

## Case Study – 1

You are a Chartered Accountant and a Senior Consultant with a firm of Chartered Accountants, LMN & Co. ("LMN"). It is April 2017 and your organisation has been recently awarded an engagement to advise ABC Limited and its subsidiaries, associates and joint ventures, as the case may be (hereinafter together referred to as "ABC Group" or "ABCG" or "the Group") on certain accounting matters.

ABC Limited has its registered office at New Delhi and is not listed on any stock exchange in India. It is exploring possibilities of listing its securities at an overseas stock exchange. The financial reporting requirements related to such listing include submission of financial statements as per International Financial Reporting Standards (IFRS).

ABCG has been preparing its financial statements as per accounting standards notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as "Indian GAAP").

As per your letter of engagement with your client, relevant extract of the scope of services is set out below:

### ***Phase 1:***

- Identification of differences between Indian GAAP and IFRS.
- Evaluation of applicable exemptions from IFRS and LMN's suggestions on exemptions that should be availed by ABCG.

### ***Phase 2:***

Conversion of opening Balance Sheet as on the date of transition to IFRS.

You have kick-started this conversion engagement with the above scope of services and you are meeting the Chief Financial Officer (CFO) of ABCG. Based on inquiries made by you, the CFO has explained the following facts to you about ABCG:

### **General information about the Group:**

1. ABCG was founded in the year 1970 and since then has diversified into several lines of businesses. Its key revenue drivers are:
  - a. Generation of thermal power
  - b. Construction of highway projects on a Build, Own, Operate and Transfer (BOOT) basis

c. Financial services

More details about these lines of businesses is provided subsequently.

2. After the global economic meltdown in the year 2008, ABCG's infrastructure and financial services business experienced a downturn which had an impact on the overall profitability of the Group. ABC Limited's board of directors voted for a spin-off of the financial services business in the year 2015-16 and floated an information memorandum through an investment bank for the proposed divestment. The Group has successfully divested 51% stake in that business in the year 2016-17. The divestment has brought the Group back into profits in the year 2016-17 and management has drawn up plans for a profitable future.

Recently, in January 2017, an investor showed interest in picking up a strategic stake in ABC Limited at a valuation of ₹ 10,000 crores. The investor has valued the shares at fair value after factoring in the liability component of all compound financial instruments.

However, the Group's infrastructure business has not found too many takers and a recent attempt to spin-off this vertical was unsuccessful.

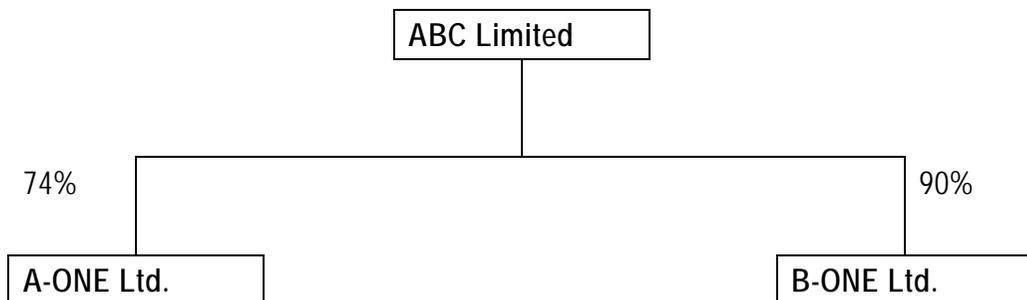
3. In February 2017, ABC Limited has renegotiated the terms of its loans with a bank amounting to ₹ 800 crores. The loan had an outstanding balance of ₹ 900 crores i.e. principal outstanding of ₹ 800 crores and interest outstanding of ₹ 100 crores. Under the renegotiated terms:
  - a. The outstanding interest on the loan amounting to ₹ 100 crores has been converted into 2,100,000 cumulative convertible preference shares (CCPS) of ABC Limited. Each CCPS is convertible into one class A equity shares of ₹ 100 each.
  - b. The principal amount outstanding has a bullet repayment at the end of 5 years. As per the original terms, the loan is repayable in three annual instalments of ₹ 344.59 crores each.
  - c. Interest rate has been revised from 14% p.a. to 11% p.a. which is the market interest in current economic environment. Interest is payable annually.
4. ABC Limited's present equity shareholding structure is given below:

Shareholder	Class A equity shares (of ₹ 100 each)	Class B equity shares (of ₹ 100 each)
AeBee	90,000,000	85,000,000
CeeDee	<u>10,000,000</u>	<u>15,000,000</u>
	100,000,000	100,000,000

5. CeeDee is a private equity investor that infused ₹ 1,000 crores in ABC Limited (Class A equity shares: ₹ 400 crores and Class B equity shares: ₹ 600 crores) on 31 March 2011 at a valuation of ₹ 8,000 crores on a fully diluted basis. ABC Ltd. has entered into a shareholders' agreement with shareholders as per which the terms of Class A and Class B equity shares are:
- Class A equity shareholders are entitled to dividend at the discretion of the Board of Directors.
  - Class B equity shareholders are entitled to a fixed non-cumulative dividend of 10% subject to availability of profits in that year and distributable cash as on balance sheet date of relevant year. The profits of ABC Limited are to be determined as per the statutory financial statements of ABC Limited. Distributable cash is defined as free cash and cash equivalents available with the issuer.
  - The projections of profits/losses and balance of ABC Limited for the 10 years subsequent to the private equity investment (as estimated on the date of such investment) are as below:

₹ crores										
Particulars	For the year ending 31 March									
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Opening cash and cash equivalents	100	85	16	8	2	8	26	48	74	104
Profit / (loss) as per IGAAP financial statements	(20)	(75)	(15)	(13)	(2)	10	13	18	23	25
Depreciation as per IGAAP	5	6	7	7	8	8	9	8	7	7
Impact on profit / loss due to IFRS conversion	8	10	(4)	5	7	(12)	6	1	0	(-2)

- Each Class B equity share is convertible into one Class A equity share at the end of 10 years from the date of infusion of funds by CeeDee.
  - Dividend of 13% is paid for similar instruments in the industry.
6. The group structure of ABCG is given below:



Generally, the matters put forth before the Board of Directors of the investee companies of ABC Limited are decided by a majority vote of the members of the board.

However, the shareholders' agreement entered into with the other shareholders of A-ONE Ltd., holding 26% of voting rights and equity share capital, provides, *inter alia*, that following matters cannot be decided by majority of the Board unless there is consent of all the parties:

- The selection, appointment and removal of any manager of the company, where such manager has the position of departmental head and has the responsibility for one of the function of the company
- Level, limits and timing and distribution of dividends
- Appointment of any additional directors
- Commencement or settlement of any litigation/proceeding material in the context of company's business
- Annual business plan

A-ONE Ltd. has taken certain loans from the banks and financial institutions, amounting to ₹ 500 crores, due after 3 years, in respect of which ABC Limited has given a corporate guarantee. Based on credit rating of A-ONE Ltd., the probability of default on this loan is expected to be 1%.

#### **Information about Thermal Power business**

1. ABC Limited set up its thermal power plant in the year 2010. The plant comprises two units of 600 MW each – Unit 1 and Unit 2. The technical experts of ABC Limited expect that the power plant will be able to supply power till the year 2025.
2. ABC Limited has entered into a Power Purchase Agreement (PPA) with the Government of Punjab (GOP).
3. The construction of the power plant was funded in debt-equity ratio of 70:30. The term loan carried an interest rate of 12% p.a. The total outlay on the plant was ₹ 4,000 crores which is also considered its fair value.
4. The salient features of the PPA are given below:
  - a. GOP has agreed to purchase 600 MW power generated by Unit-1
  - b. The term of the agreement is fixed as 10 years.
  - c. The tariff for power supply agreed with GOP is given below:

Contract year	Capacity charges	Energy charges
	₹ / kwh	
1	1.10	2.00
2	1.10	2.10
3	1.10	2.30
4	1.10	2.50
5	1.10	2.60
6	0.78	2.80
7	0.78	3.00
8	0.78	3.20
9	0.78	3.40
10	0.78	3.70

(Other information: 1 MW = 1,000 kw and the plant operates 24 hours in a day, 365 days in a year)

- Capacity charges are payable based on 85% capacity, irrespective of actual units consumed. An incentive is payable for availability of plant beyond 85% capacity and a penalty is recoverable for availability of plant below 85%. (It is assumed for this case study that exactly 85% of the capacity of plant was available).
- ABC Limited has been granted a license to extract coal from a mine located at Dhanbad (Jharkhand). The term of this license is 15 years. At the end of the term, ABC Limited is obligated to carry out certain prescribed activities in order to restore the ecological balance of the area.

