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An overview of key accounting implications arising from recent amendments in the Income-tax Act

The recently enacted *Finance Act (No. 2), 2024* (the Finance Act 2024) has made certain key amendments in the *Income-tax Act, 1961*, as applicable to companies. These amendments include (i) abolition of the concept of acquisition cost indexation of specified capital assets to compute long-term capital gain (LTCG) arising on transfer of the asset, and (ii) shifting the incidence of taxation on buyback of shares from the issuer company to the holder of shares. Among other implications, these amendments need to be carefully evaluated with regard to current and deferred tax accounting. In this article, we analyze key potential accounting implications of these two amendments.

Abolition of the concept of indexation of cost of acquisition of specified capital assets

Except for transition relief to specified non-corporate assessees for "grandfathered" immovable property acquired before 23 July 2024, the *Finance Act 2024* has removed the concept of acquisition cost indexation whilst computing long-term capital gains arising on transfer of a long-term capital asset (i.e., capital asset transferred after meeting prescribed holding period criteria). With this change, *the Finance Act 2024* has also made changes in the holding period for assets to be classified as long-term capital asset and also tax rate applicable on the long-term capital gains. Given below is the broad summary of key changes as applicable to companies.

Taxability of long-term capital gains in few categories of capital assets which are likely to impact a broad range of Indian companies:

Capital asset	Pre-amendment			Post-amendment		
	Holding period	Indexation allowed	Applicable tax rate	Holding period	Indexation allowed	Applicable tax rate
Immovable Property	>24 Months	Yes (except on depreciable assets)	20%	> 24 Months	No	12.5%
Bullion, jewelry, etc.	> 36 Months	Yes	20%	> 24 Months	No	12.5%
Unlisted Shares	> 24 Months	Yes	20%	> 24 Months	No	12.5%
Listed bonds and debentures	> 36 Months	No	20%	> 24 Months	No	12.5%
Equity oriented mutual fund (Sec. 112A)	> 12 Months	No	10% above 1 lakh LTCG	> 12 Months	No	12.5% above 1.25 lakh LTCG
REIT/Invit Units	> 36 Months	No	10% above 1 lakh LTCG	> 24 Months	No	12.5% above 1.25 lakh LTCG
Mutual Fund (other than equity oriented and specified Mutual Funds) (Sec.112)	> 36 Months	Yes	20%	> 24 Months	No	12.5%
Specified Mutual Fund (Sec.50AA) (Listed and unlisted) (Purchased on or after 1 April 2023)	NA	No	Deemed as STCG	NA	No	Deemed as STCG

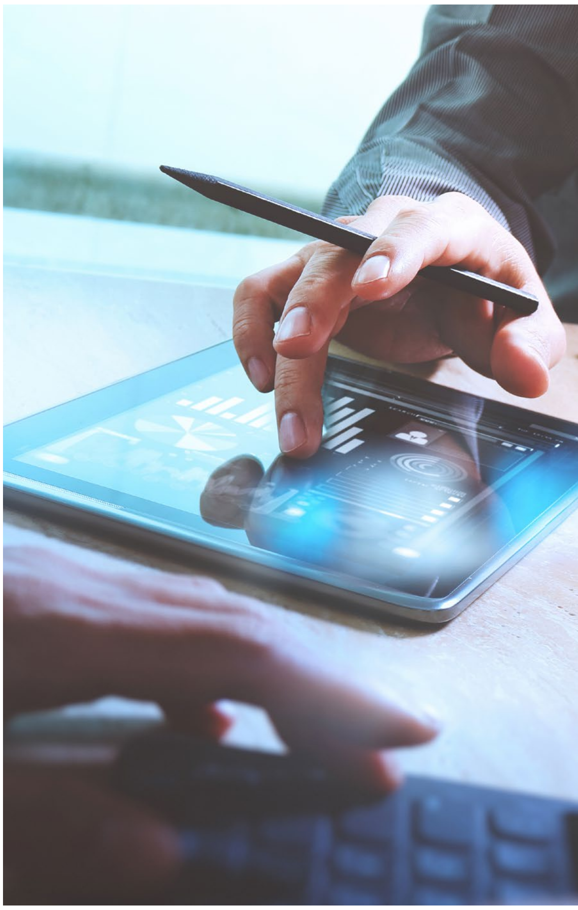
Capital asset	Pre-amendment			Post-amendment		
	Holding period	Indexation allowed	Applicable tax rate	Holding period	Indexation allowed	Applicable tax rate
Market linked debentures	NA	No	Deemed as STCG	NA	No	Deemed as STCG
Unlisted bonds and debentures	> 36 Months	No	20%	NA	No	Deemed as STCG

These amendments are applicable to all transfer of capital assets taking place on or after 23 July 2024.

Under Indian Accounting Standard (Ind AS) 12 *Income Taxes*, the indexed cost of acquisition, if allowed under the applicable Income-tax Act, was considered as tax base of the asset to determine resultant deferred tax asset/ liability arising on the asset concerned. Obviously, the deferred tax asset, if any, arising on the asset is recognized only to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized. The removal of indexation benefit along with other changes will impact the determination of tax base of the asset concerned and deferred tax asset/ liability to be recognized (assuming, probability criterion is met to recognize deferred tax asset, if any).

This can be explained with below example:

Nature of investment	Debt mutual funds
Accounting policy	Fair value through profit and loss
Date/ year of acquisition	2020
Cost of acquisition	49.50 crore
Transaction cost	0.50 crore
Total acquisition cost	50.00 crore
Index of the year of acquisition	301
Current index	363
Indexed cost of acquisition	60.30 crore
Current fair value	80.00 crore
Pre-amendment	
Current carrying amount(fair value)	80.00 crore
Indexed cost of acquisition (Tax base)	60.30 crore
Taxable temporary difference	19.70 crore
Tax rate	20%
Deferred tax liability	3.94 crore
Post-amendment	
Current carrying amount- (fair value)	80.00 crore
Actual cost of acquisition (Tax base)	50.00 crore
Taxable temporary difference	30.00 crore
Tax rate	12.5%
Deferred tax liability	3.75 crore



Besides mutual fund investments, such an impact can arise in many other cases as well. Consider that a company purchased a land several years ago. For financial reporting purposes, it is determined that the cost of the land at initial recognition is 50.00 crore and the same amount was its cost of acquisition for income tax purposes. Assuming that company has not intended to sale its land through slump sale route, prior to the amendment, under the Income-tax Act, assuming long-term capital gain arising from transfer of land will be determined basis its indexed cost of acquisition. For simplicity, it is assumed that the indexed cost of acquisition of the land as of 31 March 2024 was 85.00 crore and it is also assumed that the applicable long-term capital gains tax rate for the year ended 31 March 2024 was 20%. For financial reporting purposes, the Company was measuring land at cost using the cost model as prescribed under Ind AS 16, *Property, Plant and Equipment*. In accordance with Ind AS 12, there was a deductible temporary difference of 35.00 crore between the carrying amount (Original Cost) and its tax base (indexed cost) as of 31 March 2024. Assuming Ind AS 12 criterion for recognition of DTA was met, the Company had recognized deferred tax asset (DTA) of 7.00 crore [deductible temporary difference of 35.00 crore multiplied by applicable tax rate of 20%] as at 31 March 2024. Upon enactment of the *Finance Act 2024* in August 2024, this deductible temporary difference ceases to exist since the indexed cost of acquisition is no longer allowed.

It is obvious that the above changes will require companies to revisit previously recognized deferred tax asset/ liabilities, if any. The application of this requirement results in certain key questions. The relevant questions and our perspective thereon are given below.

Whether changes in deferred tax asset/liability should be recognized in the financial statements for the year ended 31 March 2024 or financial results for the quarter ended 30 June 2024 issued after the enactment of the Finance Act, 2024 on 16 August 2024?

The following points may also be noted in this regard:

- In accordance with Ind AS 12, deferred tax is measured by reference to the tax rates and laws, as enacted or substantively enacted by the end of the reporting period. [Paragraph 47 of Ind AS 12].
- In accordance with Ind AS 10 *Events after the Reporting Period*, changes enacted after the end of the reporting period are ignored for measurement purposes and the effect is disclosed as a non-adjusting event [Paragraph 10.22 (h) of Ind AS 10].

