Practical Issues and Illustrative Disclosures under Accounting Standards

AS 11- The Effects of Changes in Foreign Exchange Rates
AS 15- Employee Benefits
AS 19- Leases

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Coverage

- Objective and Scope
- Case Studies
- EAC, QRB and FRRB observations
- Disclosures
- Key Audit Takeaways

Applicability of AS

AS (IGAAP)	Companies		Non-corporate entities			
	Non-SMC	SMC	Level I	Level II	Level III	Level IV
AS 11	Yes	Yes	Yes	Yes	Partly	Partly
AS 15	Yes	Partly	Yes	Partly	Partly	Partly
AS 19	Yes	Partly	Yes	Partly	Partly	Partly

AS 11- The Effects of Changes in Foreign Exchange

Objective and Scope

AS 11 determine the exchange rates for foreign currency transactions & foreign operations

Foreign Exchange carried by way of:

- Transactions
  - Transactions should be reported in the entity's reporting currency
- Foreign Operations
  - Foreign operations should also be translated into the entity's reporting currency

Not covered under AS 11

- Forward exchange contracts based on Firm Commitments or Highly Probable Forecast Transactions
- Does not specify the currency in which the financial statements must be presented
- Restatement of enterprise's financial statements from reporting currency to another currency for convenience or for similar purposes
- Does not deal with exchange differences from borrowings to the extent they are regarded as an adjustment to interest cost
- Does not deal with presentation in cash flow statement of foreign currency transactions

Case studies

Case Study 1

At which rates the following items will be reported as per AS 11?

Nature of Transaction	Rates to be considered
Import purchase	Spot rate
Trade Receivables / Payables	Closing Rate
Advances (Monetary)	Closing Rate
Borrowings	Closing Rate
PPE & Investments	@ Transaction rate
PPE (Revalued)	@ Date of revaluation
Contingent liabilities	Closing rate
Prepaid expenses	@ Transaction rate

Case Study 2

What is the accounting treatment for exchange difference on long term foreign currency monetary items. Also is the accounting different for non-corporate entity?

Solution:
There is option to (a) amortize or (b) immediately charge to P&L.

In case of option (a) above, for depreciable asset, such exchange difference is added or deducted from the cost of asset & depreciated over the useful life of the asset and in case of non-depreciable assets, such exchange difference is accumulated and amortized over the period of corresponding loan duration.

Above options are also available in case of non-corporate entity.

Case Study 3

Forward Cover (FC)

In case hedge, premium to be amortized

FC - Speculation

Gain / loss in PL

FC - Derivative

(a) Fair value Hedge : PL (b) Cash Flow Hedge: Routed through Retained Earnings

Case Study 4

During the year, the Company procured imported good which were partly in stock as at balance sheet date and incurred exchange loss on actual payout to import vendor.

Can proportionate exchange loss:
a) Included in cost of inventory as at balance sheet date?
b) Included in cost of material consumed ?

Solution:

- Exchange difference cannot be included in cost of inventory.
- The Company should not adjust foreign exchange fluctuation against cost of raw material consumed.
- As per Para 40(a) of AS 11, 'An enterprise shall disclose the amount of exchange differences included in the net profit or loss for the period'.

Case Study 5

Company ABC Ltd. stated in its accounting policy that export sales are recorded at the exchange rates notified by the customs.

Is this policy appropriate as per AS 11?

Solution:

- As per FRRB and Para 9 of AS 11, a foreign currency transaction should be recorded on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of transaction '.

- Accordingly, the Company should translate the same at the exchange rate prevailing on the date of transaction instead of rates notified by custom.

Interplay between AS 11 and Other Standards

Exchange difference and Borrowing cost

AS 11 generally applies to exchange differences on all foreign currency transactions, except exchange differences arising on foreign currency borrowings to the extent regarded as an adjustment to interest cost (AS 16, para 4(e))

Foreign exchange differences on foreign currency loans

AS 11

- Exchange differences on borrowings recognized in P&L; or
- MCA notification - accounting alternative under para 46/46A permits capitalization to cost of the asset/ FCMITDA for long term borrowings even if construction is complete.

