

# Practical Insights on Ind AS and SAs

Understanding the Transition of Property, Plant and Equipment from Previous GAAP to Ind AS through Case Studies - Part II

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# 1. Introduction

In the previous edition of this series, we examined various practical issues arising on the transition of Property, Plant and Equipment (PPE) from previous GAAP to Ind AS, including recognition of capital spares, treatment of revaluation reserves, impairment losses and assets previously classified as held for sale. The discussion highlighted that although Ind AS 101 provides significant relief through the deemed cost exemptions, these exemptions need to be examined carefully in the context of the specific facts and circumstances of an entity.

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One of the most commonly used transition exemptions for PPE is contained in Paragraph D7AA of Ind AS 101, First Time Adoption of Indian Accounting Standards under which a first-time adopter may elect to use the previous GAAP carrying amount of an item of PPE as its deemed cost at the date of transition. While the exemption substantially reduces the burden of retrospectively reconstructing historical costs, practical questions continue to arise regarding its scope and the extent to which adjustments can be made to the previous GAAP carrying amount.

For instance, can an entity use previous GAAP carrying amounts for some PPE and fair value for others? What happens when a previous GAAP carrying amount includes an item that would be accounted for differently under another Ind AS? Can an error in recognising an asset under previous GAAP be protected by the deemed cost exemption? Further, how should items such as processing fees capitalised to PPE or government grants deducted from PPE be dealt with on transition?

This article examines the aforesaid issues through practical case studies.

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## 2. Can exemption allowed under D7AA be applied selectively to PPE?

### 2.1. Understanding the issue

Paragraph D7AA of Ind AS 101 provides a significant practical relief to first-time adopters by allowing the previous GAAP carrying amount of PPE to be used as its deemed cost at the date of transition. This exemption is particularly useful because it avoids the need to retrospectively reconstruct the historical cost and depreciation of PPE in accordance with Ind AS 16.

However, the question is whether an entity can use this exemption selectively. For example, an entity may prefer to retain the previous GAAP carrying amount for assets where historical records are readily available, while using fair value as deemed cost for other assets where determining an Ind AS-compliant historical cost is difficult.

The distinction is important because Ind AS 101 provides different deemed cost exemptions, and an entity cannot necessarily combine them on an asset-by-asset basis according to its preference.

## 2.2. Practical Scenario

Pedro Limited is transitioning to Ind AS and intends to avail itself of the exemption under Paragraph D7AA of Ind AS 101. However, the company proposes to retain the previous GAAP carrying amount as deemed cost for certain items of PPE while measuring other items at fair value as deemed cost.

The management believes that such an approach would enable the company to use the most convenient measurement basis for each individual asset.

The question is whether Pedro Limited can selectively apply Paragraph D7AA to certain items of PPE while using fair value as deemed cost for other items.

## 2.3. Analysis

Paragraph D7AA permits an entity to use the previous GAAP carrying amount of PPE recognised in its balance sheet as its deemed cost at the date of transition. Where this exemption is applied, the previous GAAP carrying amount is not permitted to be adjusted, except for the specific adjustment relating to decommissioning liabilities under Paragraphs 21 and 21A of Ind AS 101.

Accordingly, the exemption does not provide an option to selectively retain the previous GAAP carrying amount for some PPE while substituting fair value for other PPE merely based on the entity's preference.

Therefore, Pedro Limited cannot use previous GAAP carrying amount as deemed cost for certain PPE and fair value as deemed cost for other PPE on a selective basis.

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# 3. Unrealised profit included in subsidiary's PPE

## 3.1. Understanding the issue

The application of the deemed cost exemption becomes more complex when the PPE of a subsidiary contains an unrealised profit arising from an intra-group transaction.

Ordinarily, consolidation principles require intra-group transactions and unrealised profits to be eliminated. However, the transition provisions of Ind AS 101 contain specific requirements where a subsidiary was not consolidated under previous GAAP.

Therefore, when an entity becomes a subsidiary under Ind AS because of factors such as de facto control, it becomes necessary to determine what amount represents the subsidiary's previous GAAP carrying amount for transition purposes.

### 3.2. Practical Scenario

Delta Limited is a first-time adopter of Ind AS. Under previous GAAP, Alpha Limited was treated as an associate and was accounted for using the equity method in Delta's consolidated financial statements.

On transition to Ind AS, Delta determines that it has de facto control over Alpha. Accordingly, Alpha is treated as a subsidiary under Ind AS 110.

Before transition, Delta had sold goods to Alpha at a profit. Alpha subsequently used those goods in the self-construction of PPE. As a result, the PPE appearing in Alpha's individual financial statements included the profit earned by Delta.

Both entities have opted for the Paragraph D7AA exemption. The question is whether the unrealised intra-group profit included in the PPE should be eliminated on transition.

