AS 10 – Property, Plant and Equipment

AS 16 – Borrowing costs

AS 26 – Intangible assets

AS 28 – Impairment of assets

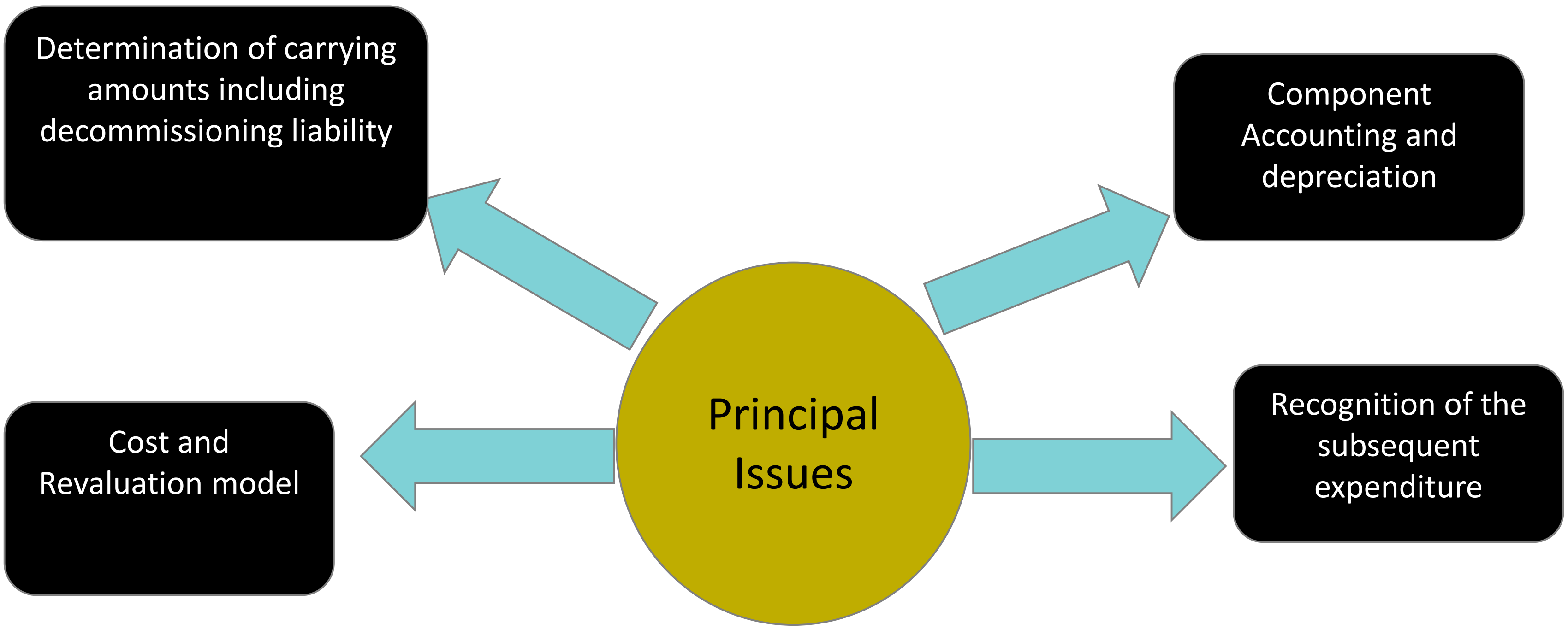
- CA Hemal Shah

Western India Regional Council – ICAI.

Accounting Standard- 10

Property Plant & Equipment (Revised 2016)

Principal issue in accounting for Fixed Assets



Element of Cost

The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non –refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Few examples of directly attributable costs are:

(a) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.

Element of Cost- Pictorial format

An item of PPE that qualifies for recognition as an asset should be measured at its cost.

Cost of an item of PPE

Includes

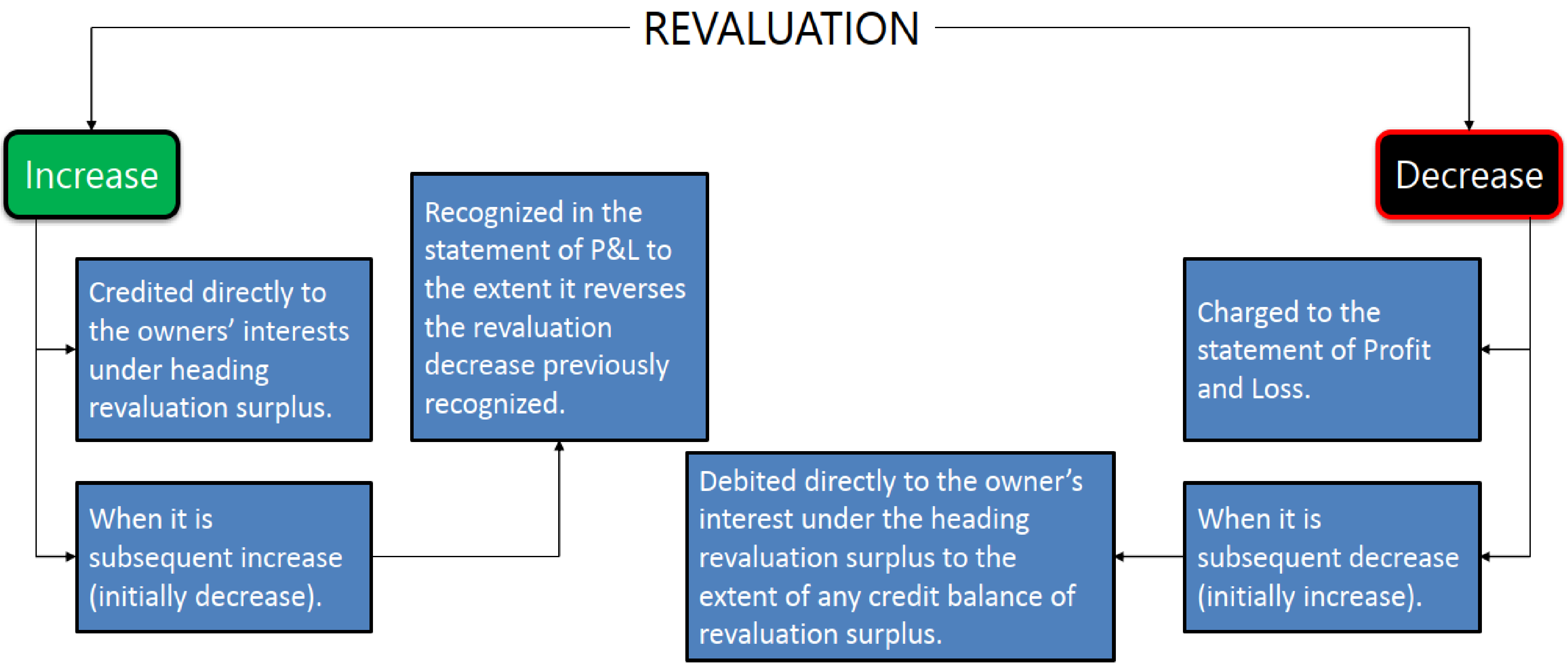
- Purchase price
- Any directly attributable costs
- Decommissioning, restoration and similar liabilities