AS 16

- Exchange differences to the extent of interest differential (difference between INR and Foreign interest rate) considered borrowing costs.
- Capitalized under para 4(e) during construction and post construction expensed as borrowing cost.

MCA issued clarification on 9th August 2012 that para 6 of AS 11 and para 4(e) of the AS -16 shall not apply to a company which is applying clause 46A of Accounting Standard-11 i.e. entire exchange difference allowed to be capitalized and not split into Borrowing cost and asset.

Others

Consolidation

- Adjustments under FCTR.
- For Profit and Loss related items monthly average rate for conversion is considered.
- Reconcile inter company balances in FC.

Cash Flow Statement

- Unrealized foreign exchange gains and losses is non-cash item.
- Separate disclosure for effect of changes in exchange rates on cash and cash equivalent.

Interim Financial Statement

- Principles applied in annual FS need to be applied for interim FS i.e. foreign currency monetary items to be translated to closing rate of interim period and ex-difference to be charged off to interim PL.

Observations of QRB

Common Errors

- Not disclosing the net ex-differences accumulated in FCTR as a separate component with a reconciliation of the ex-differences at the beginning and at the end of the reporting period (Para 40 (b)).

- Accounting policy was silent for integral foreign operations (Para 11 and 21).

- Not disclosing the amount of ex-differences included in the net profit or loss for the reporting period (Para 40(a)).

- As per FS there are earnings and expenditure in foreign currency but their Significant Accounting Policy for preparation of FS is silent about the treatment of ex-difference (Para 40(a)).

Disclosures

Disclosure Requirements

An enterprise should disclose:

- Amount of Ex-differences in PL
- FCTR movement
- Disclosure related to LTFCMI

Reason for reporting currency and currency of the country in which the enterprise is domiciled and changes if any.

In case of change in the classification of a significant foreign operation, an enterprise should disclose the nature of the change, reason & its financial impact on shareholders funds & net profit or loss for each prior period presented

Foreign currency risk management policy [not mandatory disclosure].

Key Audit Takeaways

Key Audit Takeaways

- Need to inquire for significant impact of exchange gain / loss in PL.
- Check internal control in recognizing ex-differences [manual or auto entries].
- Discuss with the TCWG for risk management policy covering foreign exchange risk.
- Audit work paper to document the hedge and unhedged foreign currency items in BS.
- Compliance with Schedule III of the Companies Act, 2013 for presentation of ex-difference in PL into realized and unrealized.
- Impact of deferred tax on ex-difference which is adjusted for tax block of PPE as per ICDS.

AS 15 Employee Benefits

Objective and Scope of AS 15

Objective	Scope

• Recognition of a liability when an employee has provided service.
 	
• Recognition of an expense when the enterprise consumes the economic benefit arising from service provided by an employee.
	• Not applicable to share-based payment.
	• Includes formal plans / agreements, legislative requirements, or any informal practices.
	• Employee benefits include:
	  ▪ Short term benefits (salary, short term leave)
	  ▪ Post-employment benefits (gratuity, PF)
	  ▪ Other long-term benefits (long service award, leave)
	  ▪ Termination benefits (Retrenchment, VRS)
	• Employee benefit plans include:
	  ▪ Defined contribution plans
	  ▪ Defined benefit plans

Case studies

Case Study 1

How to recognize gratuity liability	**Response**	**Remarks**
Arithmetic or actuarial valuation.	Actuarial	Computed by actuary as per Project Unit Credit Method [para 65 of AS-15]
Any relaxation for SMC in measurement.	Yes	Actuary is mandatory with certain relaxations in recognition & measurement [para 50-116 of AS-15]
Any relaxation for non-corporate entities.	Yes	For level 2, 3 and 4 with employee strength less than 50, liability may be computed on arithmetic basis. For level 4 entities, actuarial valuation is not required.
Actuarial valuation of DBO whether required to be carried out every year ?	No	Once in 3 years subject to necessary adjustments. Practically the above relaxation is not applied. [para 58 of AS -15]

Case Study 2

Company A conducted actuarial valuation of its defined benefit plan. The assumptions included different rates of future salary increase with respect to liability of gratuity funded, non- funded and leave encashment.

