ASB Workshop on Accounting Standards

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Implementation Issues	
AS 6	Depreciation Accounting
AS 10	Accounting for Fixed Assets
AS 16	Borrowing Costs
AS 19	Leases
AS 26	Intangible Assets
AS 28	Impairment of Assets

Accounting Standard – 10

ACCOUNTING FOR FIXED ASSETS

During Construction Period is a Company required to prepare Statement of Profit and Loss ?

YES AS ALL EXPENSES CANNOT BE CAPITALIZED

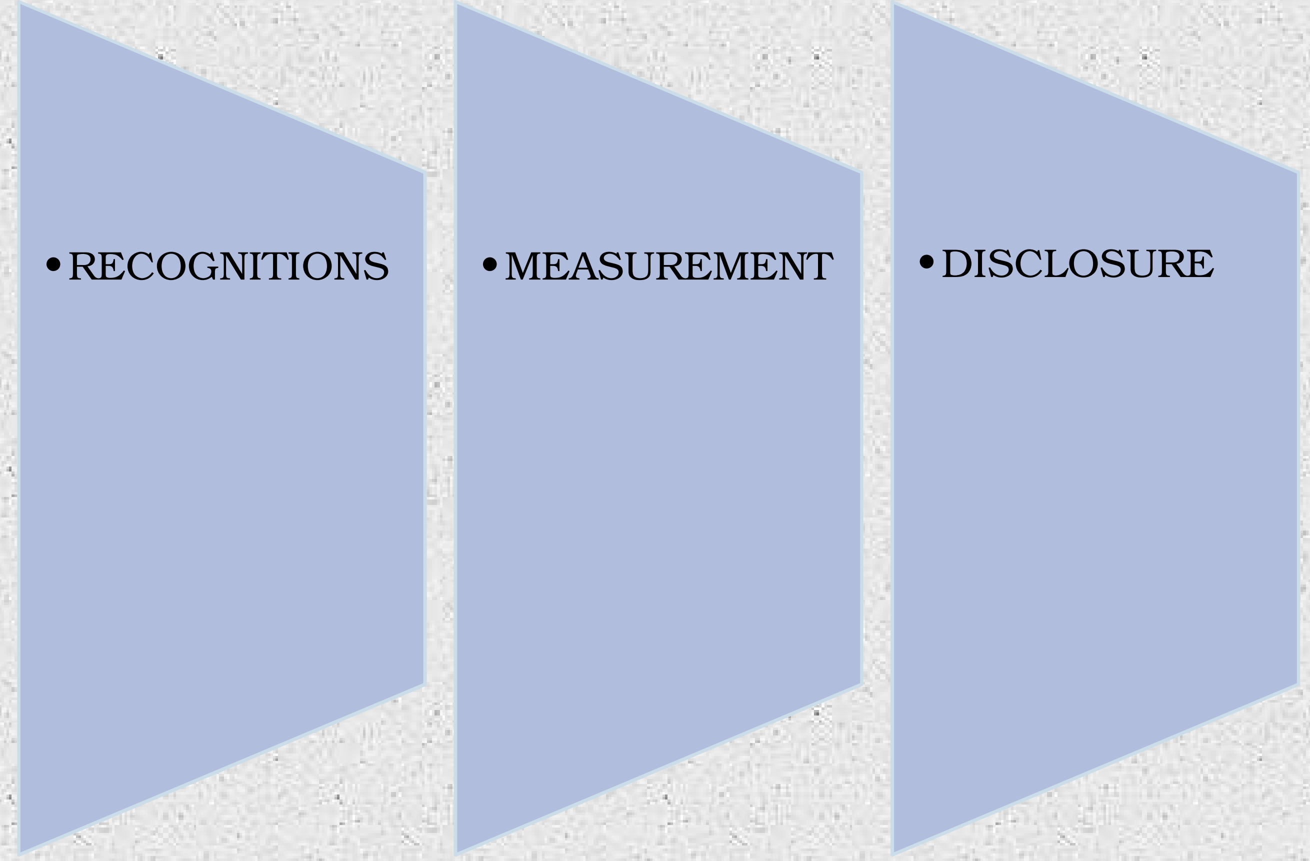
AS 10 Para 9.3

Administration and other general overhead expenses are usually excluded from the cost of the fixed assets because they do not relate to a specific fixed asset.

AS 26 Para 8

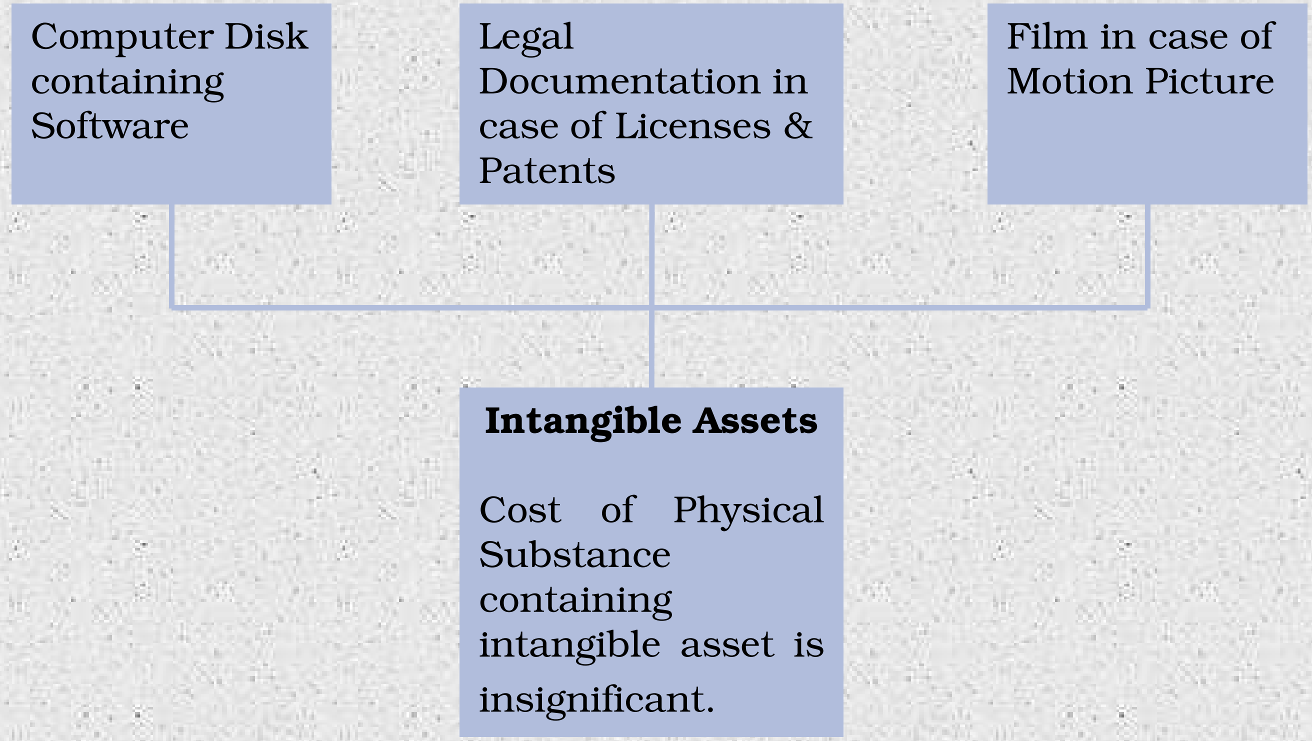
Not all the intangible items will meet the definition of an intangible asset, i.e. , identifiability, control over a resource and expectation of a future economic benefit flowing to the enterprise. If an item covered by this statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