Excludes

- Cost of opening of new facility or business
- Cost of introducing a new product or a service
- Cost of conducting the business in a new location or with a new class of customer
- Administration and other general overhead costs

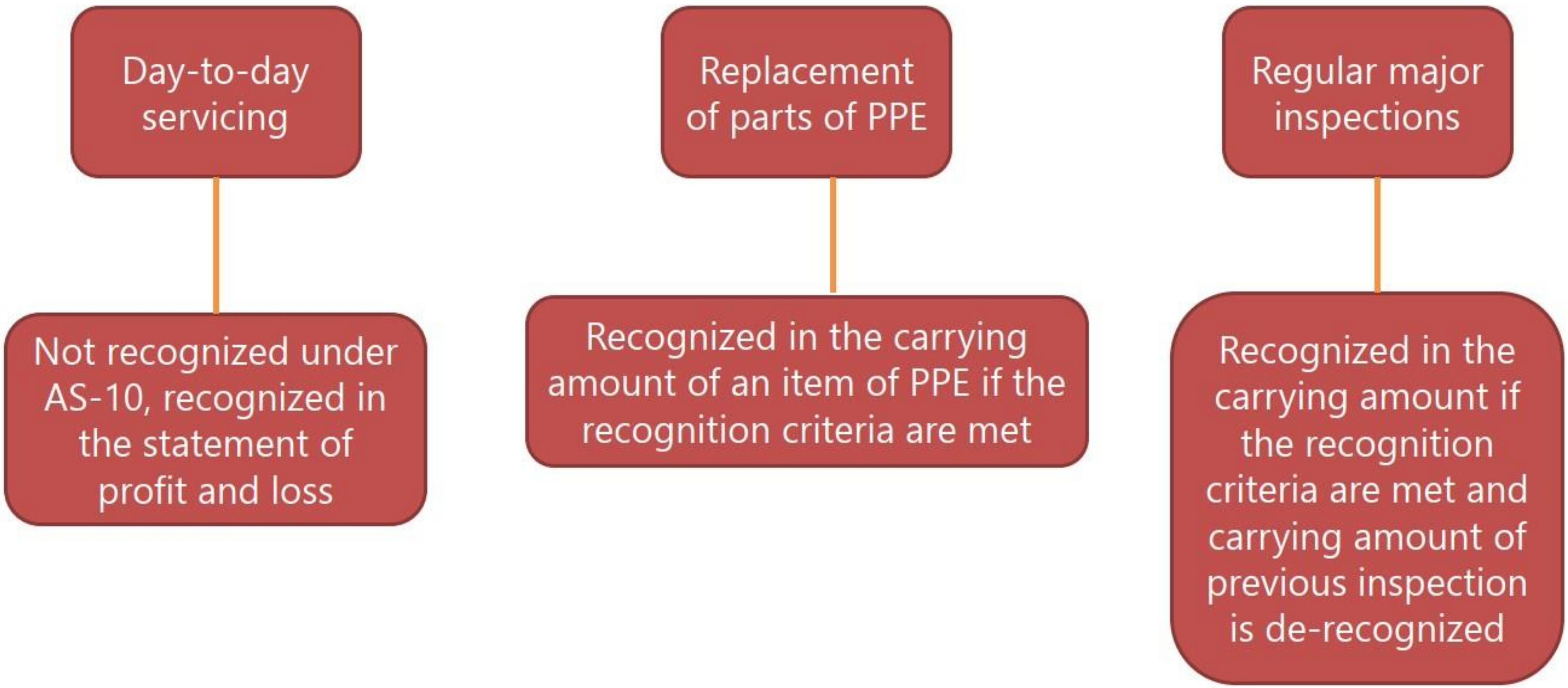
Revaluation of Fixed Assets

ACCOUNTING TREATMENT OF REVALUATION



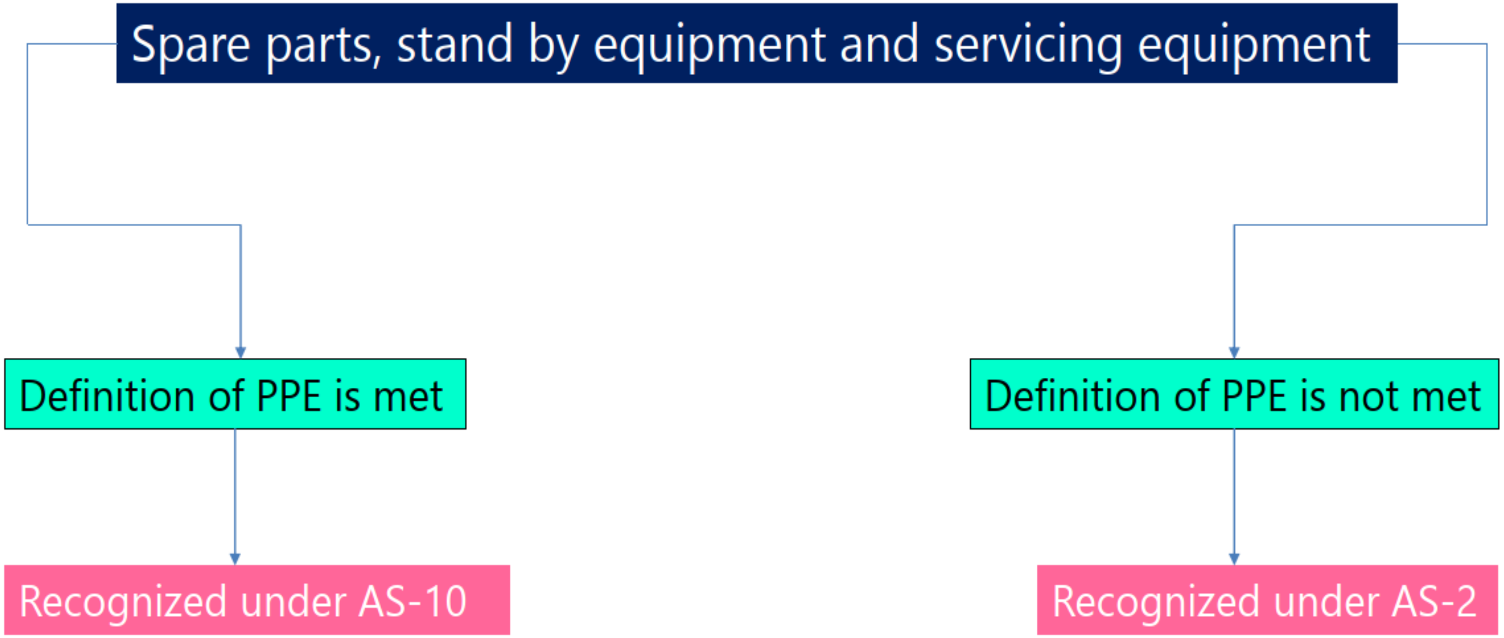
Subsequent Cost

ACCOUNTING TREATMENT FOR SUBSEQUENT COSTS



Spare parts accounting treatment

TREATMENT OF SPARE PARTS, STAND BY EQUIPMENT AND SERVICING EQUIPMENT



Few Important considerations from AS 10

- **An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost (Para 16)**

- **Cost of PPE comprises of :**
  - costs of dismantling, removing the item and restoring the site on which it is located, referred to as 'decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item

- **As per para 60 of the AS 10** - Land and buildings are separable assets and are accounted for separately, even when they are acquired together. Land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building

- Capitalisation of assets in a larger integrated projects

Critical Issues raised by participants:

- If an entity had chosen revaluation model for the year 2016-17 for certain class of PPE. Till 2019-20 they have not carried out evaluation of such revalued class of assets in support of carrying values as at 31st March 2020. Is it appropriate w.r.t. para 37 of AS 10? What disclosure is required in Auditors' report?

- 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 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?