### 3.3. Analysis

Paragraph D7AA permits continuation of the previous GAAP carrying amount of PPE as deemed cost.

Where a subsidiary was not consolidated under previous GAAP, Ind AS 101 requires the amount reported by the subsidiary in its individual financial statements under previous GAAP to be considered as the previous GAAP amount.

In the present case, Alpha was not consolidated by Delta under previous GAAP. Thus, its PPE, as appearing in its individual financial statements represents its previous GAAP carrying amount, including the intra-group profit.

Accordingly, the previous GAAP carrying amount of such PPE would continue as deemed cost under the relevant transition provisions.

Therefore, the unrealised intra-group profit included in the PPE would not be eliminated as a transition adjustment.

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## 4. Government grant deducted from PPE under previous GAAP

### 4.1. Understanding the issue

Government grants relating to PPE represent another area where the accounting treatment under previous GAAP and Ind AS may differ.

Under AS 12, Accounting for Government Grants a government grant relating to a specific fixed asset could be presented by deducting the grant from the gross value of the asset. Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance on the other hand, generally requires grants related to depreciable assets to be recognised in profit or loss on a systematic basis over the periods in which the related costs are recognised.

Consequently, on transition to Ind AS, an entity may be tempted to reverse the amount of grant deducted from PPE and recognise a corresponding deferred income balance.

However, where Paragraph D7AA is applied, the central question is whether the previous GAAP carrying amount of PPE can be adjusted merely to reflect the Ind AS 20 presentation.

## 4.2. Practical Scenario

Gamma Limited is a first-time adopter of Ind AS and elects to apply Paragraph D7AA of Ind AS 101 to its PPE.

The company had received a government grant for acquiring a tangible asset. Under previous GAAP, the grant was deducted from the gross value of the asset in accordance with Paragraph 14 of AS 12.

Under Ind AS 20, the grant would generally be recognised in profit or loss systematically over the periods in which depreciation on the related asset is recognised, with the grant commonly presented as deferred income.

The company therefore proposes to increase the carrying amount of PPE by the amount of grant previously deducted and recognise a corresponding deferred grant liability on transition. Whether such an adjustment is permissible?

## 4.3. Analysis

Paragraph D7AA does not permit an adjustment to the previous GAAP carrying amount of PPE adopted as deemed cost, except for the specific adjustment relating to decommissioning liabilities under Paragraphs 21 and 21A of Ind AS 101.

Accordingly, the fact that the accounting treatment under Ind AS 20 differs from the treatment followed under AS 12 does not, by itself, permit Gamma Limited to reconstruct the PPE balance on transition.

Therefore, the government grant previously deducted from PPE should not be added back to PPE merely because the entity has transitioned to Ind AS under Paragraph D7AA.

Consequently, a deferred grant should not be recognised merely as a transition adjustment in respect of past government grants.

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# 5. Processing fee capitalised as part of PPE under previous GAAP

## 5.1. Understanding the issue

Transition to Ind AS may require an entity to reconsider the accounting treatment of transactions that were previously accounted for under a different accounting framework. A particularly interesting situation arises when an expenditure relating to a borrowing has been capitalised into PPE under previous GAAP, while Ind AS 109 requires that expenditure to be considered in determining the effective interest rate of the borrowing.

This creates a potential interaction between Paragraph D7AA of Ind AS 101, which restricts adjustments to the previous GAAP carrying amount of PPE, and Ind AS 109, which prescribes the measurement of financial liabilities at amortised cost.

The key question is whether applying Ind AS 109 to the borrowing would also require the corresponding PPE balance to be adjusted.

## 5.2. Practical Scenario

Indian Steel Limited acquired a depreciable asset using a foreign currency loan. At the time of obtaining the loan, the company incurred a processing fee, which was capitalised as part of the cost of PPE under previous GAAP.

On transition to Ind AS, the company elects to apply the exemption under Paragraph D7AA of Ind AS 101 for PPE. At the same time, the foreign currency borrowing is required to be measured at amortised cost under Ind AS 109.

The company therefore needs to determine whether:

- a) the processing fee capitalised to PPE should be removed from PPE; and
- b) the processing fee should be considered while calculating the amortised cost of the borrowing.

## 5.3. Analysis

Paragraph D7AA does not permit an adjustment to the previous GAAP carrying amount of PPE, except for adjustments relating to decommissioning liabilities under Paragraphs 21 and 21A of Ind AS 101.

Accordingly, the processing fee that had been capitalised to PPE under previous GAAP cannot be decapitalised merely because the entity transitions to Ind AS.

However, the borrowing is a separate financial liability and must be measured in accordance with Ind AS 109.