  In the instant case, the Union Budget 2024 was presented in the Lok Sabha in July 2024 and enacted on 16 August 2024. Hence, the *Finance Act 2024* did not represent a tax law that was enacted or substantively enacted by the end of the reporting period, i.e., by 31 March 2024 or by 30 June 2024. Hence, the financial statements for the year ended 31 March 2024 or financial results for the quarter ended 30 June 2024 will not be adjusted to reflect the effect of the change brought out by the Finance Act, 2024. This would be the case even if the approval of these financial statements/ results took place after the enactment of *Finance Act 2024*. This is because Ind AS 12 requires the measurement of tax assets and tax liabilities (whether current or deferred) to be based on tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period. However, depending on materiality evaluation, companies will need to disclose the change and its impact as a non-adjusting event in the financial statements for the year ended 31 March 2024 and/ or financial results for the quarter ended 30 June 2024 issued after the enactment of the Finance Act, 2024.

  In respect of financial statements/ results for period ending after the enactment of the Finance Act, the changes are actually enacted and will need to be applied.

Whether changes in deferred tax asset/ liability arising from the Finance Act 2024 will be recognized through the statement of profit and loss? Alternatively, can they be recognized through the Other Comprehensive Income (OCI) or directly in equity?

Paragraph 60 of Ind AS 12 provides as below:

> "60. The carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences. This can result, for example, from:
>
> a) a change in tax rates or tax laws
>
> b) a reassessment of the recoverability of deferred tax assets
>
> c) a change in the expected manner of recovery of an asset
>
> The resulting deferred tax is recognized in profit or loss, except to the extent that it relates to items previously recognized outside profit or loss."

Hence, it is clear that changes in deferred tax asset/ liability will be recognized in the statement of profit and loss, unless the changes relate to items previously recognized in OCI or directly in equity. If this is the case, then only changes in deferred tax asset/ liability will be recognized in OCI or directly in equity.

Many companies impacted by the change may be required to or otherwise preparing and presenting financial information more frequently than on an annual basis. For example, listed companies report their financial results every quarter. For companies preparing and presenting interim financial report and having 31 March year-end, the Finance Act 2024 represents a tax law enacted/ substantively enacted during the second quarter of the current financial year. Are such companies required to adjust the impact of the change entirely in the quarter ended 30 September 2024 or they can spread the impact over the remaining quarters of the current financial year using the effective tax rate?

Paragraphs 29 and 30(c) of Ind AS 34, *Interim Financial Reporting*, provide as below:

"29. Requiring that an entity apply the same accounting policies in its interim financial statements as in its annual statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an entity's reporting shall not affect the measurement of its annual results, paragraph 28 acknowledges that an interim period is a part of a larger financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognizing assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.

30. To illustrate:

(c) income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes."

Taxation is one of the most difficult areas of interim financial reporting, primarily because Ind AS 34 does not clearly distinguish between current income tax and deferred tax, referring only to 'income tax expense'. This causes tension between the approach for determining the expense and the asset or liability in the balance sheet. In addition, the standard's provisions combine terminology, suggesting an integral approach to measurement with guidance requiring a year-to-date basis to be applied in respect to recognition. Overall, the integral method appears to be the basis used in determining the effective income tax rate for the whole year, but that rate is applied to year-to-date profit in the interim financial statements. In addition, under a year-to-date basis, the estimated rate is based on tax rates and laws that are enacted or substantively enacted by the end of the interim period. Changes in legislation expected to occur before the end of the current year are not recognized in preparing the interim financial report. The assets and liabilities in the balance sheet, at least for deferred taxes, are derived solely from a year-to-date approach. Hence, overall, it appears reasonable that at each quarter-end, the Company will calculate effective income tax rate for the whole-year using tax rates and tax laws that are substantively enacted by the period-end and apply such rates to the relevant year-to-date profit to determine income tax expense/ income for the period.

While Ind AS 34 does not provide further guidance on determination of weighted average annual income tax rate, we believe that the following guidance provided in illustrative examples of IAS 34, *Interim Financial Reporting*, is relevant under Ind AS 34 too:

"To the extent practicable, a separate estimated average annual effective income tax rate is determined for each taxing jurisdiction and applied individually to the interim period pre-tax income of each jurisdiction. ***Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable, a separate rate is applied to each individual category of interim period pre-tax income.*** While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across jurisdictions or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates."

IAS 34 also provides that for interim financial reporting, the tax effect of 'one-off' items are recognized in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Since the change impacts only the amount taxable under the head capital gains, a company, while presenting financial results/ statements for the quarter ended 30 September 2024, will need to calculate separate effective income tax rate for the whole-year as applicable to the capital gains using tax rates and tax laws that are substantively enacted by the period-end, i.e., till 30 September 2024. It will then apply such a rate to the year-to-date profit taxable under the head capital gains to determine income tax expense/ income for the period. In our view, given the specific guidance, it is not acceptable to calculate overall effective tax rate for the Company and apply such rate to total income of the Company, including income taxable under the head "profits and gains from business or profession,' unless the Company can clearly demonstrate that the results of both the approaches give similar results.

In certain situation, considering the irregular nature of income taxable under the head capital gains, it may not be practical for a company to estimate separate effective income tax rate for the whole-year as applicable to the capital gains. For example, this may be the case where a company has not generated income taxable under the head capital gain nor it is anticipating sale of capital asset in the near future, resulting in gains taxable under the head Capital Gains. In such cases, it may be appropriate to recognize the impact of the change entirely in the quarter ended 30 September 2024.

Taxation of buyback of shares under section 68 of the Companies Act 2013

The Finance Act 2024 has also made significant changes to taxation of buy back of shares made by a company under section 68 of the Companies Act 2013 (as amended) (hereinafter referred to as 'buyback' or 'buyback of shares'). The amended taxation provisions apply to any buyback of shares that takes place on or after 1 October 2024.

Pre-amendment, in the case of a buyback, income tax was levied on the (domestic) company effecting the buyback ('the issuer company') under section 115QA of the Income-tax Act 1961. Income chargeable to tax for this purpose meant "the amount of distributed income by the company on buy-back of shares from a shareholder," i.e., the consideration paid by the company on buy-back of shares as reduced by the amount, which was received by the company for issue of such shares. In the hands of a shareholder whose shares were bought back, any income arising to the shareholder on account of the buyback was exempt from tax under section 10(34A) of the Act.

The 2024 amendments shift the incidence of taxation on buyback of shares from the company, affecting the buyback to the shareholders. As per the amendments:

- The total amount received by a shareholder pursuant to such a buyback would be taxable as dividend income under section 2(22) of the Income-tax Act (as amended). It is important to note that the entire proceeds – not just the excess of proceeds over cost of acquisition of the relevant shares – will be taxed as dividend income.
- The cost of acquisition of the bought back shares would be regarded as a capital loss in the hands of the shareholder. Such capital loss would be allowed to be set off and/ or carried forward in accordance with the provisions of the Income-tax Act.
- Buyback of shares that takes place on or after 1 October 2024 will no longer be taxable in the hands of the Company affecting the buyback.
- Consequential amendments have also been made in section 194 of the Act to bring distribution on the buyback under the ambit of dividend for the purpose of deduction of tax at source by the issuer company.

From the shareholder perspective, the application of the above amendment implies that whilst they will need to pay tax on buyback amount as soon as buyback is affected. However, the realization of capital loss will be subject to availability of appropriate capital gains against which such loss can be offset. If a Company has no convincing evidence on availability of capital gain to offset losses, it may not be able to recognize deferred tax asset on the carry forward of capital losses. This raises an interesting question whether the Company should upfront be required to create deferred tax liability regarding tax payable on potential buyback of shares while ignoring recognition of deferred tax asset for carry forward of losses? Should such treatment be given for all investment holdings? In our view, the following key points need to be considered to arriving at an appropriate view:

a) The buyback of shares is generally uncertain, and shareholders may have no visibility whether the Issuer Company will go for buyback of shares in the foreseeable future till any firm announcement is made by the Issuer Company? Also, timing of buyback may be uncertain.

b) Buyback of shares under section 68 of the Companies Act 2013 (as amended) is generally optional for the shareholders. The Company affecting such buyback normally make an offer for buyback and it is up to the shareholders to decide whether they want to offer such shares under the buyback. Thus, buyback is at the option of the concerned shareholder.

c) The issue stated above related to mismatch, i.e., amount received being taxable as dividend income and cost of acquisition being treated as capital loss, arises only in case of buyback of shares. However, in case of sale of shares, the consideration received on sale net of the cost of acquisition is taxable under the head capital gains.

d) Ind AS 12.24 generally prohibits recognition of deferred tax asset or liability on differences arising from initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit. However, such prohibition (commonly known as 'initial recognition exception') does not apply to the transaction, which give rise to equal taxable and deductible temporary differences. Albeit under different heads, consideration received is taxable and cost is allowed as deduction under the Income-tax Act. Hence, in our view, initial recognition exception will not apply in such cases and a Company cannot avoid deferred tax accounting basis this argument.

e) Considering alternates possible with regard to realization, attention is invited to below requirements of Ind AS 12:

"51. **The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.**

"51A. In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability), and

b) the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement."