- A ceramic industry is operating on gasifier for production, NGT order to shut down the gasifier, all the company under industry went to court for the taking permission to alter the same gasifier, the petition is still pending as on 31st march 2020. Assets are owned by the company during the year but not used in the year, whether depreciation needs to be charged ? the company is expecting that order may be in their favour.

- Whether company can capitalize the expenses in current year already expensed out in previous years wrongly in start up company which operations not yet started? How the necessary impact should be provided in current year?

- 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?

Critical Issues raised by participants:

- An entity identified some of the items like Plant, furniture and fixtures, tools etc. as Asset held for Disposal or assets held for sale. Can these be considered as scrap items under "Inventory" at its NRV?

- Whether following items needs to be accounted as price adjustments to cost of an asset capitalized:

  a. Liquidated damages received for failure to deliver an asset as per timeline
  b. Cash Discount received
  c. Sundry creditor (w.r.t asset purchase) written back (amount not payable due to asset not meeting specific standards)
  d. Premium/ MTM gain-loss on forward contracts for import purchase of an asset

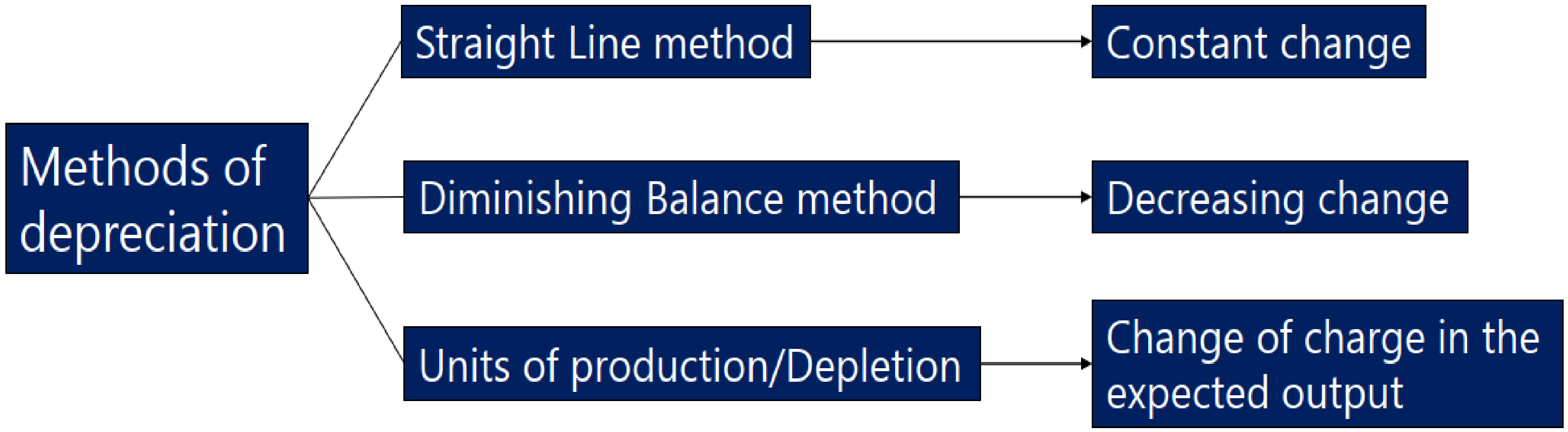
- In case of transfer of an asset amongst the group company we take the book value of the asset for transfer. However can we consider the life of the asset for the buyer as a fresh life of the asset or do we depreciate it over the balance useful time in the hands of the buyer. How do we determine the residual value of the asset at the end of each financial year.