Major Components of Accounting Standard



- RECOGNITIONS
- MEASUREMENT
- DISCLOSURE

Tangible or Intangible Assets



Computer Disk containing Software

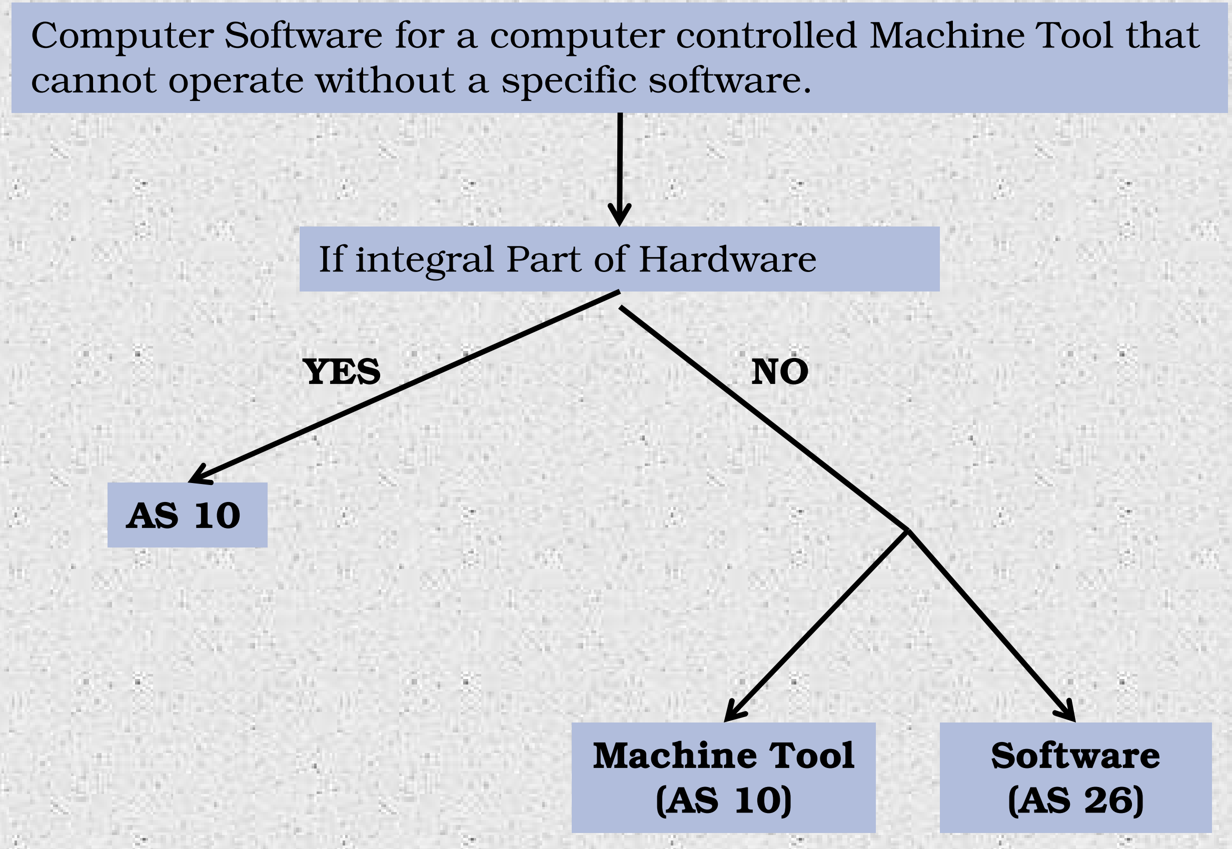
Legal Documentation in case of Licenses & Patents

Film in case of Motion Picture

Intangible Assets

Cost of Physical Substance containing intangible asset is insignificant.

Tangible or Intangible Assets



Computer Software for a computer controlled Machine Tool that cannot operate without a specific software.

If integral Part of Hardware

YES

AS 10

NO

Machine Tool (AS 10)

Software (AS 26)

Component Accounting

Accounting may be improved if total cost on fixed assets is allocated to its component parts provided:

- They are in practice separable;
- Estimates are made of the useful lives of the components.

Companies Act, 2013

Schedule II Part C

Notes

4. Useful life specified is for whole of the asset. Where cost of a part of asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.