Hence, we believe that to decide appropriate accounting, a Company will need to assess whether it expects to realize its investments or a portion thereof through buyback or sale. Considering uncertainties, companies holding shares in many cases may not be able to demonstrate realization through buyback till there is clear indication of buyback plan from the Issuer Company. If this is the case or the Company is not intending to offer the shares under buyback, then intended manner of realization is through sale. In such case, there is no need for recognizing separate deferred tax liability on consideration received/ receivable and deferred tax asset for capital loss. Rather, the Company will compare carrying amount of the investment with its tax base and decide recognition of deferred tax asset/ liability on differential amount as per the requirements of Ind AS 12.

However, in cases where the company holding shares has a clear indication of buyback plan from the issuer company and it intends to offer the shares under buyback, then intended manner of realization is through buyback. in such a case, deferred tax liability and asset recognition will be based on buyback being the intended manner of realization to the extent the company expects its investment to be realised through buyback route. particularly, this will require the company to recognize separate deferred tax liability on related carrying amount of the concerned investment, assuming it will be realized through buyback by the issuer company and the company will pay tax on dividend income. Separately, the holder company will have capital loss equal to cost of the investment and it will evaluate whether it can recognize deferred tax asset on the same as per the requirements of Ind AS 12. In most cases, both the impacts will be recognized in the statement of profit and loss as the impact is arising due to change in expected manner of realization.

Ind AS 117 *Insurance Contracts* – a standard that affects more than just insurers

The Ministry of Corporate Affairs (MCA) had earlier notified Ind AS 117, *Insurance Contracts,* vide notification dated 12 August 2024. Ind AS 117 superseded interim insurance standard Ind AS 104 *Insurance Contracts* and was effective for annual reporting periods beginning on or after 1 April 2024. Whilst the MCA had notified Ind AS 117, the roadmap for applicability of Ind AS to insurance companies was not notified. This would have effectively required insurance companies to prepare their own financial statements as per legacy Indian GAAP; however, they would have also separately required to prepare another set of financial statements as per Ind AS for providing to their parent, investor, or venturer, if any, for preparation consolidated financial statements by the parent/ investor/ venturer.

Subsequently, the MCA notified the Companies (Indian Accounting Standards) Third Amendment Rules, 2024 ('relief amendment'), to address challenges that were expected to be faced by the insurers/ insurance companies in complying with the complex reporting requirements. As per the notification, the insurers or insurance companies may provide their financial statements prepared in accordance with Ind AS 104 to their parent, investor, or venturer for preparation consolidated financial statements by the parent/ investor/ venturer, until the Insurance Regulatory and Development Authority notifies Ind AS 117. Additionally, Ind AS 104 has been reissued for use by the insurers or insurance companies.

This amendment enumerates the following principles:

- This relief is provided only to insurers or insurance companies for preparing the consolidation reporting package.
- The relief offers the option to prepare the consolidation package using Ind AS 104.
- Apparently, no relief has been provided to the non-insurance companies and they may need to apply Ind AS 117 to the extent relevant immediately.

Accordingly, non-insurance companies presenting quarterly financial information will need to adopt Ind AS 117 during the quarter ended 30 September 2024. Companies impacted by Ind AS 117 and presenting only annual financial statements will adopt Ind AS 117 while presenting financial statements for the year ended 31 March 2025.

In this Article, we look at key impacts of Ind AS 117 adoption that are likely to arise for non-insurance companies.

Relevance of Ind AS 117 for non-insurance entities

Ind AS 117 deals with accounting for insurance contracts and not just insurance companies. Hence, any entity which enters into contracts meeting definition of 'insurance contract' under the standard is likely to be impacted. These entities may no longer be permitted to apply previous accounting practices, such as Ind AS 115 *Revenue from Contracts with Customers* or Ind AS 109 *Financial Instruments,* unless a specific exemption from Ind AS 117 is available. Particularly, entities issuing contracts, such as extended warranties, product breakdown contracts and fixed fee service contracts, should carefully analyze the terms of their contracts to determine whether they are likely to be impacted by Ind AS 117. This is particularly for the reason that unlike its predecessor Ind AS 104, Ind AS 117 does not provide entities an option to their existing accounting policies for arrangements meeting the definition of the term 'insurance contract.'

Ind AS 117 focuses on accounting for insurance contracts and not just insurance entities. Entities issuing contracts such as extended warranties, product breakdown contracts and fixed fee service contracts, should carefully analyze terms of their contracts to determine whether they are likely to be impacted. Unlike Ind AS 104, Ind AS 117 does not provide entities an option to their existing accounting policies for arrangements meeting definition of the term 'insurance contract.'

Definition of insurance contract

Ind AS 117 defines the term 'insurance contract' as a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. Hence, the definition focuses on transfer of **significant insurance risk** arising due to **uncertain future event** from the policyholder to the issuer. The term 'insurance risk' is defined as the risk, other than financial risk, transferred from the holder of a contract to the issuer.

Uncertain future event (the insured event)

Uncertainty (or risk) is the essence of an insurance contract. Accordingly, Ind AS 117 requires at least one of the following to be uncertain at the inception of an insurance contract:

a) The probability of an insured event occurring

b) When the insured event will occur, or

c) How much the entity will need to pay if the insured event occurs.

An insured event will be one of the following:

- The discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract
- A loss that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term, or
- The determination of the ultimate cost of a claim which has already occurred but whose financial effect is uncertain.

A policyholder is adversely affected when they suffer a loss due to an insured event. Contracts that pay out regardless of loss, such as gambling contracts, do not qualify as insurance contract.

An insurance contract must involve an uncertain event specific to the policyholder. Contracts like weather derivatives, which pay out based on general events not unique to the holder, do not qualify as insurance contract.

The compensation to the policyholder can be in cash or in kind. Payment in kind refers to compensation through goods or services rather than cash. For example, when the entity replaces a stolen good instead of reimbursing the policyholder in cash for its loss, constitutes a payment in kind.

Meaning of insurance risk

For a contract to qualify as insurance under Ind AS 117, it must transfer significant insurance risk. Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (i.e., probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.

No quantitative guidance supports the determination of 'significant' in Ind AS 117. The lack of a quantitative definition of significant insurance risk means that insurers must apply their own judgement as to what constitutes significant insurance risk.

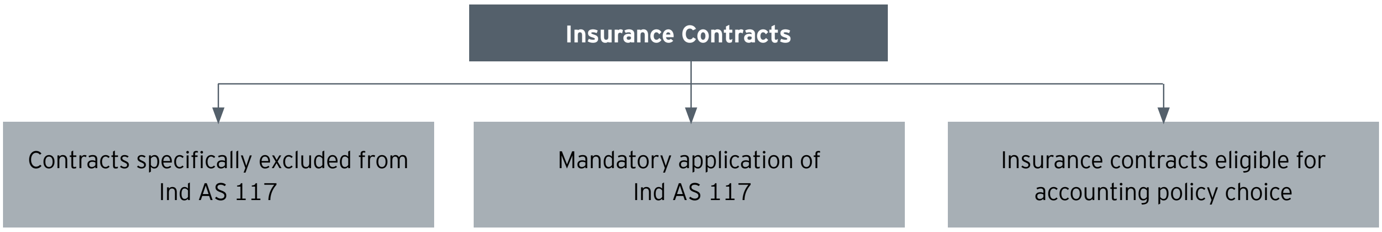
Ind AS 117 defines insurance risk as any risk, excluding financial risk, transferred from the policyholder to the issuer. It is important to make a distinction between non-financial risk and financial risk because this affects the measurement and presentation of insurance contracts. According to Ind AS 117, financial risk is the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. For example, exposure to an index of regional earthquake losses is a financial risk, while the risk of an earthquake affecting a specific property is an insurance risk. Given below are some more examples of arrangements that are designed to address the impact of non-financial risks:

- Life and general insurance policies
- Warranty arrangements
- Residual value guarantee contracts
- Rent guarantees
- Financial guarantee contracts
- Performance bonds/ guarantees
- Contingent consideration agreed in a business combination
- Services performed at a fixed fee
- Indemnity issued by a vendor in a sale of its business
- Loans or mortgages issued with a waiver for death or job loss
- Guarantees of minimum profit
- Contracts that guarantee minimum output (e.g., electricity generation by a solar plant

Non-financial risk becomes insurance risk when one party accepts this risk from a counterparty. For example, when a manufacturer provides warranties for goods it sells to customers, it is effectively accepting the insurance risk that the product may be defective by promising to compensate or make good with the customer.