- A Ltd. has an item of plant with an initial cost of Rs. 1,20,000. At the date of revaluation, accumulated depreciation amounted to Rs. 55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be Rs. 65,000. Pass JV for revaluation

- PQR Associates a partnership firm has purchase a lap top worth Rs. 35,000 in exchange of old desktop whose fair market value is Rs. 5,000. What will be the cost of Lap Top As per AS 10. Explain accounting treatment in the books of PQR Associates.

Methods of Depreciation

- The method of depreciation should reflect the pattern of expected future economic benefits.
- It should be consistent from one period to another.
- Change in the method of depreciation is permitted for compliance of statute, accounting standard and for more appropriate presentation.



Disclosure requirement in the Financials

The financial statements should disclose, for each class of property, plant and equipment:

- the measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;
- the depreciation methods used;
- the useful lives or the depreciation rates used. In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact;
- the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
- a reconciliation of the carrying amount at the beginning and end of the period showing:
  - additions;
  - assets retired from active use and held for disposal;
  - acquisitions through business combinations ;
  - increases or decreases resulting from revaluations under paragraphs 34, 42 and 43 and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 28;
  - impairment losses recognised in the statement of profit and loss in accordance with AS 28;
  - impairment losses reversed in the statement of profit and loss in accordance with AS 28;
  - depreciation;
  - the net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11, The Effects of Changes in Foreign Exchange Rates; and
  - other changes.

Accounting Standard- 16

Borrowing Cost

Overview of Borrowing Cost elements

Definition:

- Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds. Types of borrowing costs are explained
  - Interest & Commitment charges on short term and long term borrowings
  - Amortisation of amounts or premium relating to borrowings;
  - Amortisation of ancillary cost incurred in connection with the arrangement of borrowings;
  - Finance charges in respect of assets acquired under finance and
  - Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs
- Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Commencement of capitalisation

As per para 6 of As 16:

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.

Other borrowing costs should be recognised as an expense in the period in which they are incurred

As per para 14 of As 16:

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence **when all the following conditions are satisfied**:

(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;

(b) borrowing costs are being incurred; and

(c) activities that are necessary to prepare the asset for its intended use or sale are in progress."

Determination of the capitalisation rate for capitalisation of borrowing cost

There are 2 types of Borrowing:

Type of Borrowing	Amount to be capitalised
Specific Borrowing	The amount to be capitalized is: Actual Borrowing Cost incurred during the period Minus Any income on temporary investment of borrowed funds (Eg: The excess money invested in Fixed Deposit will have interest gain)
General Borrowing	The amount to be capitalized involves few steps: a. Calculate **Capitalization Rate**. It will be weighted average of borrowing cost. b. Cost to be **Capitalized** = Capitalization rate * Amount spent on qualifying asset out of general borrowing Note: Amount of borrowing cost capitalized during a period should not exceed the amount of borrowing cost incurred during the period

Suspension/ Cessation of capitalisation

- Borrowing costs should be suspended during extended periods in which active development is interrupted.

  Accordingly, borrowing cost on account interruption of active development during COVID-19 needs to be expended out.

- Capitalisation should cease when substantially all activities necessary to prepare the qualifying asset for its intended use or sale are complete.

- In case of construction of a qualifying assets in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing cost in relation to a part should cease when substantially all the activities cease necessary to prepare that part for its intended use or sale are complete.

General points

- Expenditure on a qualifying asset includes only such expenditure:

  - that has resulted in payment of cash
  - transfer of other assets
  - assumption of interest bearing liabilities

- Expenditure to be reduced by progress payments and grants

- Average carrying amount of the asset during a period <u>including borrowing costs previously capitalised</u> is normally a reasonable approximation of the expenditure to which capitalisation rate is applied in that period.

- When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount, the carrying amount is written down in accordance with the requirements of other accounting standards.

- Interest should be capitalised only on the portion of generally borrowed funds (raised without specifying any particular project) utilised for capital projects as capital expenditure and the balance amount of interest on the unutilised portion of the funds available should be charged off to the statement of profit and loss.

Critical Issues

<u>What would be the accounting treatment in case of borrowing in foreign exchange where there is gain/loss on exchange difference?</u>

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.”

Paragraph 4 (e) of AS 16 covers exchange differences on the amount of principal of the foreign currency borrowings to the extent of difference between interest on local currency borrowings and interest on foreign currency borrowings.

For this purpose, the interest rate for the local currency borrowings should be considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered under paragraph 4 (e) of AS 16.

This has been explained in the form of an illustration in the next slide:

Critical Issues

- **XYZ Ltd. has taken a loan of USD 10,000 on April 1, 2019, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 2019, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 2020, is Rs. 48/USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11% PA as on April 1, 2019.**

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

(i) Interest for the period = USD 10,000 x 5% x Rs. 48/$ = Rs. 24,000/-
(ii) Increase in the liability towards the principal amount = $10,000 x (48-45) = Rs. 30,000/-
(iii) Interest that would have resulted if the loan was taken in INR = $10000 x 45 x 11% = Rs. 49,500
(iv) Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 49,500 – Rs. 24,000 = Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount due to foreign exchange difference, only Rs. 25,500 will be considered as the borrowing cost.

Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500.

Remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

Critical Issues

Can we capitalise the borrowing cost on the leasehold improvement costs for a warehouse taken on lease and leasehold improvement done over it?

- Borrowing cost standard is applicable to lease hold improvement also
- Test of “Substantial period of time”

Disclosure requirement in the Financials

As per para 23, of the AS 16:

The financial statements should disclose:

(a) the accounting policy adopted for borrowing costs; and

(b) the amount of borrowing costs capitalised during the period.

Accounting Standard- 26

Intangible Assets

AS 26 – Important considerations

Definitions

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:
(a) controlled by an enterprise as a result of past events; and
(b) from which future economic benefits are expected to
flow to the enterprise.

Critical consideration under AS 26 for Intangible Assets:

- Identifiable i.e. Distinguishable from Goodwill i.e separable in terms of able to sell, exchange, rent, distribute
- Future Economic Benefits
- Control - An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.

…”

AS 26 – Important considerations

As per Para 63 of AS 26:

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use."

As per Para 59 of AS 26:

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

- it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and
- the expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Research V/s Development

Research:

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

In the research phase:

No intangible asset arising from research should be recognised. Expenditure on research should be recognised as an expense when it is incurred.

Examples of research activities are:

- activities aimed at obtaining new knowledge;
- the search for, evaluation and final selection of, applications of research findings or other knowledge;
- the search for alternatives for materials, devices, products, processes, systems or services; and
- the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Research V/s Development

Development:

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

In the development phase

An intangible asset arising from development should be recognised if, an enterprise can demonstrate all of the following:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and use or sell it;
- its ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of development activities are:

- the design, construction and testing of pre-production or pre-use prototypes and models;
- the design of tools, jigs, moulds and dies involving new technology;
- the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Cost of an Internally Generated Intangible Asset

As per Para 53 of the AS 26,

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use. The cost includes, if applicable:

- expenditure on materials and services used or consumed in generating the intangible asset;
- the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;
- any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and
- overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories. AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset.

As per Para 54 of the AS 26,

The following are not components of the cost of an internally generated intangible asset:

- selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;
- clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and
- expenditure on training the staff to operate the asset.

Critical Issues:

- ***The company acquired patent on Machine. The company has incurred the major legal expense for defence of patent infringement cost in the year in which the patent received. Whether the legal cost shall be capitalized as an intangible asset?***

As per AS-26, para 25, "The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost."

The legal cost envisaged in the above example is different from professional fees specified in para 25.

Legal expense for defence of patent infringement cost are to maintain the flow of economic benefits and there is no value addition to such assets and hence needs to be charged off

Critical Issues:

- ***Whether the following expenditure incurred will result in creation of an intangible Asset?***

a) Benefits arising from research
b) Training expenses
c) Management or technical talent
d) a portfolio of customers
e) Market share
f) Advertising for building a brand
g) Relocating or re-organising part or all of an enterprise

The expenditure on intangible items which does not meet the definition and recognition criteria of an intangible assets should be recognised as an expense in the period in which it is incurred. AS-26 states that an intangible assets should be recognised if and only if

a) It is probable that future economic benefits that are attributable to the asset will flow to the enterprise and
b) The cost of the asset can be measured reliably.

Conclusion:
Items mentioned in (a) to (g) above, though may have intangible value or benefit, they will not be considered as intangible asset since they do not meet the criteria of AS-26. Either control or identification or future economic benefits or measurement would be missing one way or other.

Critical Issues:

- A Ltd., got territorial rights to use a Brand for 20 years. A Ltd., paid upfront Rs. 10 crores as non-refundable deposit. If pre-mature termination takes place from either party, than balance amount would be refunded considering Rs.50 lakhs p.a. as usage fees. A Ltd. is unsure as to whether Territorial rights would give rise to intangible asset and if so, what should be the amortisation period, 10 or 20 years?

By definition 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.

Further, AS 26 also mentions that an intangible asset should be recognised if, and only if:
a) it is probable that the future economic benefits that are attributable to the asset will
flow to the enterprise and
b) the cost of the asset can be measured reliably.

From above, it emerges that territorial rights are identifiable, the enterprise through agreement has control over it, future economic benefits will arise from exploitation of those rights and there is a specific cost attached to those rights. Since Territorial rights meet the definition and recognition criteria, the same will be considered as an Intangible asset.

The second and important question is whether amortisation period should be 10 or 20 years. Since there is persuasive evidence that the intangible asset is available for use for 20 years and that economic benefits are expected to flow from use of such asset, A Ltd. can amortise the territorial rights over a period of 20 years in preference to 10 years as stipulated in the bench mark treatment by AS. However A Ltd. is well advised to carryout out the impairment test on an annual basis in respect of such intangible asset.

Critical Issues:

- A Ltd. a pharmaceutical company, has developed over the past two years a new pharmaceutical drug which recently i.e. in May 2020 got approval from regulatory authorities to market the drug. The company was uncertain whether it would get the approval from regulators. Till such time, company has expensed the development expenses as research and development expenses. The company wants to bring amount of Rs. 200 lakhs earlier expensed as an intangible asset in its books since the drug has received approval and that such expense meets the definition criteria of intangible asset. Is the contention of A Ltd. correct?

Critical Issues:

- SAP License costs:

  - In a common scenario of business installing SAP as its base system, SAP license can be considered to be ‘available for use’ only when SAP applications and facilities are also ready. Therefore, till the SAP license is not ‘available for use’, the same should be classified as ‘intangible asset under development’ and thereafter it should be recognised as part of the ‘intangible asset’.
  - The expenditure on annual renewal fee in the extant case will be incurred to continue to retain the licence and will not generate future economic benefits in excess of originally assessed standard of performance of the license. Thus, it should not be capitalised and should be expensed in the statement of profit and loss.