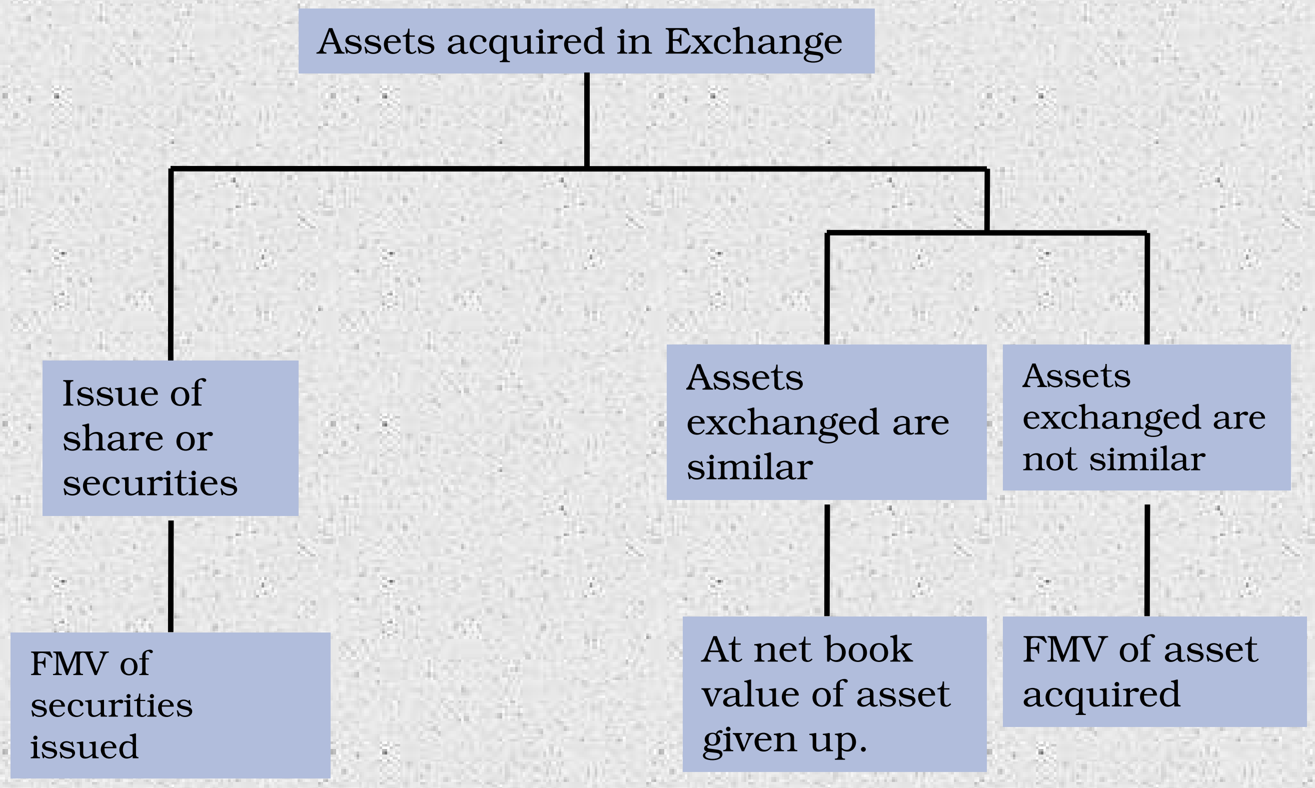
Component of Cost

Cost of an item = Purchase Price + Import duties of Fixed Asset +
Non refundable duties and directly attributable costs.

Cost that are directly attributable	Cost that are not directly attributable
Cost of employee benefits arising directly from construction or acquisition of property and plant	Cost of opening a new facility
Cost of site preparation	Cost of introducing a new product or service
Initial delivery and handling costs	Cost of conducting business in new location
Installation and assembly cost	Administrative and other general overhead costs
Cost of testing the fixed asset	
Professional fees	

Same Principles in case of Self Constructed Asset.

Non Monetary Consideration



Assets acquired in Exchange

Issue of share or securities

FMV of securities issued

Assets exchanged are similar

At net book value of asset given up.

Assets exchanged are not similar

FMV of asset acquired

Improvement

- Expenditure that increases future benefits beyond its previously assessed standards is added in gross block e.g. increase in capacity.

- Addition which is integral part of existing asset to be added to gross block.

- Addition to be separately accounted if:
  - Separate Identity
  - Capable of being used after disposal of existing asset.

- Under AS -16 subsequent cost is PPE if recognition criterion is met and carrying cost of part replaced is de-recognised.

Revaluation

- AS 10 permits revaluation, but does not lay down the frequency.
- Increase in net book value on revaluation → Credit to revaluation reserve
- If such increase is reversal of already recognised decrease → credit to P&L A/c
- Decrease in net book value on revaluation → Debit to P&L A/c
- If such decrease is reversal of already recognised increase → Debit to Revaluation Reserve a/c (provided it has not been utilised)
- An entire class of assets should be revalued or th selection of assets for revaluation should be on systematic basis.
- On disposal of a previously revalued asset, balance in revaluation reserve to be transferred to General Reserve.

Other Main Principles

- Assets retired from active use to be
  - Shown separately
  - Valued at net book value or net realisable value whichever is lower

- Goodwill to be accounted for when paid, amortization not necessary.

Case Study 1

Whether amount payable by the company on account of liquidated damages due to delay in commencement of supply of gases to customers consequent upon delay in bringing the plant to its working condition on the appointed target date can be capitalised in its books of account as additional cost attributable to the project in accordance with the provisions of AS-10?

Solution to Case Study 1

As per Expert Advisory Committee Opinion dated March 18, 2010:

The amount payable by the company cannot be capitalised as additional cost attributable to the project.It cannot be treated as deferred revenue expenditure to be amortised over a period of 3 to 5 years after commencement of commercial production.

The company should charge off the amount as an expense in the profit and loss account.

Case Study 2

A bank owns more than 200 properties purchased in different years and all the properties have been revalued in the year 2008. Whether different rates of depreciation will be applicable on the 200 properties purchased in different years and revalued in the year 2008?

Solution to Case Study 2

As per Expert Advisory Committee Opinion dated December 15, 2009

The rate of depreciation of a building depends on the depreciable amount of the building and its expected useful life. The useful life may vary in case of each building. The depreciable amount may also vary depending on its cost of purchase/construction or its revalued amount, as the case may be, and its estimated residual value. Accordingly, the rate of depreciation may vary for each of the buildings and, therefore, should be determined individually for each property.

Accounting Standard - 6

DEPRECIATION ACCOUNTING

Basic Principles

- Allocation of Depreciable amount on systematic basis over useful life of asset;
- Periodical review of useful life;
- Consistency in following basis for providing depreciation.

Change in Method of Depreciation

Change in depreciation method is done in the following cases:

- For compliance of statute;
- For compliance of accounting standard
- For more appropriate presentation in financial statement.

Change in Method of Depreciation

- Change in method to be made effective from date of use i.e. Retrospectively.
- Such resultant surplus/ deficiency is treated through P&L A/c.
- Such change in method is treated as a change in accounting policy and should be quantified & disclosed
- Under Ind AS 16, change in method is a change in estimate and to be applied prospectively

Change in Rate of Depreciation

- Change in rate is a change in accounting estimates. It is effected prospectively.

Addition to Fixed Assets

If such addition is an integral part of existing asset or changes in cost due to price adjustments, etc:

- Depreciation to be provided prospectively – however, over the residual useful life of main asset.

Addition to Fixed Assets

If Addition to or extension of an asset is capable of being used after discarding the existing asset:

Depreciation to be provided independently on the basis of its own useful life

Change in Historical Cost due to Revaluation

- Depreciation should be charged on revalued amount and on estimate of remaining useful life of such asset.
- Transfer amount equivalent to accumulated additional depreciation from Revaluation Reserve to Profit and Loss A/c or General Reserve

(GN on Treatment of Reserve Created on Revaluation of Fixed Assets)

General non-compliances

Schedule XIV to the Companies Act, 1956 and AS-6 require to disclose the depreciation rates, if they are different from the specified principal rates.

Simply disclosing the fact that rates applied are higher than “Schedule XIV rates” is not correct treatment

General non-compliances

An entity was providing depreciation at “Schedule XIV rates”. On revaluation, depreciation on revalued amount was provided over residual useful life.