Can the entity do so?

Solution:

As per FRRB, basic assumptions like salary increase cannot differ for same set of employees for different nature of liabilities i.e. gratuity and leave encashment.

Case Study 3

The annual report of a Company read that "Contributions to the Government Provident Fund and ESI are charged to revenue. Since the Company does not have any defined retirement benefit scheme in this regard, AS 15 is not applicable to the Company"

Is there any non- compliance of AS 15 in the above matter?

Solution :

As per FRRB, EPF and ESI are not defined benefit but defined contribution plans for which there are separate requirements as per AS 15.

Case Study 4

Company XYZ amortize past service cost in respect of gratuity and leave encashment over three years.

Is the Company correct in its approach?

Solution:
With reference to Para 94 and 55 of AS 15, if such benefit would vest in the future, such past service cost can be recognized on a straight line basis until the benefits become vested. If already vested then it has to be charged off immediately.

Case Study 5

As per the accounting policy, company's defined contribution plan represents contribution to PF Trust which is administered by the Company and such contribution is charged off to the statement of profit and loss in the financial year to which they relate.

The Company has an obligation to make good the shortfall, if any, between the return on investments of the trust and the notified interest rate.

Is the approach adopted by the above Company correct?

Solution:

With reference to Q9 of ASB Guidance on AS 15, where the Company makes good the shortfall, such a Provident Fund would tantamount to a guarantee of a specified rate of return. Thus, this in effect is a defined benefit plan (and not defined contribution plan) in accordance with Para 26(b) of AS 15.

Case Study 6

As at Balance Sheet date of 31st March 2022 Company XYZ got its gratuity plan and leave encashment plan certified by an independent actuary. However, the Company had communicated to its employees the closure of one of its division in March 2022 itself. The management agreed to give 2 months of Basic Salary aggregating to Rs. 2 crore to its employees who are being terminated.

How should the entity account for above as on 31st March 2022?

Solution:

As per Para 125 of AS 15, AS 29 provision shall apply wherever required. This is an adjusting event as per AS 4 and entity shall provide for the same in its books.

QRB Report on Common Errors in Disclosures

QRB Report on Common Errors in Disclosures

- Accounting Policy discloses details about Indian operations and ignores the recognition and measurement in case of foreign branches.

- Accounting Policy should distinguish between defined contribution plan and defined benefit plan.

- Not disclosing about defined benefit plans in regard to the enterprises accounting policy for recognizing actuarial gains and losses as required by Para 120 (a) of AS 15.

- As regards defined benefit plans, as required by Para 120(n)(ii) of AS 15 it is mandatory to disclose experience adjustments for the amounts for the current annual period and previous four annual periods.

QRB Report on Common Errors in Disclosures

- Leave encashment and compensated absences were not shown as ‘Other long-term employee benefits’ as per Para 127(a) of AS 15.
- The amount recognized as an expense for defined contribution plan had not been disclosed in the notes to accounts as required by Para 47 of AS 15.
- Disclosure not given for employers best estimate of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date as per para 120(o) of AS 15.

Disclosure Requirements

Disclosure Requirement

For illustrative disclosures of AS 15, click on the below file.

AS 15 disclosures

Key Audit Takeaways

Key Audit Takeaways

- Discuss with the actuary to understand the reason for variation in actuarial gain / loss.
- Discuss with the management about need to revise estimates [i.e. salary growth, attrition].
- Disclosures as per requirement of AS 18. Further, if actuarial valuation is done at entity level then appropriate disclosure to be given for separate figures not available for KMP.
- Need to disclose employee related costs capitalized under CWIP as per AS 10.
- Audit procedure to include questionnaire for the HR [e.g. informal practices, long service awards, death in service benefits]
- At the time of curtailment in the company, disclosure requirement as per AS 15 must be taken care of with respect to effects of curtailment.

AS 19
Leases

Objective and Scope

Objective:

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

Scope:

Applicable to all leases other than:

- Lease agreements to explore for or use natural resources,
- Licensing agreements for items such as motion picture films, video recordings, etc.
- Lease agreements to use lands

Case studies

Case Study 1

M/s ABC leased from Company X an equipment of Rs. 110 crores and from Company Y another equipment worth Rs. 45 crores. Both the equipment's have a useful life of 6 years and the lease term is for 66 months. The assets shall be taken over by M/s ABC at free of cost at end of lease term.