- **Expenditure incurred for widening of two lanes road to four lanes road cannot be capitalised as an intangible asset** because an expenditure incurred by an enterprise can be recognised as an asset only if it is a ‘resource controlled by the enterprise. As per paragraph 14 of AS 26, an enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. However, if the land/ road will not be the property of the Company, then the same cannot be capitalised in the books of the Company.

Disclosure requirement in the Financials

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:
(a) the useful lives or the amortisation rates used;
(b) the amortisation methods used;
(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;
(d) a reconciliation of the carrying amount at the beginning and end of the period showing:
(i) additions, indicating separately those from internal development and through amalgamation;
(ii) retirements and disposals;
(iii) impairment losses recognised in the statement of profit and loss during the period (if any);
(iv) impairment losses reversed in the statement of profit and loss during the period (if any);
(v) amortisation recognised during the period; and
(vi) other changes in the carrying amount during the period.

The financial statements should also disclose:
(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;
(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;
(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and
(d) the amount of commitments for the acquisition of intangible assets.

Accounting Standard- 28

Impairment of Assets

Overview of AS 28-Impairment of Assets:

Impairment Loss:

If carrying amount<= Recoverable amount, then Asset is not impaired.

If carrying amount > Recoverable amount, then Asset is impaired.

Impairment loss = Carrying Amount- Recoverable Amount

Recoverable Amount: is higher of Net Selling price and its value in use

Net Selling price is the Asset's market price less cost of disposal

Value in use= Present value factor*(estimated future net cash flows arising from the use of the assets+ disposal value)

Cash generating unit:
Cash generating unit is the smallest identifiable group of assets that generates cash inflow from continuing use that are largely independent of the cash flow from other assets or group of assets.

Cash generating unit - Goodwill:

In testing a cash-generating unit for impairment, an enterprise should identify whether goodwill that relates to this cash-generating unit is recognised in the financial statements. If this is the case, an enterprise should:

(a) perform a ‘bottom-up’ test, that is, the enterprise should:

(i) identify whether the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash-generating unit under review; and

(ii) then, compare the recoverable amount of the cash-generating unit under review to its carrying amount (including allocated goodwill, if any) and recognise any impairment loss

The enterprise should perform the step at (ii) above even if none of the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash-generating unit under review; and

(b) if, in performing the ‘bottom-up’ test, the enterprise could not allocate the carrying amount of goodwill on a reasonable and consistent basis to the cash-generating unit under review, the enterprise should also perform a ‘top-down’ test, that is, the enterprise should:

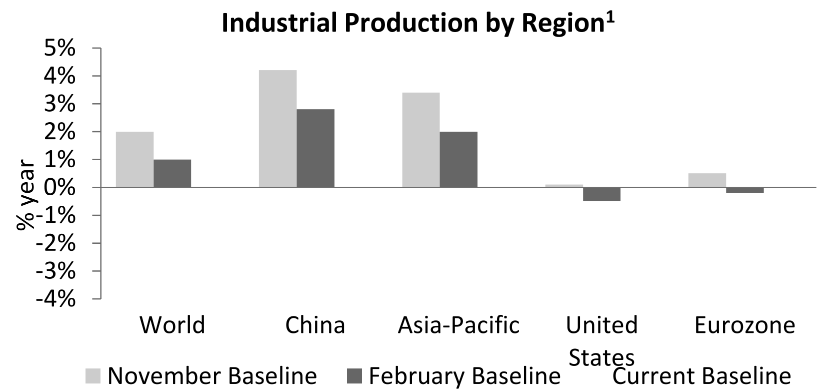
(i) identify the smallest cash-generating unit that includes the cash-generating unit under review and to which the carrying amount of goodwill can be allocated on a reasonable and consistent basis (the ‘larger’ cash- generating unit); and

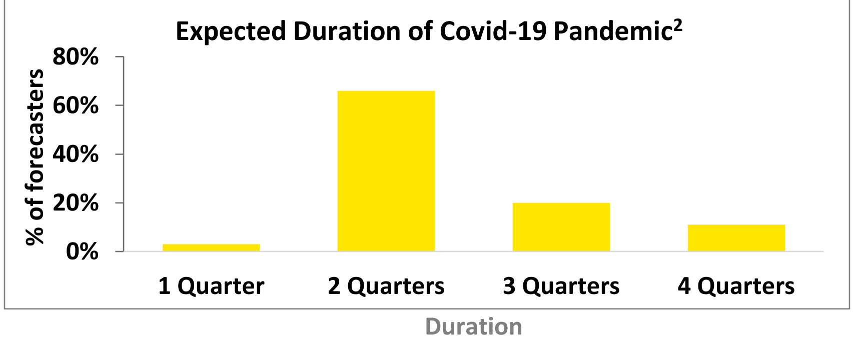
(ii) then, compare the recoverable amount of the larger cash- generating unit to its carrying amount (including the carrying amount of allocated goodwill) and recognise any impairment loss

Current scenario due to Covid-19
Global and India Economic Impact

- Worst recession since Great Depression, global economic growth to turn sharply negative, partial recovery in 2021. Over 170 countries will experience negative per capita income growth this year – IMF

Global





Revised economic growth for India

Agencies/ Institutions	Previous forecast (%)	Revised forecast (%)
Fitch Ratings[3] (FY21)	5.6	2.0 (slowest since economic reforms)
Moody's[4] (CY20)	5.3	2.5
S&P[5] (FY21)	5.7	3.5
Oxford Economics[6]	6.0	-1.0
Goldman Sachs[7] (FY21)	3.3	1.6

Insights from FICCI Survey of 317 companies (conducted between March 15-19)[8]

53% indicated marked impact on business operations even at early stages	80% experienced decrease in cash flows
66% felt big reduction in order books	63% cited reduction in supply chain

1. Oxford Economics/Focus Economics
2. Oxford Economics/Focus Economics based on survey conducted on 23-24 March 2020)
3. Fitch Ratings, 02/04/20
4. Moody's Investors, 14/11/19, 25/03/20
5. Livemint, 04/04/20
6. Oxford Economics/Focus Economics
7. Bloomberg-Quint, 08/04/20
8. "Impact of Coronavirus on Indian Businesses," FICCI Survey, March 2020