It was observed that this is not correct treatment as depreciation on total revalued amount is required to be provided on one single basis.

General non-compliances

- Withdrawal of amount from General Reserve and crediting it to P&L A/c to off set extra charge to P&L A/c on account of retrospective re-computation of depreciation charge is not correct accounting treatment .

- No provision of depreciation for the shut down period is also non compliance of AS-6

Example of Accounting policy

Depreciation on fixed assets is provided on the straight line method based on useful lives of respective assets as estimated by the management or at the rates prescribed under Schedule XIV of the Companies Act, 1956, whichever is higher. Leasehold land is amortised over the period of lease. Depreciation rates adopted by the Company are as follows:

Asset	**Useful lives**
Leasehold Land	Period of lease
Building	20 years
Leasehold Improvements	Period of lease or 10 years whichever is less
Plant & Machinery	3 years to 20 years

Fixed assets costing not more than Rs. 5,000 each are depreciated @ 100 percent in the year of capitalisation. Depreciation is charged on addition/deletion on pro-rata basis including the month of addition/deletion

Case Study 1

During the year 2009-10, ABC Ltd. purchased certain machinery spares for its Processing Plant. In addition, the Company had in its inventory certain machinery spares for its Effluent Treatment Plant. These machinery spares can be used only in connection with a particular item of machinery and are of irregular use. Both these plants have been fully depreciated in the books of account of ABC Ltd. What should be the correct accounting treatment of such spares purchased during the year as well as held as inventory?

Solution to Case Study 1

As per Expert Advisory Committee Opinion : Volume 23

The cost of machinery spares should be charged to the statement of profit and loss in the year of purchase itself in case the principal item of fixed asset has been fully depreciated in the books of account. The cost of such machinery spares lying in inventory should also be charged to the statement of profit and loss and a disclosure in the notes to accounts should be made in this regard.

Case Study 2

BBC Ltd. was constructing an assembling unit as part of its factory which was also under construction. Due to recession, BBC Ltd. decided to abandon its project. However, since its assembling unit was at the advance stage of completion, BBC Ltd. decided to convert the same in to a warehouse and gave on long term lease to ABC Ltd. The auditor advised them to classify as “Investment Property”. However, the auditor is not able to decide whether the same should be depreciated or not? Please advise.

Solution to Case Study 2

Under section 205 and 350 read with Schedule XIV to the Companies Act, 1956, no distinction is made between Fixed Assets and Investment Properties and hence depreciation would be required on all assets owned by the Company.

As per Circular No. (10)-CL-VI/61 dated 27-9-1961, the Department of Companies Affairs has opined that Immovable properties unless acquired for resale represent Fixed Assets - it would be obligatory to provide depreciation thereon.

Case Study 3

CBC Ltd. acquired a division of a company on going concern basis. The lump-sum consideration paid was allocated on fair value basis over the various fixed assets, current assets and current liabilities acquired and balance was classified as goodwill. Fixed assets inter-alia include a 20 years old building. The seller company had estimated its total useful life as 60 years and accordingly, 1/3rd of the cost was already depreciated under SLM method. The valuer of CBC Ltd. has estimated its balance useful life as 60 years. Now there is a dispute among two fresh CAs employed by the auditor firm. One of the CAs is of the view that the building should be depreciated over balance useful life as originally estimated and also considering depreciation already provided i.e. should be depreciated over 40 years. The other CA is of the view that it should be depreciated over balance useful life as estimated by the valuer i.e. 60 years. Please advise.

Solution to Case Study 3

In respect of second hand assets, no specific depreciation rates are prescribed in Schedule XIV to the Companies Act, 1956. Also AS-6 does not give any specific guidance on the subject. The preferred treatment should be to depreciate the fixed asset over the lower of management determined remaining useful life and Schedule XIV useful life (without considering past usage). Support may be derived from Para 23 of AS-6

Case Study 4

YY Ltd. wants to apply unit of production method to depreciate certain assets. As an auditor, do you have any objection?

Solution to Case Study 4

As per para 3 of AS-6, Definition:

Depreciation

……. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset.

Useful life

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

However, the depreciation charged should not be less than the rates specified under Schedule XIV to the Companies Act, 1956

Case Study 5

YNOT Ltd. has not applied rates prescribed under Sch XIV and has provided depreciation based on its estimate of useful lives. In case of certain assets, the rate is lower than Sch XIV's rates while in majority of cases, it is more. So overall depreciation for the year is more than depreciation what would have been provided under Sch. XIV. As an auditor, do you have any objection?

Solution to Case Study 5

The company has not complied with Schedule XIV to the Companies Act, since compliance should be determined with respect to each class of assets and not the entire fixed assets of the company

Accounting Standard – 16

BORROWING COSTS

Main Principles

Borrowing costs may include:

- Interest / commitment charges on all borrowings; amortisation of ancillary costs (including discounts or premium) incurred in connection with the arrangement of borrowings;
- finance charges in respect of assets acquired under finance leases;
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Main Principles

- AS-16 does not deal with actual / imputed cost of equity / preference capital
- Borrowing costs that are directly attributable to the acquisition, construction or production of any "qualifying asset" should be capitalised.
- Other borrowing costs should be recognized as an expense as and when incurred

Main Principles

- Qualifying assets - assets that takes a “substantial period” of time to get ready for its intended use or for sale

- Inventories that are routinely manufactured / produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets

- Generally, a period of 12 months is considered as a substantial period of time

Main Principles

- Period for capitalization

  - ✓ Commence when expenditure for acquisition, construction or production is being incurred / activities necessary to prepare the asset for its intended use or sale are in progress (provided borrowing costs is incurred); and
  - ✓ Cease when all the activities for its intended use or sale are complete

- Capitalization should be suspended during extended periods in which development is interrupted

Main Principles

- Income on the temporary investment of the borrowed funds be deducted from borrowing costs
- Weighted average cost should be applied in case general borrowing
- Exchange difference on foreign currency borrowings represent saving in interest, compared to interest rate for the local currency borrowings, it should be treated as part of interest cost. *(Para 4e of AS-16)*
- _Benefit of para 46A of AS 11 extended to exchange differences in para 4(e) vide MCA Circular.

Disclosures

- Accounting policy adopted for borrowing cost;
- Amount of borrowing costs capitalized during the period.

General non compliances

- Capitalisation of borrowing costs (incurred on specific borrowing as well as general borrowings) is not optional – it should be capitalised if the conditions stated are fulfilled.

- Financial statements should disclose accounting policy adopted for borrowing costs and the amount of borrowing costs capitalized during the period

Example of Accounting Policy

Borrowing costs that are attributable to the acquisition and/or construction of qualifying assets are capitalised as part of the cost of such assets, in accordance with notified Accounting Standard 16 “Borrowing Costs”. A qualifying asset is one that necessarily takes a substantial period of time to get ready for its intended use. Capitalisation of borrowing costs is suspended in the period during which the active development is delayed due to, other than temporary interruption. All other borrowing costs are charged to the profit & loss account as incurred.