Ind AS 109 requires fees that are an integral part of the effective interest rate of a financial instrument to be considered in determining the effective interest rate. A loan processing fee that represents an origination fee would therefore be taken into account in determining the effective interest rate.

Thus, the processing fee affects the measurement of the loan liability, even though it does not result in an adjustment to PPE under Paragraph D7AA.

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## 6. Error in recognising an asset under previous GAAP

### 6.1. Understanding the issue

The deemed cost exemption is intended to provide relief from the retrospective application of Ind AS measurement requirements. It is not intended to provide a mechanism for carrying forward errors that existed under previous GAAP.

This distinction is particularly important because an entity may identify, during its transition exercise that an item previously capitalised as PPE did not actually satisfy the definition of an asset. The fact that the item appears within PPE in the previous GAAP balance sheet does not automatically mean that its carrying amount qualifies for protection under Paragraph D7AA.

### 6.2. Practical Scenario

Beta Limited is a first-time adopter of Ind AS and has elected to apply the exemption under Paragraph D7AA.

During the preparation of its Opening Ind AS Balance Sheet, the company discovers that an item had been capitalised as PPE under previous GAAP even though the item did not satisfy the definition of an asset.

Management argues that since the item was included in PPE under previous GAAP, its carrying amount should be continued as deemed cost under Paragraph D7AA.

The question is whether the deemed cost exemption can be used to retain the carrying amount of an asset that was incorrectly recognised under previous GAAP.

### 6.3. Analysis

Paragraph D7AA permits the previous GAAP carrying amount of PPE to be used as deemed cost. However, this relief cannot be used to preserve an amount that arose because of an error in recognition under previous GAAP.

The purpose of the exemption is to avoid retrospective reconstruction of the measurement of properly recognised PPE. It does not override the requirement to correct errors.

Accordingly, Beta should first rectify the previous GAAP error in accordance with Paragraph 26 of Ind AS 101. The resulting correction should be separately distinguished from adjustments arising from the transition to Ind AS.

Therefore, an entity cannot rely on Paragraph D7AA to continue an item that was incorrectly recognised as PPE under previous GAAP.

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## 7. Conclusion

Paragraph D7AA of Ind AS 101 provides significant practical relief by allowing the previous GAAP carrying amount of PPE to serve as deemed cost. However, the exemption should not be viewed as an unrestricted mechanism to preserve every amount appearing under PPE in the previous GAAP financial statements.

The case studies demonstrate that the exemption has defined boundaries. An entity cannot selectively combine the previous GAAP carrying amount with fair value as deemed cost merely according to its preference. Similarly, an amount forming part of the previous GAAP carrying amount, such as a processing fee capitalised to PPE or a government grant deducted from PPE, cannot ordinarily be adjusted merely to align the historical PPE balance with the accounting treatment that would otherwise be required under Ind AS.

At the same time, Paragraph D7AA does not prevent the application of other Ind AS requirements to related balances. For example, while the processing fee may remain embedded in the PPE carrying amount, it must still be appropriately considered in determining the amortised cost of the related borrowing under Ind AS 109. Likewise, the exemption cannot be relied upon to preserve an asset that was incorrectly recognised under previous GAAP.

Thus, the key principle emerging from these cases is that the deemed cost exemption provides relief from retrospective measurement, but it does not provide immunity from the recognition and other transition requirements of Ind AS 101. A first-time adopter must therefore distinguish between a genuine previous GAAP carrying amount that is eligible to become deemed cost and an amount that requires correction because of an error, a separate Ind AS measurement requirement, or another specific transition provision.