Scope of Ind AS 117

While Ind AS 117 has a very wide definition of the term 'insurance contract,' it does not apply to all contracts meeting such a definition. Rather, Ind AS 117 provides certain scope exclusions where entities are prohibited from applying Ind AS 117 and, in certain other cases, it allows entities an option to apply Ind AS 117 or other Ind AS. Insurance contracts can generally be categorized into the following three groups:



Contracts specifically excluded from Ind AS 117

Ind AS 117 excludes the following transactions from its scope that may meet the definition of insurance contracts:

#	Scope exclusion	Applicable Ind AS	Remarks
1.	Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer	Ind AS 115 *Revenue from Contracts with Customers*	Scope exclusion is applicable to both Assurance type and service type warranties as defined under Ind As 115. However, warranties provided by third parties would fall within the scope of Ind AS 117.
2.	Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item	Ind AS 115, Ind AS 38 *Intangible Assets* and Ind AS 116 *Leases*	Examples include some licence fees, royalties, variable and other contingent lease payments and similar items
3.	Residual value guarantees provided by the manufacturer, dealer or retailer and lessees' residual value guarantees embedded in a lease	Ind AS 115 and Ind AS 116	Stand-alone residual value guarantees that transfer insurance risk is not addressed by other Ind AS and are within the scope of Ind AS 117.
4.	Contingent consideration in a business combination	Ind AS 103 *Business Combinations*	Contingent consideration in a business combination is required to be recognized at fair value at the acquisition date, with subsequent remeasurements of non-equity consideration included in profit or loss.
5.	Employers' assets and liabilities from employee benefit plans	Ind AS 19 *Employee Benefits* and Ind AS 102 *Share-based Payment*	
6.	Insurance contracts where the entity is the policyholder (unless these contracts are reinsurance contracts held)	Ind AS 109	Ind AS 37 may also be relevant.

Insurance contracts eligible for accounting policy choice

Ind AS 117 permits entities to apply either Ind AS 117 or another Ind ASs to certain contracts that meet the definition of an insurance contract. Examples of such contracts are given below:

Fixed fee service contracts

A fixed-fee service contract is one in which the level of service depends on an uncertain event but the fee does not. Examples include roadside assistance programs and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. Such contracts can meet the definition of an insurance contract because:

- It is uncertain whether, or when, assistance or a repair will be needed
- The owner is adversely affected by the occurrence, and
- The service provider compensates the owner if assistance or repair is needed

Although these contracts may meet the definition of insurance contracts, their primary purpose is to provide services for a fixed fee. Ind AS 117 permits entities a choice of applying Ind AS 115 instead of Ind As 117 to such contracts that it issues if, and only if, they meet specified conditions. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:

- The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer
- The contract compensates the customer by providing services, rather than by making cash payments to the customer, and
- Insurance risk transferred by the contract arises primarily from the customer's use of services, rather than from uncertainty over the cost of those services.

The accounting policy choice between applying Ind As 117 or Ind AS 115 applies only to fixed-fee service contracts. When an entity charges a fee which varies with the level of service provided (e.g., an elevator service contract that levies a fee per breakdown according to the work required), then the contract is unlikely to transfer significant insurance risk and it would be a service contract within the scope of Ind AS 115.

Examples of contracts likely to attract fixed fee service contracts of Ind AS 117

- Annual maintenance contract where a service provider agrees to repair specified equipment in the event of a malfunction.
- Car breakdown service contract where service provider offers roadside assistance or towing for a fixed annual fee, based on expected breakdowns across all cars at a portfolio level rather than the individual customer level.

The service provider can choose to account for such contracts as per Ind AS 115 or Ind AS 117.

Financial guarantee contracts (FG contracts)

A financial guarantee contract is defined as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. These contracts transfer credit risk and may have various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract.

Financial guarantee contracts are excluded from the scope of Ind AS 117 unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. If so, the issuer may elect to apply either Ind AS 117 or Ind AS 32, Ind AS 107 and Ind AS 109 to the financial guarantee contracts. The issuer may make that choice contract by contract, but the choice for each contract is irrevocable.

Ind AS 117 does not elaborate on the phrase 'previously asserted explicitly'. However, the application guidance to Ind As 109 suggests that assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications, contracts, and financial statements.

This accounting policy election is the same as that was available previously in Ind AS 104.

How we see it

In our view, on transition to Ind AS 117, an entity that has previously asserted explicitly that it regards financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts may reconsider its previous election regarding accounting for financial guarantee contracts made under Ind AS 104 and decide whether it would prefer to account for those contracts under Ind AS 117 or Ind AS 109. This is because there are no specific transition provisions either within Ind AS 117 or Ind AS 109 as to whether previous elections made under a different standard, i.e., Ind AS 104, should be continued. Hence, Ind AS 117 would not prevent an entity from making new elections on the application of Ind AS 117. However, an entity which had not previously asserted explicitly that it regards such contracts as insurance contracts or which had not previously used accounting applicable to insurance contracts (i.e., Ind AS 109 accounting was applied) may not reconsider its previous election (either implicitly or explicitly made).

Loan contracts that transfer significant insurance risk only on settlement of the policyholder's obligation created by the contract

Some contracts meet the definition of an insurance contract but limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract (for example, loans with death waivers). An entity may choose to apply either Ind AS 117 or Ind AS 109 to such contracts that it issues unless such contracts are excluded from the scope of Ind AS 117 under any of other scope exclusions. The entity must make that choice for each portfolio of insurance contracts, and the choice for each portfolio is irrevocable.

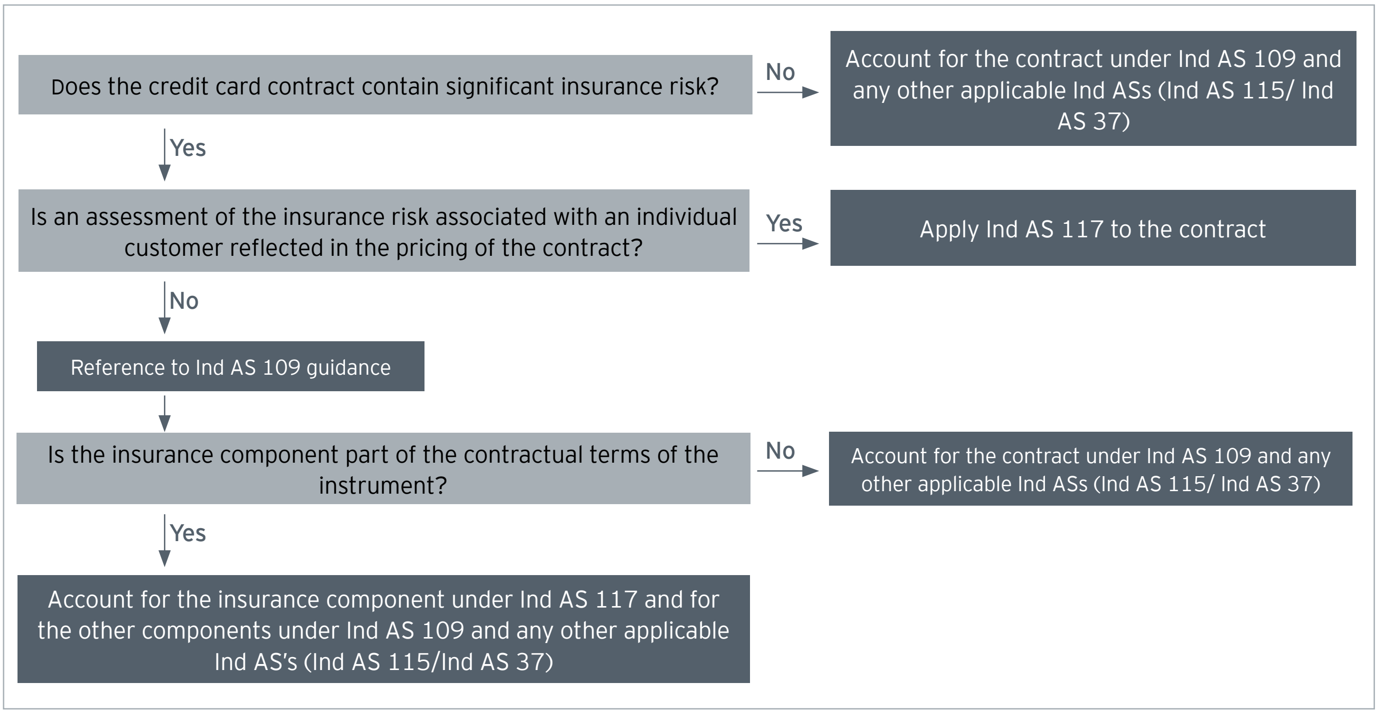
Examples of such contracts are:

- Mortgages loan when the outstanding balance of the mortgage is waived if the borrower dies.
- Lifetime mortgages (sometimes called equity release mortgages) where the entity's recourse is limited to the mortgaged property. If the property is sold for less than the mortgage balance (when the customer dies or moves into long-term care) then the loss is borne by the entity.
- Student loan contracts where repayments are income and/or life contingent and may not be made at all if the borrower's income never exceeds the repayment threshold or the borrower dies.
- A loan provided to a customer to buy a non-financial asset, which is repaid via low installments over the period of the loan with a final, higher 'balloon' payment at maturity. At maturity the customer can choose to return the non-financial asset to the entity instead of making the 'balloon' payment and the supplier is exposed to a loss if the value of the non-financial asset received is less than the 'balloon' amount. If the contract compensates the customer only for changes in market prices and not for changes in the condition of the customer's non-financial asset, then it would not provide insurance coverage and meet the definition of a derivative within the scope of Ind AS 109.

Credit card contracts (or similar contracts) that provide insurance coverage

Credit card contracts (or similar contracts that provide credit or payment arrangements) that provide services that meet the definition of an insurance contract are excluded from the scope of Ind AS 117 if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer. If excluded from Ind AS 117, these contracts would be within the scope of Ind AS 109 and other applicable standards. However, if, and only if, the insurance component is a contractual term of such a financial instrument (rather than, say, required by local legislation), Ind AS 109 requires an entity to separate and apply Ind AS 117 to that insurance component.

This can be illustrated by the diagram below:



An example of a credit card contract (or similar contract) that provides insurance coverage is one in which the entity:

- Must refund the customer for some claims against a supplier in respect of a misrepresentation or breach of the purchase agreement (for example, if the goods are defective or if the supplier fails to deliver the goods) if the supplier does not rectify it
- Is entitled to be indemnified by the supplier for any loss suffered in satisfying its liability with its customer.

The requirements in Ind AS 117 for credit cards or similar arrangements that provide insurance coverage will result in a different accounting treatment depending on the terms and conditions of the arrangement:

- Fully accounted under Ind AS 117: When insurance risk is assessed for individual customers in pricing
- Fully accounted under other standards: When insurance risk is not assessed for individual customers and insurance coverage is not a contractual term
- Mixed approach: When insurance coverage is a contractual term but not priced based on individual risk, then the insurance component separated and accounted for under Ind AS 117

Accounting for contracts covered under Ind AS 117

Once an arrangement is considered an insurance contract within the scope of Ind AS 117, then such contracts are grouped together for measurement when they share similar risk characteristics. There are three ways to measure such groups of insurance contracts – the General Model, the Premium Allocation Approach (PAA), and the Variable Fee Approach (VFA).

The three models have similar objectives in that they provide a mechanism to release the premium received as insurance revenue over the coverage period that the insurance service is provided to the counterparty. This results in a liability representing the compensation for promising to fulfill future claims and service costs and earn a profit margin (contractual service margin).

In addition, all three models require entities to separately recognize and provide for claims when incurred. This is then remeasured subsequently for changes in expectations of future cash outflows (claims, service costs, etc.).

The general model is the default model for accounting for insurance contracts, whereby the liability is constantly reassessed to reflect the experiences and current expectations of future claims. For contracts with a coverage period of one year or less, the PAA may be elected to simplify the accounting to allocate the premium over the coverage period on the basis of either the passage of time or the expected release from risk. When the coverage period is more than one year, if it is reasonably expected that the liability recognized under the PAA would be materially the same as the general model, then this simplified approach can be applied.

The VFA is a tailored version of the general model, which is to be applied to contracts with direct participation features. Direct participation features exist where the payout under the insurance contract is substantially linked to the return of an identified pool of underlying items (usually investments).

Each of these models can be complex and has its own detailed measurement and disclosure requirements.

Conclusion: A new beginning for some non-insurance entities

Non-insurance entities who have not previously applied insurance accounting are not necessarily exempt from applying insurance accounting in the future. The elimination of the unbundling feature of Ind AS 104, along with the stricter measurement requirements set out in Ind AS 117, may have a significant impact on the accounting of contracts that meet the definition of an insurance contract. Due to the complexity and time-consuming nature of applying Ind AS 117, non-insurance entities (if they have not already done so), must carefully evaluate this Standard to determine its applicability.

Where non-insurance entities conclude they have issued contracts within the scope of Ind AS 117, they will need to assess the adequacy of their information systems, relevant processes, personnel and governance to satisfy considerably more complex recognition and measurement procedures as well as the demanding presentation and disclosure requirements set out in the Standard.

While the relief amendment is a significant boon for insurance companies, it is imperative that these entities closely monitor regulatory developments and prepare for the eventual implementation of Ind AS 117. A proactive approach will not only ensure compliance but also position companies for sustained growth and stability in a competitive market environment.

An overview of amendments to Ind AS 116, impacting sale and leaseback accounting

On 9 September 2024, the Ministry of Corporate Affairs (MCA) notified amendment to Indian Accounting Standard (Ind AS) 116 *Leases* (the amendment). This amendment deals with subsequent accounting for a seller-lessee in respect of the sale leaseback transaction accounted for as a sale under Ind AS 115, *Revenue from Contracts with Customers*. The amendment specifies how a seller-lessee should measure lease liability arising in a sale and leaseback transaction so that the seller-lessee does not recognize any amount of the gain or loss that relates to the right of use it retains.

The amendment does not change accounting for leases unrelated to sale and leaseback transactions. Further, it does not include any new requirements for initial measurement of the right-of-use asset and lease liabilities arising from a sale-and-leaseback transaction.

The amendment applies to annual reporting periods beginning on or after 1 April 2024.

Background

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. In such transaction, the seller-lessee assesses whether the transfer of the asset satisfies the requirements in Ind AS 115 to be accounted for as a sale. If it is accounted for as a sale, Ind AS 116 requires the seller-lessee to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognizes only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

However, Ind AS 116 did not specify the measurement of the liability that arises in a sale and leaseback transaction. Hence, pre-amendment, a seller-lessee could have recognized a gain excluded from initial measurement of the right of use asset through remeasurement/ subsequent measurement of lease liabilities. This could have been particularly the case for leaseback transactions, which include variable lease payments that do not depend on an index or rate.

This has been addressed in the amendment.

Amendment to Ind AS 116

The amendment does not prescribe any new requirement for initial measurement of the right-of-use asset and lease liabilities arising from a sale-and-leaseback transaction. On initial recognition, the seller-lessee measures the right-of-use asset as a proportion of the carrying amount of the underlying asset and includes variable lease payments when it measures a liability arising from a sale-and-leaseback transaction.