Case Study 1

CNN Ltd. had borrowed from a financial institution for setting up a factory – a qualifying asset. Now CNN Ltd is able to borrow a fresh loan from a bank at much lower rate of interest. However, CNN Ltd. will have to pay “prepayment charges” to the financial statement. Can CNN Ltd. capitalise “prepayment charges” as part of borrowing cost?

Solution to Case Study 1

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

The prepayment fee is incurred by the company for extinguishment or liquidation of borrowings rather than for arrangement of borrowings.

Further, there is no nexus between the borrowings from the earlier lending bank and the new lending bank. Therefore, it cannot be also said that these costs are incurred for the arrangement of borrowings from the new lending bank.

Cont…

Solution to Case Study 1

Therefore, can it be regarded as borrowing cost?

However, one must consider substance over form.

AS 1 – Para 17: The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form

Case Study 2

LMB Ltd. had capitalised borrowing costs. Subsequently, the banker waived partial interest. What should be the treatment of such waiver of interest in the books of LMB Ltd.?

Solution to Case Study 2

As per Expert Advisory Committee Opinion – Volume XVIII – 09

Waiver of interest should not be deducted from cost of the asset but should be recognised as income in the profit and loss account.

As per Expert Advisory Committee Opinion and Volume XXIII – 23,

Cost of an asset should represent the expenditure which is actually incurred and if it is determined that an item of cost which was capitalised correctly but subsequently is not to be paid, then the same should be reduced from the cost of the asset.

Case Study 3

What would be the accounting treatment in case of borrowing in foreign exchange where there is gain on exchange difference but loss on interest?

Solution to Case Study 3

As per para 4 (e) of AS 16, “Borrowing cost may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.”

Case Study 4

BMW Ltd. has borrowed USD 70,000 @ 3% p.a. for its qualifying assets on 1st day of the FY. (Rs. 45 per USD). On that day, BMW Ltd.'s banker would have extended loan in INR @ 9% p.a. On last day of the FY, exchange rate was Rs. 48 per USD. What would be the amount that BMW Ltd would be able to capitalise in view of paragraph 4(e) of AS-16 / ASI 10?

Solution to Case Study 4

The following computation would be made to determine the amount of borrowing costs for the purpose of para mentioned above.

i. Interest for the period = USD 70,000 x 3% x Rs. 48/USD = Rs. 100,800

ii. Increase in the liability towards the principal amount = USD 70,000 x (48-45) = Rs. 210,000

iii. Interest that would have resulted if the loan was taken in Indian currency = USD 70,000 x 45 x 9% = Rs. 283,500

iv. Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 283,500 – Rs. 100,800 = Rs. 182,700

Cont.....

Solution to Case Study 4

Therefore out Rs. 210,000 increase in liability towards principal amount only Rs. 182,700 to be considered as borrowing cost for capitalisation purpose and the remaining Rs. 27,300 to be considered as exchange difference as per AS 11. In addition Rs. 100,800 interest cost would also be eligible for capitalisation purpose

AS – 19 Leases

Scope

The Standard applies for all leases other than :

- lease agreements to explore for or use natural resources (oil, gas, timber, metals & other mineral rights);
- licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents & copyrights;
- lease agreements to use lands.

Objective

To prescribe appropriate accounting policies & disclosures for lessee & lessor in relation to finance Leases and operating Leases.

Lease

A **lease** is an agreement whereby the lessor conveys to the lessee in return for payment or series of payments the right to use an asset for an agreed period of time.

Criteria for classification of lease

- Classification depends on **substance** of the transaction rather than the **form.**

- The classification of lease depends on the extent to which risks and rewards incident to ownership lie with the lessor and the lessee.

Types Of Lease

Finance Lease:

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually transfer.

Operating Lease:

An operating lease is a lease other than a finance lease.

Indicators for finance lease

- If the lessee can cancel the lease, the lessor's losses associated with cancellation are borne by lessee.

- Gains or losses from fluctuation in fair value of residual fall to lessee.

- Lessee can continue lease for a secondary period at a rent substantially lower than market rent.

Examples when lease shall be classified as finance lease

- Ownership transferred by the end of lease term;
- Lease contains bargain purchase option;
- Lease term covers major part of asset's economic life of the asset;
- Present value of minimum lease payments amounts to at least substantially all of fair value of leased asset;
- Leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Accounting for finance lease: In the books of lessee

Leased asset as well as liability for lease should be recognized at the lower of-

- fair value of the leased asset at the inception; or
- present value of minimum lease payment from the lessee point of view

whichever is lower.

Accounting for finance lease: In the books of lessor

The substance of finance lease is that that the sells the leased assets to the lessee:

Therefore the lessor should recognize asset given under finance lease as receivable at an amount equal to net investment in the lease and corresponding credit to sale of asset.

Net Investment = Gross investment – unearned finance income

Gross Investment = (Minimum lease payment from lessor point of view + Unguaranteed residual value)

Unearned Finance Income = (Gross investment - Present Value of Gross Investment)

Recognition of Finance Income

Interest and finance income should be recognized in proportion to outstanding balance receivable from lease over lease period.

Disclosures for Finance Lease: By Lessor

- General description of significant leasing arrangements;
- Accounting policy adopted in respect of initial direct cost;
- Reconciliation of total gross investment in lease and present value of MLP receivable at balance sheet date
- Minimum Lease Payment receivable in following categories:
  - Not later than 1 year;
  - Later than 1 year and not later than 5 years;
  - Later than 5 years

Disclosures for Finance Lease: By Lessor

- Unearned finance income;
- The unguaranteed residual values accruing to the benefit of the lessor;
- The accumulated provision for uncollectible minimum lease payments receivable;
- Contingent rents recognised in the statements of profit and loss.

Accounting for operating lease: In the books of lessor

- Record leased out asset as the fixed asset in the balance sheet ;
- Charge Depreciation as per AS-6
- Calculate lease income in profit & loss account using straight-line method.
- If any other method reflects more systematic allocation of earning derived, that approach can be adopted.

Accounting for operating lease: In the books of lessor

- Other costs should be recognized as expenses in the year in which they are incurred.

- Initial direct cost of the lease may be expensed immediately or deferred.

Accounting for operating lease: In the books of lessee

- Lease payments should be recognized as expense in the profit and loss account on the straight-line basis over the lease term.

- Any other method can be used if it is more representative.

Sale and lease back

A sale and lease back transaction involves the sale of an asset by vendor and leasing of the same asset back to the vendor.