Severely impacted sectors due to Covid - 19

- Airlines
- Automobiles
- Entertainment
- Ports & Airports
- Travel & Tourism
- Financial Service
- Real Estate
- Oil & Gas
- Retail
- Hospitality
- Restaurants
- Gems Jewellery

Sectors hit hardest unlikely to see a material revival even by Q4

Industry

→ % share in GVA → % share in sub-sector GVA		Q1	Q2	Q3	Q4
Sub-sector: Mining (3%)					
Sub-sector: Manufacturing (18%)					
Food products, beverages & tobacco (10%)	Dairy products				
	Beverages & consumer foods				
	Textiles & leather (12%)				
	Metals (14%)				
	Machinery & equipment (25%)				
Other manufacturing (39%)	Cement				
	Pharmaceuticals				
	Consumer durables				
	Automobiles				
	Gems & jewellery				
	FMCG				
Sub-sector: Utilities (mostly power) (2%)					
Sub-sector: Construction (8%)					

Services

→ % share in GVA → % share in sub-sector GVA		Q1	Q2	Q3	Q4
Sub-sector: Services (52%)					
	Trade (w/sale, retail) (22%)				
	Hotels & restaurants (2%)				
Communication & broadcasting (3%)	Communication (telecom)				
	Broadcasting (media)				
Transport (9%)	Rail transport				
	Road transport				
	Air transport				
	Transport services				
	Financial services (11%)				
Real estate & professional services (29%)	Real estate				
	Professional services (IT)				
	Public administration (11%)				
Other services (14%)	Healthcare				
	Education				

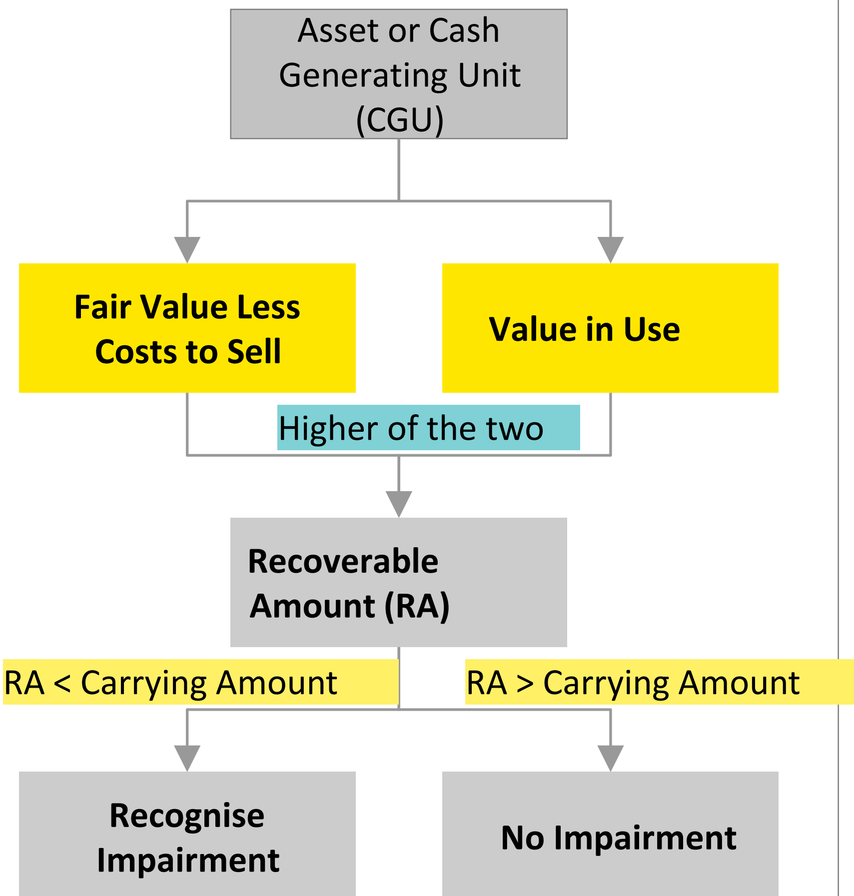
Worst hit | | | Recovery

Source: CRISIL

Preparation & Audit of financial statements

Assets impairment

Impairment of an asset / CGU



Advent of COVID 19 has resulted in a significant adverse economic environment for many businesses.

Companies are to test for impairment if there are any indicators of impairment such as

- temporary ceasing of operations, immediate decline in demand or prices.
- Disrupted supply chains and workforce arrangements.
- Legal issues (force majeure clauses being invoked by vendors, customers).
- Working capital (lower probability of receivable recovery) and other funding issues.
- trade with countries significantly affected by COVID

Per guidance from ICAI, companies would have to test assets/ CGUs for impairment if indicators of impairment are present given the impact of COVID19.

As COVID19 was known from January 2020, only disclosures in the financial statements of 31 March 2020 would not suffice.

The presentation covers impairment testing pertaining to CGUs (including goodwill and intangible assets)/ equity instruments

Few recent examples on Impairment

	What changed?	How impacted??
bp	**Long term price assumptions of Oil** from $70 to $ 55 per barrel	**Intangible assets** like Right to exploration which were valued basis Oil price assumptions, now have to be impaired - $17.5 bn
ADITYA BIRLA GRASIM	Grasim Industries carried out Impairment testing of **Goodwill pertaining to Aditya Birla Finance Limited (Subsidiary co).**	**Goodwill** in the Consolidated balance sheet impaired by Rs 1,270.27 crores
TATA MOTORS	**Reassessed recoverable amount of Passenger Vehicle business** post COVID_19 as separate CGU.	**PPE** and other assets pertaining to Passenger Vehicle Business Rs 1,418.64 crores

Preparation & Audit of financial statements
Assets impairment

- Key takeaways from guidance issued by ICAI and valuation bodies on navigating the challenges in estimating Fair Value or Value In Use are as follows:

There is significant valuation uncertainty due to the impact of COVID19.

