

# Channel Financing Arrangement

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The Company sells its products to Dealers and Distributors (D&Ds) with an average credit period of 30 days. It has been evaluated and concluded that the sales meet the criteria for revenue recognition prescribed in Indian Accounting Standard (Ind AS) 115, 'Revenue from Contracts with Customers'. No interest is charged by the Company for the credit period of 30 days.

If the D&D makes payment to the Company within 1-3 days from the date of sale, the concerned D&D is eligible for cash discount of 2%.

In many cases, the D&Ds lack availability of working capital / banking limits available with them and, therefore, are not able to make upfront payment to the Company. To bridge this gap and get upfront cash against its sales, the Company has entered into a channel financing arrangement with Banks which shall provide working capital limits to D&Ds [Channel Partners] ensuring upfront payment to the Company.

# Channel Financing Arrangement

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- This arrangement for sanction of working capital limits is entered into between the Bank and the D&D.
- The limits sanctioned have the following hypothecations/ security from D&D:
  - Primary: Against all stocks, receivables and current assets of the D&D
  - Collateral: first loss default guarantee (FLDG) by the Company
  - Guarantee: of D&D
- Interest on the credit facility is computed on daily balances duly compounded and is payable on monthly basis by D&D to Bank.
- The Company receives full payment, net of cash discount of 2%. There are no discounting charges when Bank makes the payment to the Company on behalf of D&Ds.

# Channel Financing Arrangement

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## Analysis

The FLDG arrangement means that the Company has retained all significant risks and rewards of receivables from D&D. Hence, it cannot derecognise the receivables. Rather, it needs to recognise the amount received under the arrangement as an obligation in the balance sheet.

Should it be presented as borrowings or other financial liabilities?

# Channel Financing Arrangement

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## Analysis

The primary liability to pay the amount received from the bank by the Company against trade receivables/invoices is that of D&D and the Company has no obligation to make payment to Bank until there is a default by the D&D. Further, although the Company is giving FLDG and its recommendation to the bank but the credit arrangement is entered into between the Bank and the D&D wherein the amount of loan, rate of interest and other terms and conditions have been agreed upon considering the credit worthiness, asset hypothecation, etc. of the D&D only. The Company's drawing powers/ borrowing limits are also not impacted due to outstanding channel finance balances. Thus, the amount received by the Bank is not in the nature of borrowings. Hence, it should be presented as 'Other Financial Liabilities'.



# Accounting for reversal of provision for doubtful debts

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- A company recovered certain trade receivables which were earlier provided for in the financial statements
- Such provision for doubtful debts made previously was reversed and recognised as 'Other operating revenues'
- Auditor felt that the reversal should be recognised under 'Other income'

# Accounting for reversal of provision for doubtful debts

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## Analysis

The reversal should be presented under the line item 'Impairment Loss' since:

- The nomenclature 'Provision for doubtful debts', is not relevant under Ind AS, as it is now termed as impairment loss on trade receivables. Similarly, provision written back is termed as reversal of impairment loss.
- Impairment loss including reversals of impairment losses or gains should be presented separately on the face of the Statement of Profit or Loss (as per Part II of Division II of Schedule III to the 2013 Act and the Guidance Note on Division II - Ind AS Schedule III to the 2013 Act)

**Thank You**