Accounting treatment of sale and lease back

If lease is finance lease:

- Any profit or loss of sale proceeds over the carrying amount should not be immediately recognised as profit or loss in the financial statements of a seller lessee.

- It should be deferred and amortized over lease term in proportion to the depreciation of leased asset.

Accounting treatment of sale and lease back

If lease back is operating lease:

- Any profit or loss arising out of sale transaction is recognised immediately when sale price is equal to fair value.

When lease back is operating lease

If sale price is below fair value:

- Profit- i.e. carrying amount is less than sale value, recognise profit immediately
- Loss- i.e. carrying amount is more than the sale value, recognise loss immediately, provided loss is not compensated by future lease payments .
- Loss- i.e. carrying amount is more than sale price, defer and amortize loss if loss is compensated by future lease payment.

When lease back is operating lease

If sale price is above fair value:

- If carrying amount is equal to fair value which will result in profit, amortize the profit over lease period.
- If carrying amount less than fair value will result in profit, amortize and defer the profit equal to to sale price less fair value and recognise balance immediately.

When lease back is operating lease:

If sale price is above fair value:

- Carrying amount is more than the fair value which will result in loss, should be recognised immediately. Profit equal to- selling price less fair value- should be amortized.

Case Study 1

ABC Limited has taken the assets in lease from ACX Limited. The following information is given below:

- Lease term: 4 years
- Fair value at inception of lease: Rs 16,00,000
- Lease Rent: Rs. 5,00,000 p.a. at the end of year
- Guaranteed Residual Value : Rs1,00,000
- Expected Residual Value : Rs. 3,00,000
- Implicit Interest Rate : 1497%

Solution to Case Study 1

Present value of minimum lease payment

Year	MLP	PVF at 14.97%	PV
1	5,00,000	.8698	4,34,900
2	5,00,000	.7565	3,78,250
3	5,00,000	.6580	3,29,000
4	6,00,000 (including Rs. 1,00,000)	.5724	3,43,440
	21,00,000		14,85,590

Solution to Case Study 1

- Present value of minimum lease payment (Rs. 14,85,590) is less than Fair Value at the inception of lease (Rs. 16,00,000) so the leased asset and liability should be recognized at Rs.14,85,590.
- Apportionment of Finance Lease:

Year	Liability	MLP	Finance Charge	Principal Amt. of Reduction
0	14,85,590	-	-	-
1	12,07,983	5,00,000	2,22,393	2,77,607
2	8,88,818	5,00,000	1,80,835	3,19,165
3	5,21,874	5,00,000	1,33,056	3,66,944
4	-	6,00,000	78,125	5,21,875

Non-compliances observed on AS 19

Case 1:

- From one of the notes to accounts, it has been noted that “Office Premises includes building taken on lease from Industrial Development Corporation for a period of 95 years”.

Observations:

- Considering the period of lease, it was felt that these assets has been taken on finance lease; however, the following disclosures as required under paragraph 22 of AS 19 were not found in the Notes to the Accounts.

Non-compliances observed on AS 19

Case 2:

- In the Schedule of Fixed Assets, there has been a footnote stating that ’Plant and Machinery’ worth Rs. X are assets given on operating lease.

Observations:

- It was observed that it is not ascertainable from the available information as to whether the given value represents the gross value or the written down value of the plant & machinery given on lease. Further, the accumulated depreciation on the same was also not separately disclosed.
- Accordingly, it was viewed that the disclosures requirements of paragraph 46 of AS 19 has not been complied with in context of assets given on operating lease.

Non-compliances observed on AS 19

Case 3:

- From the Schedule of Other Income as well as Schedule of Administration and Other Expenses, it has been noted that there is an income by way of lease rent as well as expenses in the nature of lease rentals.

Observation:

- It was viewed that the lease rental income as well as lease rental expenses indicates that the company had given as well as taken certain assets on lease. It was felt that it was not clear as to whether such leases were finance leases or operating leases. Further, the relevant disclosures had also not been made as required by AS 19 in this regard. It was felt that the company had not followed AS 19 for accounting for such assets.
- Further, it was observed that the accounting policy as adopted for recognition of the revenue received as Lease rent had not been disclosed. It was viewed that it was not in line with Paragraph 24 of AS 1, which requires disclosure of all significant accounting policies. Hence, there is a non-Compliance of AS 1 as well as AS 19.

Accounting Standard – 26

INTANGIBLE ASSETS

Intangible Asset

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

An asset is a resource:

- controlled by an enterprise as a result of past events; and
- from which future economic benefits are expected to flow to the enterprise

Main Principles

- Recognition Condition → future economic benefits should flow to the entity and the cost of the asset can be measured reliably
- Initial measurement at cost
- Internally generated goodwill, brands, mastheads, publishing titles etc. should not be recognised as an asset
- No intangible asset arises from research work

Intangible asset arising from development

Recognition conditions:

- enterprise can demonstrate its feasibility to complete,
- intention and ability to use or sell,
- generation of future economic benefits,
- availability of resources for completion and
- ability to measure the expenditure

Main Principles

- Expenditure on an intangible item that cannot be treated as an asset, should be recognised as an expense and treated as goodwill (capital reserve), in case of an amalgamation (AS 14)

- Treatment of expenditure (other than expenditure on VRS) incurred on intangible items, which do not meet the criteria of an 'intangible asset‘ to be expensed out when incurred

Main Principles

- Expenditure, on an intangible item recognised as an expense should not form part of cost of an intangible asset at a later date

- Subsequent expenditure to be added to cost only if it is probable that the expenditure will generate future benefits in excess of the original estimates

- Impairment loss → carrying amount - recoverable amount

Main Principles

- An intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses

- An intangible asset should be amortised over its useful life on a systematic basis, to reflect the pattern in which the economic benefits are consumed or if the pattern cannot be determined reliably, on the straight-line method

Main Principles

- Rebuttable presumption for useful life of an intangible asset – not exceeding ten years intangible assets in form of legal rights, the useful life is not to exceed the period of the legal rights, unless renewable, which is virtually certain

- An intangible asset to be derecognised on disposal or when no future economic benefits are expected from its use and gain or loss recognised

Disclosures

- Disclosure for each class of intangibles, their useful lives, amortisation, amount and method, carrying amount (gross and net), accumulated amortisation, any additions, retirements, impairment losses recognised or reversed and any other change

- In case of useful life of an intangible asset exceeding ten years, proper disclosure of the reasons for the same should be given

- Research and Development expenditure recognised as expense for the period to be disclosed

General non compliances

- Research phase expenditure should be expensed and Development phase expense should be recognised as Intangible assets if the recognition criteria given in Para 44 of AS 26 are satisfied. It was observed that no bifurcation was done between research phase and development phase expenditure

- Specific disclosure is required to be made for the useful lives of intangible assets or the amortisation rates

General non compliances

- Expenses like Debenture Issue Expenses, Expenses related to increase in authorised capital, premium on restructuring of loan cannot be considered as Intangible Assets

- Preliminary and Preoperative expenditure cannot be deferred and should be charged to P&L A/c

- Nature of Goodwill should be stated. Para 63 of AS-26 and Para 19 of AS-14 require amortisation of goodwill

Case Study 1

SENSEX Ltd. is the member of BSE Ltd. It holds “card” of BSE at an acquired cost of Rs. X crores. SENSEX Ltd. has classified card as fixed assets. However, no depreciation is provided. SENSEX Ltd. wants to know whether card can be classified as infinite intangible asset?