Multiple methods and scenarios (e.g., base case, optimistic case, pessimistic case) for cash flows are to be considered by management to arrive at value.

Despite volatility, quoted prices in active market still relevant for listed securities.

Assumptions are to be made basis the best estimate of events that are likely to occur.

Preparation & Audit of financial statements
Assets impairment – Possible red flags

- The following areas may raise red flags for impairment:

High acquisition premium paid in the past

Low headroom in past impairment studies

Aversely impacted industries (travel, airlines, hotels, etc.)

Companies with high financial leverage (i.e. higher insolvency risk)

Businesses with high operating leverage

Companies involved in international trade with countries significantly impacted by COVID19

Reversal of Impairment (Para 98 and 99)

- An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been 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. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

- A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or sale, since the date when an enterprise last recognised an impairment loss for that asset. An enterprise is required to identify the change in estimates that causes the increase in estimated service potential.

  Examples of changes in estimates include:

  - a change in the basis for recoverable amount (i.e., whether recoverable amount is based on net selling price or value in use);
  - if recoverable amount was based on value in use: a change in the amount or timing of estimated future cash flows or in the discount rate; or
  - if recoverable amount was based on net selling price: a change in estimate of the components of net selling price.

Reversal of an Impairment Loss for Goodwill

As per AS 108 of the AS:

As an exception to the requirement in paragraph 98, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

(a) the impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and

(b) subsequent external events have occurred that reverse the effect of that event.

As per AS 109 of the AS:

Accounting Standard (AS) 26, Intangible Assets, prohibits the recognition of internally generated goodwill. Any subsequent increase in the recoverable amount of goodwill is likely to be an increase in internally generated goodwill, unless the increase relates clearly to the reversal of the effect of a specific external event of an exceptional nature.

As per AS 110 of the AS:

Impairment loss can not be reversed for goodwill because of a change in estimates (for example, a change in the discount rate or in the amount and timing of future cash flows of the cash- generating unit to which goodwill relates).

As per AS 111 of the AS:

A specific external event is an event that is outside of the control of the enterprise. Examples of external events of an exceptional nature include new regulations that significantly curtail the operating activities, or decrease the profitability, of the business to which the goodwill relates.

Critical Issues:

- S Ltd. acquired an asset at the beginning of 2001 at a cost of Rs. 10 lakhs. The asset is expected to have a residual value of nil and a useful life of eight years. The straight line method of depreciation is used. At the end of 2004, there are indicators that the asset's carrying amount has been impaired. The value in use of the asset is a negative amount of Rs. 2 lakhs, as the cash outflows from the use of the asset will exceed the cash inflows. The asset's net selling price is also negative because S Ltd. would have to incur substantial disposal cost. What should be the impairment loss provided in books of the company?

The carrying amount at the end of 2004, working out depreciation on straight line method comes as under:

Cost (2001)	Rs 10 lacs
Depreciation	Rs 1.25 lacs for 4 years= Rs 5 lacs
Carrying Value (2004)	Rs 5 lacs

As per A

(a) Its net selling price (if determinable)
(b) Its value in use (if determinable) and
(c) Zero

In case of S Ltd., the asset's net selling price is negative, and the value in use is negative. Hence, the carrying amount should be restricted to zero or in other words **impairment loss is restricted to Rs. 5 Lakhs**, unless the negative amount qualifies for recognition as **a provision in accordance with AS 29.**

Critical Issues:

- A company has Soya crushing facility as well as has set-up a state of the art refinery for oil refining. It purchases Soya beans from market and produces soya meal and oil from its crushing. Soya meal is sold in the market, whereas oil is further refined and sold in tins. However, due to tax structure, use of alternate oil as well as heavy imports, the refinery is not operating at optimum levels and incurring losses. Unrefined Soya Oil is easily saleable in market. Internal transfer to refinery is at cost. Whether impairment test should be carried out and if so, for which unit ?

According to AS 28, if an active market exists for the output produced by an asset or a group of assets, this asset or group of assets should be identified as a separate cash generating unit, even if some or all of the output is used internally. If this is the case, management's best estimate of future market prices for the output should be used:

a) in determining the value in use of this cash-generating unit, when estimating the future cash inflows that relate to the internal use of the output and
(b) in determining the value in use of other cash-generating units of the reporting enterprise, when estimating the future cash outflows that relate to the internal use of the output.

Thus, there are two CGUs, one will be the Soya crushing facility, which will comprise of Soya meal and Crude Oil and other will be the refinery. Further, in ascertaining the profitability of these two cash generating units, the transfer price of oil should be taken at market price and not at cost. Thus, based on budgets / forecasts, the recoverable amount of the refinery CGU should be worked out. If carrying amount is more than recoverable amount, impairment loss should be recognised.

Critical Issues:

- 10 years ago, B Ltd., bought its headquarters building for Rs.20 crores. Since, then, the real estate market has collapsed and the building's market value as at balance sheet date is estimated at Rs. 10 crores. Disposal cost of the building would be negligible. The building's carrying amount at the balance sheet date is Rs.18 crores and its remaining useful life is 30 years. The building meets all the enterprise's expectations and it is likely that these expectations will be met in for the foreseeable future. B Ltd. has no plans to move from its current head quarters. Whether it is required to provide impairment loss of Rs.8 crores at the balance sheet date?

As per AS 28, recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or group of assets.

The value in use of the building cannot be determined because the building does not generate independent cash inflows. Therefore, the recoverable amount of the building will be at CGU level. If there is only one CGU i.e. the enterprise as a whole then at that level.
And if that calculation is greater than the net asset value, the building's cash generating unit is not impaired and hence no impairment is required to be carried out for the building.

Disclosure requirement in the Financials

For each class of assets, the financial statements should disclose:

(a) the amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

(b) the amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

(c) the amount of impairment losses recognised directly against revaluation surplus during the period; and

(d) the amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

Thank you