#### Information about Infrastructure business

- In 2008, ABC Limited won the bid to construct a 93 km long highway from Ahmedabad to Baroda from Government of Gujarat (GOG).
- The terms of the arrangement require ABC Limited to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (i.e. years 3–10).
- The terms of the arrangement also require ABC Limited to resurface the road at the end of year 8.
- At the end of year 10, the arrangement will end.
- ABC Limited estimates that the costs it will incur to fulfil its obligations will be:

Particulars	Year	Cost (₹ crores)
Construction services	1	500
	2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

6. The terms of the arrangement require the grantor to pay the operator ₹ 200 crores per year in years 3–10 for making the road available to the public.
7. For the sake of simplicity, let us assume that all cash flows take place at the end of the year. IRR is determined as 6.18%.
8. The construction margin observed in markets for the obligations under the arrangement is given below:

Particulars	Margin on cost
Construction services	5%
Operation services (per year)	20%
Road resurfacing	10%

### Information about Financial Services business

- i. B-ONE Ltd. is a non-banking financial company and focuses on retail lending – car loans, personal loans and home loans.
- ii. B-ONE Ltd. was acquired by ABC Limited in the year 2011-12. For the purpose of this acquisition, ABC Limited took a term loan from a bank at an interest rate of 13% p.a.
- iii. During the year 2016-17, a portfolio of car loans was transferred to a trust against issuance of units by the trust. The trust is funded by certain investors who have been guaranteed a return by B-ONE Ltd.
- iv. Owing to weak financial condition of B-ONE Ltd., it is occasionally supported by interest free loans from ABC Limited.

After the meeting with the CFO, you proceed for a meeting with your Senior Partner, Ms. JKL, an IFRS expert. You have briefed her about your discussion with the CFO.

During the meeting, Ms. JKL has asked you a few questions, which are listed down below:

## I. Descriptive Questions

1. (a) What are the key areas of differences where application of IFRS has to be assessed / worked upon vis-a-vis the current accounting practices followed as per the Indian GAAP? (Write each area of difference in a sentence or a paragraph) *(7 Marks)*
- (b) As on the date of transition, examine the exemptions (if any) from retrospective application of IFRSs that ABCG is entitled to? *(3 Marks)*
2. (a) Whether the debt restructuring tantamount to substantial modification of terms of the loan? Demonstrate this through a computation. *(4 Marks)*
- (b) Analyse the shareholders' agreement entered into between ABC Limited and the 26% shareholders of A-ONE Ltd. in the context of above background and determine the impact, if any on the consolidated financial statements of ABC Limited. *(4 Marks)*
3. (a) In respect of the infrastructure business, demonstrate the computation of below elements of the statement of comprehensive income (every year):
  - i. Revenue and Contract costs.
  - ii. Any other income under the arrangement with GOG.
  - iii. Net effect of its accounting under IFRIC 12. *(6 Marks)*
- (b) An extract of separate Indian GAAP balance sheet (without figure) of ABC Limited is given below. Prepare an extract of IFRS balance sheet of ABC Limited:
  - (a) Classify the assets and liabilities under appropriate heads as per relevant IFRS and
  - (b) State the measurement basis against each asset or liability stated therein:

	As at	As at
	31 March 2017	31 March 2016
	₹	₹
Non-current liabilities		

Particulars	As at	As at
	31 March 2017	31 March 2016
	₹	₹
Long-term borrowings - Loan from Yep Bank Ltd. (ABC Ltd. paid processing fee of 1%)		
<b>ASSETS</b>		
<b>Non-current assets</b>		
<i>Fixed assets</i>		
<i>Tangible assets</i> – Land purchased for power plant in 1990 but the plans were shelved subsequently. Currently, the use is undetermined		
Non-current investments <ul style="list-style-type: none"> <li>• Investment in equity shares of subsidiary</li> <li>• Investment in equity shares of an unrelated unlisted company</li> </ul>		
Long-term loans and advances		
Interest free loan to B-ONE Ltd. Loans to employees at discounted rate of interest		
<b>Current assets</b>		
<i>Current investments</i> – Investment in mutual funds		
<i>Inventories</i> – Spare parts for power plant with useful life of more than one year		

(6 Marks)

## II. Objective Type Questions

*Write the correct answer to each of the following questions by choosing one of the four options given. Each question carries two marks.*

1. What is the date of transition to IFRS?
  - (a) 1 April 2017
  - (b) 31 March 2016
  - (c) 1 April 2015
  - (d) None of the above.
  