Solution to Case Study 1

As per Expert Advisory Committee Opinion – Volume XXVII – 26

The card should be amortised over the best estimate of its useful life subject to the rebuttable presumption of 10 years, in accordance with the requirements of paragraphs 63 and 72 of AS 26.

Case Study 2

MTR Ltd. has acquired exclusive license to use the trademark for 6 years from TMR Ltd. for a fixed amount. MTR Ltd. has also acquired exclusive option to acquire trademark earliest at the expiry of 3 years. For this purpose MTR ltd. has paid advance on signing of agreement and has also agreed to pay a sum on end of each financial year based on profit for that year. If MTR Ltd. buys trademark than all the payments are to be adjusted against consideration, otherwise to be returned to MTR Ltd. Advise accounting treatment.

Solution to Case Study 2

As per Expert Advisory Committee Opinion – Volume XXIII – 23

Amortise the license fee under the trademark agreement over the period of the agreement

Account for and disclose as advances recoverable until such time MTR Ltd. exercises its option to acquire the trademark or decline to acquire it.

Trademark to be capitalised only after MTR Ltd. purchases them i.e. from the date of purchase as per the agreement and thereafter, amortise over its useful life

Case Study 3

Whether following would be considered as an intangible asset?

A User license payments for an ERP package.

Sol. It should be capitalised as intangible assets and amortised over useful life

B Telecom license which is not transferable, not saleable, not assignable :-

Sol. The fees paid should be treated as an intangible asset and amortised over the period of its useful life

Case Study 3

C. Club membership

Sol. Non refundable club membership should be shown as an intangible asset if it meets the recognition criteria and amortises over a period of membership

D. Marketing and Technical rights for formulation acquired by Pharma company

Sol. Consideration paid is shown as intangible asset unless recognition criteria are not met and are amortised over a period of useful life

Case Study 3

E Franchisee rights

Sol Self generated franchisee rights are not intangible under AS 26. Acquired franchisee rights would be intangibles, unless recognition criteria are not met.

F Distribution rights acquired by media company

Sol To be capitalised as intangibles assets and amortised for a period. Generally amortisation should be at accelerated rate in the initial year since the market for the products diminishes rapidly after the initial period of release.

Case Study 3

G Brand building expenses incurred on acquired brands

Sol Acquired brands are required to be capitalised if they fulfill the recognition criteria. However, subsequent brand building expenses incurred by the company cannot be capitalised as intangibles.

Case Study 3

H Legal fees to defend patent right

Sol Legal Fees paid for registration should be treated as intangibles. Subsequent costs are unlikely to meet the capitalisation test as it is incurred to maintain the asset at its originally assessed standard of performance. Accordingly it should be recognised as an expense.

Case Study4

CST Ltd. acquired 5000 user licenses @ Rs. 4,000 per user of anti-virus software having 3 years validity. CST Ltd. wants to charge the entire expense to Profit & Loss a/c. Please advise.

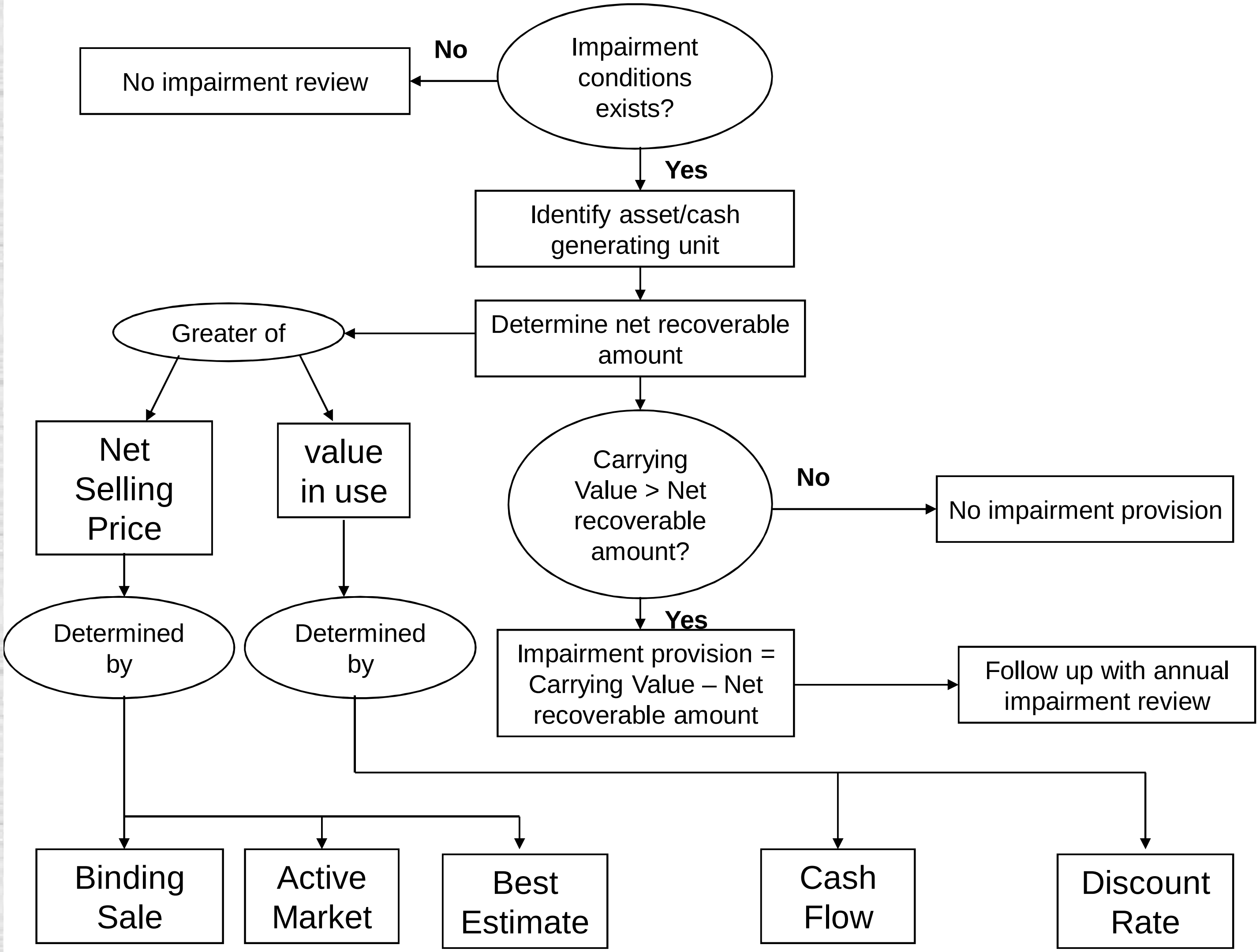
Solution to Case Study 4

Sch XIV does not deal with intangibles.