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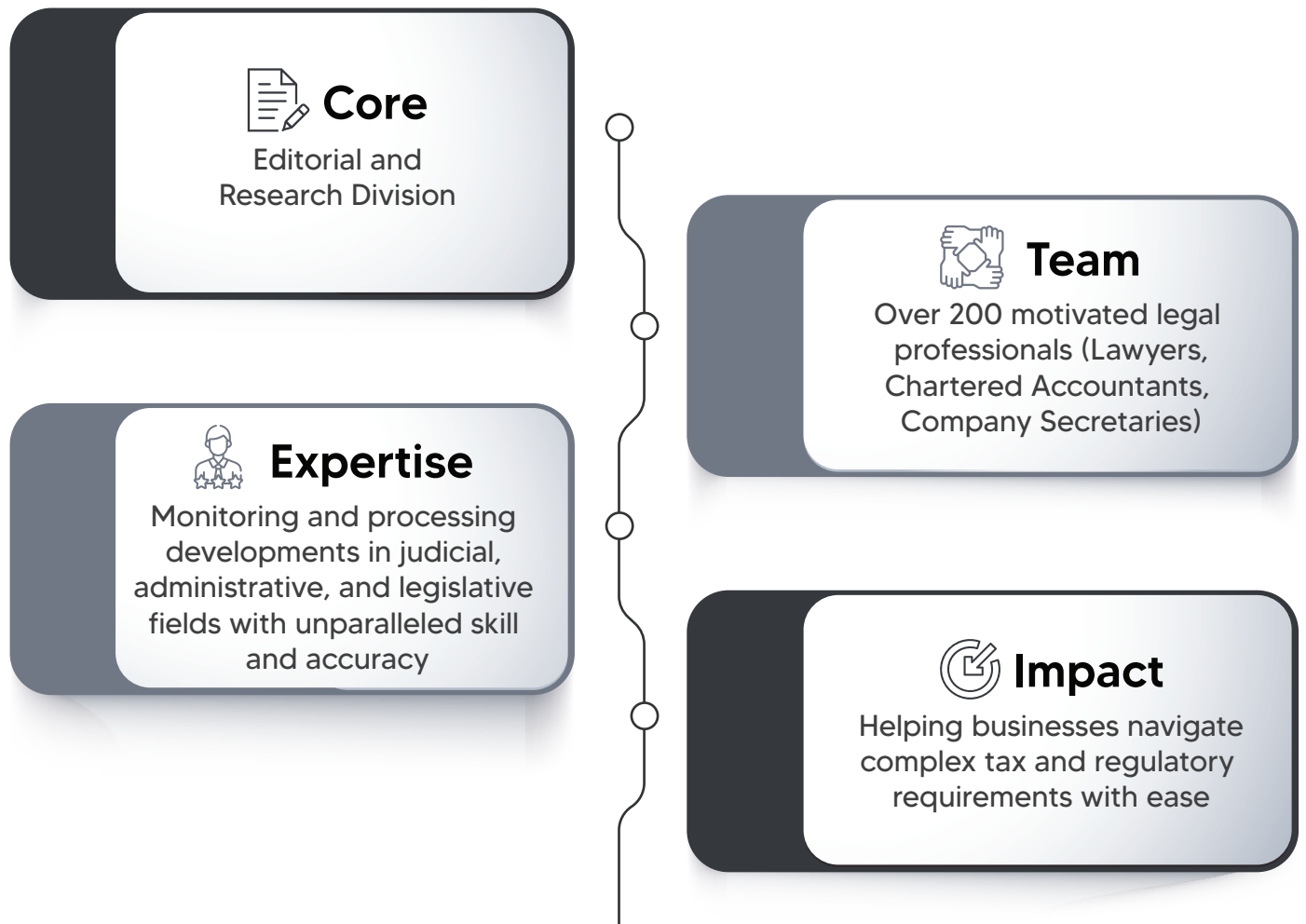
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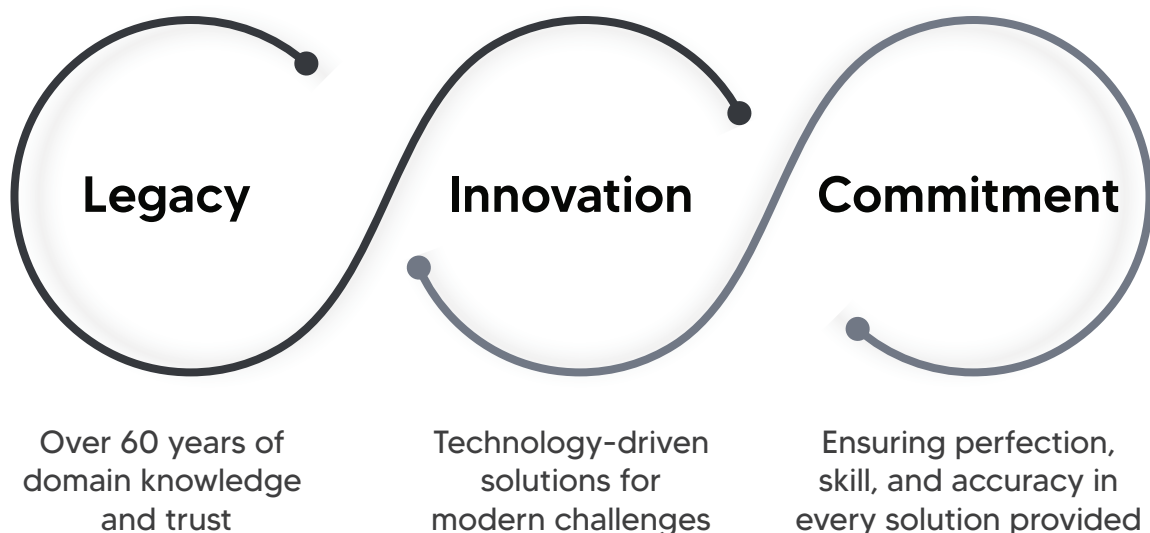
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