The amendment prescribes that after the commencement date in a sale and leaseback transaction, the seller-lessee applies paragraphs 29 to 35 of Ind AS 116 to the right-of-use asset arising from the leaseback and paragraphs 36 to 46 of Ind AS 116 to the lease liability arising from the leaseback. In applying paragraphs 36 to 46, the seller-lessee determines 'lease payments' or 'revised lease payments' in such a way that the seller-lessee would not recognize any amount of the gain or loss that relates to the right of use retained by the seller-lessee. Applying these requirements does not prevent the seller-lessee from recognizing, in profit or loss, any gain or loss relating to the partial or full termination of a lease, as required by paragraph 46(a) of Ind AS 116.

The amendment does not prescribe specific measurement requirements for lease liabilities arising from a leaseback. However, it is clear that the initial measurement of the lease liability arising from a leaseback may result in a seller-lessee determining 'lease payments' that are different from the general definition of lease payments in Ind AS 116.

As part of the amendments, an Appendix D has been added to Ind AS 116 which contains two illustrative examples to illustrate the Sale and leaseback transaction with fixed payments and above-market term and the subsequent measurement of a right-of-use asset and lease liability in a sale and leaseback transaction with variable lease payments that do not depend on an index or rate. The second illustrative example clarifies two approaches a seller-lessee may adopt to determine subsequent lease payments. This will require the seller-lessee to develop and apply an accounting policy that results in information that is relevant and reliable in accordance with Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

The following new examples are included in Ind AS 116.

Example – Sale and leaseback transaction with fixed payments and above-market terms

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of INR2,000,000. Immediately before the transaction, the building is carried at a cost of INR1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of INR120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of Ind AS 115, Revenue from Contracts with Customers to be accounted for as a sale of the building. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback.

The fair value of the building at the date of sale is INR1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. Applying paragraph 101(b) of Ind AS 116, the amount of the excess sale price of INR200,000 (INR2,000,000 – INR1,800,000) is recognized as additional financing provided by Buyer-lessor to Seller-lessee.

The interest rate implicit in the lease is 4.5% per annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of INR120,000, discounted at 4.5% per annum) is INR1,459,200, of which INR200,000 relates to the additional financing and INR1,259,200 relates to the lease-corresponding to 18 annual payments of INR16,447 and INR103,553, respectively.

Buyer-lessor classifies the lease of the building as an operating lease.

Seller-lessee

Applying paragraph 100(a) of Ind AS 116, at the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, which is INR699,555. Seller-lessee calculates this amount as: INR1,000,000 (the carrying amount of the building) × INR1,259,200 (the discounted lease payments for the 18-year right-of-use asset) ÷ INR1,800,000 (the fair value of the building).

Seller-lessee recognizes only the amount of the gain that relates to the rights transferred to Buyer-lessor of INR240,355 calculated as follows. The gain on sale of the building amounts to INR800,000 (INR1,800,000 - INR1,000,000), of which:

a) INR559,645 (INR800,000 × INR1,259,200 ÷ INR1,800,000) relates to the right to use the building retained by Seller-lessee, and

b) INR240,355 (INR800,000 × (INR1,800,000 - INR1,259,200) ÷ INR1,800,000) relates to the rights transferred to Buyer-lessor.

At the commencement date, Seller-lessee accounts for the transaction as follows:

Debit cash	INR2,000,000	
Debit right-of-use asset	INR699,555	
Credit building		INR1,000,000
Credit lease liability		INR1,259,200
Credit financial liability		INR200,000
Credit gain on rights transferred		INR240,355

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Debit building	INR1,800,000	
Debit financial asset	INR200,000 (18 payments of INR16,447, discounted at 4.5 % per annum)	
Credit cash		INR2,000,000

After the commencement date, the buyer-lessor accounts for the lease by treating INR103,553 of the annual payments of INR120,000 as lease payments. The remaining INR16,447 of annual payments received from seller-lessee are accounted for as (a) payments received to settle the financial asset of INR200,000 and (b) interest revenue.

Second example illustrates a sale and leaseback transaction with variable lease payments that do not depend on an index or rate.

Example: subsequent measurement of a right-of-use asset and lease liability in a sale and leaseback transaction with variable lease payments that do not depend on an index or rate

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of INR1,800,000 (the fair value of the building at the date of sale). Immediately before the transaction, the building is carried at a cost of INR1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for five years. Lease payments – payable annually – comprise fixed payments and variable payments that do not depend on an index or rate.

The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of Ind AS 115 *Revenue from Contracts with Customers* to be accounted for as a sale of the building. Accordingly, Seller-lessee accounts for the transaction as a sale and leaseback.

The interest rate implicit in the lease cannot be readily determined. Seller-lessee's incremental borrowing rate is 3% per annum.

Under paragraph 100(a) of Ind AS 116, the seller-lessee determines 25% of the building transferred to the buyer-lessor pertains to the right of use it retains[1].

Consequently, at the commencement date Seller-lessee accounts for the transaction as follows.

Debit cash	INR1,800,000	
Debit right-of-use asset	(INR1,000,000 x 25%) INR250,000	
Credit building		INR1,000,000
Credit lease liability		INR450,000
Credit gain on rights transferred		((INR1,800,000 - INR1,000,000) x 75%) INR600,000

Seller-lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

In measuring the lease liability applying paragraphs 36-46 of Ind AS 116, Seller-lessee develops an accounting policy for determining 'lease payments' in a way that it would not recognize any amount of the gain that relates to the right of use it retains. Depending on the circumstances (including the method Seller-lessee used - applying paragraph 100(a) of Ind AS 116 - for determining the measurement of the right-of-use asset and the gain recognized on the transaction at the commencement date), either Approach 1 or Approach 2 could meet the requirements in paragraph 102A.

[1] Applying paragraph 100(a) of Ind AS 116, Seller-lessee determines the proportion of the building transferred to Buyer-lessor that relates to the right of use retained by comparing, at the commencement date, the right of use it retains via the leaseback to the rights comprising the entire building. Paragraph 100(a) does not prescribe a particular method for determining that proportion.

Approach 1: expected lease payments at the commencement date

Applying paragraph 102A of Ind AS 116, Seller-lessee determines 'lease payments' to reflect the expected lease payments at the commencement date that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at that date of INR450,000. The lease liability and the right-of-use asset arising from the leaseback are:

	Lease liability				Right-of-use asset		
Year	Beginning Balance	Lease payments [2]	3% interest expense [3]	Ending balance	Beginning Balance	Depreciation charge	Ending balance
	INR	INR	INR	INR	INR	INR	INR
1	450,000	(95,902)	13,500	367,598	250,000	(50,000)	200,000
2	367,598	(98,124)	11,028	280,502	200,000	(50,000)	150,000
3	280,502	(99,243)	8,415	189,674	150,000	(50,000)	100,000
4	189,674	(100,101)	5,690	95,263	100,000	(50,000)	50,000
5	95,263	(98,121)	2,858	0	50,000	(50,000)	0

In applying paragraph 102A and paragraph 38(b) of Ind AS 116, seller-lessee recognizes in profit or loss the difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability. For example, if seller-lessee pays INR99,321 for the use of the building in Year 2, it recognizes INR1,197 (INR99,321 – INR98,124) in profit or loss.

Approach 2: equal lease payments over the lease term

Applying paragraph 102A of Ind AS 116, Seller-lessee determines 'lease payments' to reflect equal periodic payments over the lease term that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at the commencement date of INR450,000.

The lease liability and the right-of-use asset arising from the leaseback are:

	Lease liability				Right-of-use asset		
Year	Beginning Balance	Lease payments [4]	3% interest expense	Ending balance	Beginning Balance	Depreciation charge	Ending balance
	INR	INR	INR	INR	INR	INR	INR
1	450,000	(98,260)	13,500	365,240	250,000	(50,000)	200,000
2	365,240	(98,260)	10,957	277,937	200,000	(50,000)	150,000
3	277,937	(98,260)	8,338	188,015	150,000	(50,000)	100,000
4	188,015	(98,260)	5,640	95,395	100,000	(50,000)	50,000
5	95,395	(98,260)	2,865	0	50,000	(50,000)	0

In applying paragraph 102A and paragraph 38(b) of Ind AS 116, seller-lessee recognizes in profit or loss the difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability. For example, if seller-lessee pays INR99,321 for the use of the building in Year 2, it recognizes INR1,061 (INR99,321 – INR98,260) in profit or loss.