The cost of all licenses should be capitalised as software and amortised over the period of validity and should not be written off by considering the cost per user license as a low cost item since the same is not permitted by AS 26

Accounting Standard- 28

IMPAIRMENT OF ASSETS



Impairment conditions exists?

No

No impairment review

Yes

Identify asset/cash generating unit

Determine net recoverable amount

Greater of

Net Selling Price

value in use

Carrying Value > Net recoverable amount?

No

No impairment provision

Yes

Impairment provision = Carrying Value – Net recoverable amount

Follow up with annual impairment review

Determined by

Determined by

Binding Sale

Active Market

Best Estimate

Cash Flow

Discount Rate

Main Principles

- An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount

- Recoverable amount is the higher of an asset's net selling price and its value in use

- Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life

Main Principles

- A cash generating unit is the smallest identifiable group of assets that generates cash inflows largely independent of the cash inflows from other assets

- Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash generating unit under review and other cash generating units

Main Principles: Value in Use

- Cash flow projections should be based on assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence

- Cash flow projections should be based on the most recent financial budgets/forecasts (maximum 5 years, unless longer period justified) that have been approved by management

Main Principles: Value in Use

Cash flow projections beyond the period covered by the most recent budgets/forecasts should be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified

Main Principles

- Future cash flows should be estimated for the asset in its current condition. They should not include estimated future cash inflows or outflows that are expected to arise from:
  - a future restructuring to which an enterprise is not yet committed; or
  - future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance

Main Principles

- Discount rate should be a pre tax rate that reflect current market assessments of the time value of money and the risks specific to the asset and should not reflect risks for which future cash flow estimates have been adjusted

- An impairment loss should be recognised as an expense in the profit and loss account immediately. Impairment loss of a revalued asset should be treated as a revaluation decrease as per AS 10

Main Principles

- If the estimated impairment loss is greater than the carrying amount of the asset, recognise a liability if, and only if, required by another AS

- In case of any indication of impairment, the recoverable amount should be estimated for the individual asset. If it is not possible, determine the recoverable amount of the cash-generating unit to which the asset belongs

- Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified

Main Principles

- Carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined

- In testing a cash-generating unit for impairment, identify whether goodwill that relates to this unit is recognised in the financial statements. If this is the case, an enterprise should:
  - perform a 'bottom-up' test
  - if, in the 'bottom-up' test, the carrying amount of goodwill could not be allocated on a reasonable and consistent basis to the cash-generating unit under review, the enterprise should also perform a 'top-down' test

Main Principles

In testing a cash-generating unit for impairment, identify all the corporate assets that relate to the cash-generating unit under review. For each identified corporate asset, apply 'bottom-up' test or 'bottom-up' and 'top-down' test both as required

Main Principles

- Impairment loss should be recognised for a cash-generating unit if, and only if, its recoverable amount is less than its carrying amount. The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:
  - first, to goodwill allocated to the cash-generating unit (if any); and
  - then, to the other assets of the unit on a pro rata basis based on the carrying amount of each asset in the unit

Main Principles

- An impairment loss recognised for an asset in prior accounting periods should be reversed if there is a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. The carrying amount of the asset should be increased to its recoverable amount
- After a reversal of an impairment loss, the depreciation (amortisation) charge for the asset should 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 remaining useful life

Main Principles

- An impairment loss recognised for goodwill should not be reversed in a subsequent period unless:
  - the impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and
  - subsequent external events have occurred that reverse the effect of that event

Disclosures

- For each class of assets, the financial statements should disclose:
  - amount of impairment losses recognised in the profit and loss a/c during the period line item(s) of the profit and loss a/c in which those impairment losses are included;
  - amount of reversals of impairment losses recognised in the profit and loss a/c during the period line item(s) of profit and loss a/c in which those impairment losses are reversed;

Disclosures

- Amount of impairment losses recognised directly against revaluation surplus during the period;
- Amount of reversals of impairment losses recognised directly in revaluation surplus during the period; and
- Relevant details on above lines are required to be disclosed for each reportable segment.
- Events and circumstances that led to the recognition or reversal of the impairment loss
- the amount of the impairment loss recognised or reversed;

Disclosures

- For an individual asset:
  - the nature of the asset; and
  - the reportable segment to which the asset belongs, based on the enterprise's primary format (as per AS 17)
- For a cash-generating unit:
  - a description of the cash-generating unit;
  - the amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and
  - if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified

Disclosures

- whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

- if recoverable amount is net selling price, the basis used to determine net selling price; and

- if recoverable amount is value in use, the discount rate used in the current estimate and previous estimate (if any) of value in use

Disclosures

- If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

  - the main classes of assets affected by impairment losses (reversals of impairment losses) for which no information is disclosed; and
  - the main events and circumstances that led to the recognition (reversal) of these impairment losses for which no information is disclosed

General non compliances

The entities should disclose the accounting policy in respect of impairment of assets or should mention whether impairment was conducted or not.

Example of Accounting policy

- As at the balance sheet date, the carrying amount of assets is tested of impairment so as to determine:
  - The provision of impairment loss, if any; and
  - The reversal of impairment loss recognised in pervious periods, if any.

  Impairment loss is recognised when the carrying amount of asset exceeds its recoverable amount.

  Recoverable amount is determined:
  - In the case of an individual asset, at the higher of the net selling price and the value in use; and
  - In the case of a cash generating unit (a group of assets that generates identified, independent cash flows), at the higher of the cash generating unit's net selling price and the value in use.

  (Value in use is determined as the present value of estimated future cash flows from the continuing use of an asset and from its disposal at the end of its useful life.)

Observations of EAC

- It is not necessary that if the revenues of an enterprise cannot be segmented, its assets also cannot be segmented
- It is possible to have more than one CGU in an enterprise which does not provide segment information as per AS 17
- Distribution assets may be covered by the definition of 'Corporate assets'

Observations of EAC

- It is the factor of independence of cash inflows which determines the CGUs in an enterprise rather than physical clustering of assets for CGU

- Even in a highly profitable enterprise some assets may be impaired

Suggestions and queries are warmly welcomed!!!