Determine whether the above is an operating lease or financial lease.

Solution:
It is a finance lease considering the lease term and conditions.

Case Study 2

The Statement of Significant Accounting Policies of a Company includes the following:
“Furniture and fixtures includes the cost of Rs. 50,000 towards interior decoration and civil work for leased premises and depreciation rate adopted in respect of these assets are at the rate of 10% under straight line method.”

There is no reasonable certainty that the lessee will obtain ownership at the end of lease term.

Is the Company’s depreciation policy appropriate?

Solution:
As per FRRB and Para 18 of AS 19, if there is no reasonable certainty that the lessee will obtain ownership at the end of the lease term, the asset should be fully depreciated over the lease term or its useful life whichever is shorter.

Case Study 3

Entity A sold an Asset to Entity B. Entity A then acquired the asset on lease from Entity B and the lease payments will cover the majority part of the economic life. Entity A had immediately recognized the excess sales proceeds over the carrying amount in the books of accounts as income.

Is the accounting treatment followed by Entity A in accordance with AS 19?

Solution:

The accounting treatment followed by entity is not in accordance with Para 48 of AS 19.

Para 48 states that 'If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset'.

So the entity has to defer and amortise the excess amount in the proportion of depreciation of the leased asset.

Case Study 4

Company ABC Ltd. leased a machinery from Company DEF Ltd for covering the majority useful life of the asset. Company DEF Ltd incurred expense on Legal fees and commission for arranging this lease agreement.

The accountant of Company DEF Ltd. is unsure of the accounting treatment of expenses incurred for arranging this lease. What should be done?

Solution:

As per Para 31 of AS 19, 'Initial direct cost incurred in negotiating and arranging a lease should either be recognized immediately in the statement of P&L or allocated against the finance income over the lease term since they are incurred to produce finance income.

So the entity can either recognize the expenses in the books immediately or defer it in proportion of finance income.

Case Study 5

Entity has taken a premises on rent for 3 years. Rent for premises is Rs. 1,00,000 per annum including 5% escalation clause per year.

What will be the accounting treatment in case of lessee?

Solution:

As per Para 40 of AS 19, 'Lease income from operating leases should be recognized in the statement of profit and loss on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.'

The difference between the equalised rent amount and the actual lease rental will be transferred to lease equalisation reserve account.

Case Study 6

How to recognize lease incentive (in the form of rent free period for fit-out period) in the books of lessee in case of operating lease.

Solution:

This incentive need to be equalized over the lease period i.e. aggregate of actual lease rental payout to be spread over the lease period on SLM basis.

Disclosure Requirements

Disclosure Requirement: Finance Leases

Lessor

- A reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date.
- 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 recognized in the statement of profit and loss for the period.
- Accounting policy adopted in respect of initial direct costs.

Lessee

- Assets acquired under finance lease as segregated from the assets owned.
- Contingent rents recognized as expense in the statement of profit and loss for the period.
- For each class of assets, the net carrying amount at the balance sheet date.
- The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date.
- A general description of the lessee's significant leasing arrangements.

Disclosure Requirement: Operating Leases

Lessor

- For each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date
- The future minimum lease payments under non-cancellable operating leases in the aggregate
- Total contingent rents recognized as income in the statement of profit and loss for the period
- A general description of the lessor 's significant leasing arrangements; and
- Accounting policy adopted in respect of initial direct costs

Lessee

- General description of the significant leasing arrangement
- The total of future minimum lease payments under noncancellable operating leases
- Lease payments recognized in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents
- The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;
- Sub-lease payments received (or receivable) recognized in the statement of profit and loss for the period

Key Audit Takeaways

Key Audit Takeaways

- Complex transaction where the lease is bundled i.e. embedded lease.
- High value of security deposits but lower lease rental payment.
- No future commitment but as per past trend it is annually renewed.
- Obligation on lessee to restore the property in original form.
- Off balance sheet items - Future commitments for lease rentals.

Thank You