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2. Applying paragraph 102A and paragraph 36(b) of Ind AS 116, Seller-lessee reduces the carrying amount of the lease liability with 'lease payments' that reflect the expected lease payments estimated at the commencement date and, when discounted, result in the carrying amount of the lease liability at that date of INR450,000.

3. Applying paragraph 102A and paragraph 36(a) of Ind AS 116, Seller-lessee increases the carrying amount of the lease liability to reflect interest on the lease liability using its incremental borrowing rate.

4. Applying paragraph 102A and paragraph 36(b) of Ind AS 116, Seller-lessee reduces the carrying amount of the lease liability with 'lease payments' that reflect equal periodic payments over the lease term that, when discounted, result in the carrying amount of the lease liability at the commencement date of INR450,000.

Effective date and transition

The amendment is effective for the annual reporting periods beginning on or after 1 April 2024.

A seller-lessee applies the amendment retrospectively in accordance with Ind AS 8 to sale and leaseback transactions entered into after the date of initial application of Ind AS 116. (i.e., the amendment does not apply to sale and leaseback transactions entered into prior to the date of initial application). The date of initial application is the beginning of the annual reporting period in which an entity first applied Ind AS 116 .

How we see it

The amendment may represent a significant change in accounting policy for entities that enter into sale and leaseback transactions with variable payments that do not depend on an index or rate. Entities will need to determine an accounting policy in accordance with Ind AS 8 for the 'lease payments' in these types of transaction.

IFRS 18 *Presentation and Disclosure in Financial Statements:* be ready for a major shake-up in presentation of financial statements

In April 2024, the International Accounting Standards Boards (IASB) published a new IFRS Accounting Standard, viz., IFRS 18 Presentation and Disclosure in Financial Statements. IFRS 18 marks the culmination of the IASB's Primary Financial Statements (PFS) project, running since 2014, whose objective was to improve communication in financial statements.

Once effective, IFRS 18 will replace IAS 1 and some requirements currently included within IAS 1 are moved to IAS 8 (which was also renamed as 'Basis of Preparation of Financial Statements') and to a much lesser, extent IFRS 7 Financial Instruments: Disclosures. There are also narrow scope consequential amendments made to other IFRS Accounting Standards including:

- IAS 7 statement of cash flows
- IAS 33 earnings per share
- IAS 34 interim financial reporting

IFRS 18 and the consequential amendments to other IFRS Accounting Standards are effective for periods beginning on or after 1 January 2027, with earlier application permitted.

While IFRS 18 represents a major overhaul of the requirements relating to presentation and disclosure of information in financial statements, many of the existing requirements in IAS 1 are carried forward. This is because the IASB has chosen to focus on targeted improvements designed to address the three key concerns expressed by users of financial statements (hereafter users), being:

- Financial statements, particularly the statement of profit or loss, are not sufficiently comparable across reporting entities
- The transparency and understandability of non-GAAP measures needs to be improved, and
- The level of disaggregation in financial statements does not always provide the information users need and material information can be obscured

New requirements in IFRS 18 are primarily intended to address these concerns. This Article deals with the key new requirements in IFRS 18 and key consequential amendments in other IFRS Accounting Standards that could impact the financial statements for most reporting entities.

What are the major changes?

The application of IFRS 18 will not impact recognition and measurement of items in the financial statements but it is expected to change how entities present and disclose their financial statements particularly the statement of profit and loss (also known as the 'income statement') IFRS 18 will affect the complete set of financial statements and the areas that are likely to be significantly affected include:

Part of financial statements	Key changes	Potential impact of change
Statement of profit or loss	▶ Classification of income and expenses in three new defined categories - operating, investing, and financing ▶ Two new required subtotals - operating profit and profit before financing and income taxes	High
Notes to the financial statements	Disclosure of management-defined performance measures (MPMs) in a single note	High
Both the primary financial statements and the notes	▶ Enhanced requirements for grouping of information (aggregation and disaggregation) ▶ Guidance on whether information should be in the primary financial statements or in the notes ▶ Disclosures about items labeled 'other'	Medium

Key changes are explained further below:

Presentation of new categorization and subtotals in the statement of profit and loss

Under the IAS 1, there is no requirement to classify income and expenses into different 'categories' and it allows but does not require sub-totals. Operating profit, one of the most frequently used measures of performance, has until now not been defined in IFRS Accounting Standards, which has resulted in entities applying different definitions to the same subtotal. This has resulted in significant diversity, which makes it difficult for users of the financial statements to understand the information presented in the statement of profit and loss and compare information between entities.

To address these challenges and enhance comparability, IFRS 18 requires an entity to classify all items of income and expenses into three new and defined categories, viz., operating, investing and financing. These three categories are complemented by the requirement to present subtotals and totals for 'operating profit or loss,' and 'profit or loss before financing and income taxes'.' The first subtotal is intended to give a relevant representation of an entity's operations, while the second is intended to allow users to analyze the performance of an entity before the effect of its financing decisions. These categories and subtotals ought to result in a more standardized statement of profit or loss.

Main business activities

For the purposes of classifying its income and expenses into the three new categories required by IFRS 18, an entity will need to assess whether it has a 'specified main business activity' of investing in assets or providing finance to customers, as specific classification requirements apply to such entities. Determining whether an entity has such a specified main business activity is a matter of fact and circumstances which requires judgement. An entity may have more than one main business activity.

An entity will be required to assess whether it has a 'specified main business activity' of investing in assets or providing finance to customers, as there are specific requirements for such entities.

The investing category

The investing category will generally include income and expenses from investments in associates, joint ventures and unconsolidated subsidiaries, cash and cash equivalents and other assets, if they generate a return individually and largely independent of the entity's other resources (IFRS 18 includes examples of such assets). To illustrate, for entities that do not have a specified main business activity of investing in assets or providing finance to customers, income and expenses in the investing category could include:

- Income generated by the assets mentioned above (for example, interest. dividends and rental income)
- Income and expenses that arise from the initial and subsequent measurement of those assets, including on derecognition of the assets (for example, impairment losses and reversals of impairment losses)
- Incremental expenses directly attributable to acquiring and disposing of those assets (for example, transaction costs and costs to sell)

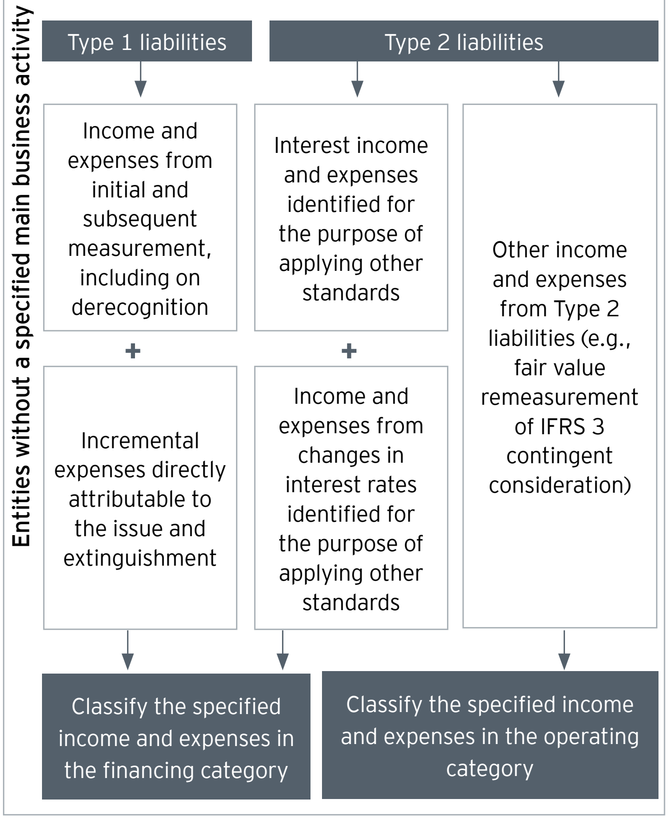
The financing category

In order to determine what income and expenses to classify in the financing category, IFRS 18 requires an entity to differentiate between two types of liabilities (which we have termed as 'Type 1' and 'Type 2' for brevity in this publication):

- **Type 1**: liabilities that arise from transactions that involve only the raising of finance (i.e., entity receives finance in the form of cash, own equity or the discharge of a liability and will return cash or its own equity in exchange at a later date)
- **Type 2**: other liabilities (i.e., liabilities other than Type 1 liabilities)

The following diagram summarizes the requirements for Type 1 and Type 2 liabilities:

Figure 1: Classification of income and expense in the financing category



For entities that do not provide financing to customers as a main business activity, the financing category includes income and expenses that arise from the initial and subsequent measurement of all Type 1 liabilities, as well as incremental expenses attributable to the issue and extinguishment of such liabilities. For example, interest expense on a debt instrument issued. There are separate requirements for entities that provide financing to customers as a main business activity, which is discussed in the 'Operating' section below.