2. As at the balance sheet date, how should the assets and liabilities of financial services business undertaken by B-ONE Ltd. be accounted for in the consolidated financial statements of ABC Limited if the assets & liabilities are within the scope of measurement requirements of IFRS 5?
  - (a) At original cost
  - (b) At carrying amount
  - (c) At fair value less costs to sell
  - (d) At lower of carrying amount and fair value less costs to sell.
  
3. What will be the classification of Class A equity shares by ABC Limited?
  - (a) Class A equity shares will be classified as "Compound Financial Instrument"
  - (b) Class A equity shares will be classified "Financial Liability"
  - (c) Class A equity shares will be classified as "Compound Financial Liability"
  - (d) Class A equity shares will be classified as "Equity".
  
4. What is the classification of Class B equity shares issued by ABC Limited?
  - (a) Class B equity shares will be classified as "Equity" only
  - (b) Class B equity shares will be classified as "Financial Liability" only
  - (c) Class B equity shares will be classified as "Compound Financial Liability"
  - (d) Class B equity shares will be classified as "Compound Financial Instrument".

5. What will be the journal entry (including amounts thereof) to be passed in respect of initial recognition and measurement of Class A equity shares issued to CeeDee?

- (a) Bank Dr. ₹ 400 crores  
                     To Class A equity shares ₹ 400 crores
- (b) Bank Dr. ₹ 1000 crores  
                     To Class A equity shares ₹ 1000 crores
- (c) CeeDee Dr. ₹ 400 crores  
                     To Class A equity shares ₹ 400 crores
- (d) CeeDee Dr. ₹ 1000 crores  
                     To Class A equity shares ₹ 1000 crores.

6. What will be the journal entries (including amounts thereof) to be passed in respect of initial recognition and measurement of Class B equity shares issued to CeeDee?

- (a) Bank Dr. ₹ 600 crores  
                     To Compound Financial Instrument ₹ 600 crores
- (b) Bank Dr. ₹ 600 crores  
                     To Financial Liability (Class B equity shares) ₹ 600 crores
- (c) Bank Dr. ₹ 600 crores  
                     To Equity component of Class B equity shares ₹ 568.8 crores  
                     To Liability component of Class B equity shares ₹ 31.2 crores
- (d) Bank Dr. ₹ 600 crores  
                     To Class B equity shares ₹ 600 crores.

7. State which of the following statement is true in case of Power Purchase Agreement (PPA) entered by ABC Limited with the Government of Punjab (GOP).

- (a) the PPA with GOP cannot be fulfilled by the use of the power plant since it is not a specific asset
- (b) There is no arrangement in the PPA which conveys the right to use the asset
- (c) The PPA with GOP contains an embedded lease arrangement
- (d) GOP has the ability or right to operate the asset or direct others to operate the asset in a manner it determines.

8. How should the activity of construction of power plant be classified in the financial statements of ABC Limited.
- (a) Property, plant and equipment held for use in the supply of goods or services
  - (b) Property, plant and equipment under an operating lease arrangement
  - (c) Contract revenue whose consideration has a financial asset component and an intangible asset for the remainder
  - (d) Lease receivable under a finance lease arrangement.
9. What will be the other accounting implications that ABC Limited needs to bear in mind in respect of its power generation business except classification of construction of power plant?
- (a) No other accounting implications to be taken into account by ABC Limited
  - (b) ABC Limited needs to recognise penalty recoverable on account of shortfall in the utilisation of plant capacity
  - (c) ABC Limited needs to create a provision for incentive payable for plant capacity utilised above 85%
  - (d) ABC Limited needs to recognise a provision for site restoration in accordance with the terms of the mining license granted to it.
10. What should be the accounting treatment of car loan portfolio transferred by B-ONE Ltd. to the Trust?
- (a) the financial asset is not derecognised by ABC Limited as it does not constitute a transfer
  - (b) the financial asset is derecognised by ABC Limited as it constitutes a transfer
  - (c) the financial asset is not derecognised by ABC Limited though it constitutes a transfer
  - (d) the financial asset is derecognised by ABC Limited though it does not constitute a transfer.