Interest income and expenses, as well as the effect of interest rate changes that arise while applying another IFRS accounting standard to ·other liabilities' (i.e., Type 2 liabilities above), are recognized in the financing category. For example, the interest expenses recognized under IFRS 16 *Leases* on the accounting for lease liabilities.

The latter part of this requirement is important, as not all IFRS Accounting Standards require an entity to disaggregate income and expenses arising from changes in the carrying amount into separate amounts for interest income and expenses and other types of income and expenses - *IFRS 2 Share-based Payments is an example of such a standard*.

An entity would therefore recognize in the financing category the interest expenses on:

- Payables recognized under IFRS 9
- Contracts with a significant financing component, recognized under IFRS 15
- Revenue from Contracts with Customers
- Lease liabilities recognized under IFRS 16
- Net interest expense on a net defined benefit liability (or asset)
- Unwinding of a discount on a provision

Taking a long-term provision as an example, an entity could recognize three types of changes to the provisions:

1. Periodic unwinding of the discount
2. Effects of changes in the discount rate
3. Effects of changes in the best estimate of the expenditure required to settle the liability

Only the first two would be classified in the financing category, because they are financing in nature.

How we see it

Under IAS 1, practice is somewhat mixed with respect to the presentation of the different types of changes in provisions. Thus, the prescriptiveness of IFRS 18 will assist in comparability between entities.

For the avoidance of doubt, the standard outlines income and expenses that are not interest income or expenses arising as a result of applying IFRS Accounting Standards and that will therefore be classified in the operating category, for example:

- Expenses recognized for the consumption of purchased goods or services
- Current and past service costs from a defined benefit plan and
- Fair value remeasurements of a contingent consideration liability recognized by applying IFRS 3 Business Combinations

The operating category

The operating category is intended to capture income and expenses from the entity's main business activities. However, IFRS 18 describes it as a residual category, so the operating category will comprise all income and expenses not included within the other categories, even if such income and expenses are volatile and/or unusual.

This approach was intended to work for different business models, while still providing a complete picture of the entity's operations. By applying the residual approach, the operating category will include all income and expenses from an entity's main business activities and will also include other items that are not classified within any other category. However, any income or loss from investments accounted for using the equity method is to be included in the investing category, regardless of the specified main business activities of the entity.

If an entity has a specified main business activity of investing in assets, the income and expenses from those assets will be included in the operating category, e.g., real estate companies will need to present rental income in the operating category.

Entities with a specified main business activity of providing financing to customers will classify income and expenses from cash and cash equivalents that relate to providing financing to customers (for example, cash and cash equivalents held for related regulatory requirements) within the operating category. These entities will also need to determine which of their Type 1 liabilities (mentioned above) relate to providing financing to customers, since income and expenses arising from these liabilities must be included in the operating category. For income and expenses from Type 1 liabilities that do not relate to providing financing to customers, a policy choice is available to the entity to include these in either the operating or the financing categories. If an entity is unable to distinguish between these Type 1 liabilities, the income and expenses on all Type 1 liabilities will need to be included in the operating category.

Operating profit or loss subtotal

IFRS 18 specifies that an entity shall present a subtotal representing operating profit or loss, which comprises all income and expenses classified in the operating category. This has been introduced to provide useful information to users, to reduce diversity in reporting and to enhance comparability.

How we see it

Although many entities already present an operating profit or loss subtotal, it cannot be presumed that the classification of income and expenses to the operating category will not change. For example, many entities currently present 'share of the profit or loss of associates and joint ventures accounted for using the equity method' in the operating category, which is not permissible under IFRS 18.

Income taxes

An entity is required to classify in the income taxes category tax expense or tax income that are included in the statement of profit and loss applying IAS 12 Income Taxes and any related foreign exchange differences. The IASB has clarified that the presentation of income and expenses related to income tax in that category complies with the presentation requirements of IAS 12.

Discontinued operations

An entity is required to classify in the discontinued operations category income and expenses from discontinued operations as required by IFRS 5. The IASB has clarified that the presentation of income and expenses related to discontinued operations in that category complies with the presentation requirements of IFRS 5.

Presentation of specific items

The requirement to classify all income and expense into one of the five categories above can be difficult for items that might fit into more than one of these categories. Thus, IFRS 18 provides guidance for classifying some specific types of income and expense.

Foreign exchange differences

Foreign exchange differences are classified in the same category as the income and expenses from the items that gave rise to those differences. For example, foreign exchange differences on a trade receivable denominated in a foreign currency will be classified in the operating category, whereas foreign exchange differences arising from a debt instrument liability (that will be settled in cash) denominated in a foreign currency will be classified in the financing category. However, an entity is permitted to classify foreign exchange differences in the operating category if classifying them in the same category as the income and expenses from the items that gave rise to them would involve undue cost or effort.

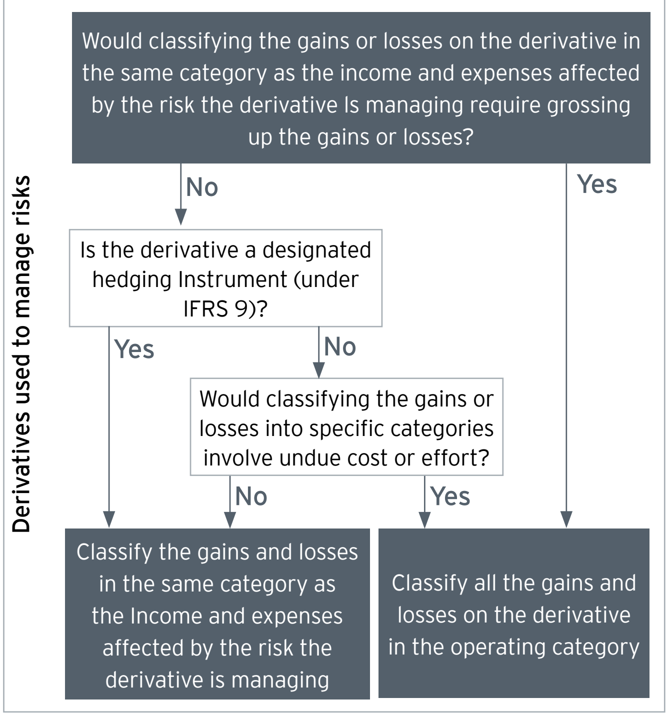
How we see it

The undue cost and effort exemption, resulting in the classification of particular foreign exchange differences in the operating category, is a pragmatic solution which could involve significant judgement.

Fair value gain or loss derivatives

The classification of fair value gains and losses on derivatives depends on whether the derivatives are used to manage exposure to identified risks and whether they are designated as hedging instruments. The following diagram, based on Figure 5 in the illustrative examples to IFRS 18, summarizes these requirements:

Figure 5: Classification of gains and losses on derivatives used to manage risks



The requirements for derivatives only specify the appropriate category for gains and losses arising on them; they do not override the requirements in other IFRS , nor do they specify the line item.

How we see it

Many entities already present the gains and losses on designated hedging instruments and on those instruments used to manage risk in the manner required by IFRS 18. However, the new prescriptive requirements will require entities who are not currently presenting this information in line with IFRS 18 to change the current practice.

Example of presentation of the statement of profit of loss

A simple illustration of IFRS 18 requirements is prescribed below for an entity without specified main business activities (i.e., the entity does not invest in assets or provide financing to customer as main business activity):

Statement of profit or loss*

Revenue	Operating
Cost of sales	
Gross profit	
Other operating income	
Selling expenses	
Research and development expenses	
General and administrative expenses	
Goodwill impairment loss	
Other operating expenses	
Operating profit	
Share of the profit from associates and joint ventures	Investing
Gain on disposal of associates and joint ventures	
Profit before financing and income tax	
Interest expenses on borrowing and lease liabilities	Financing
Interest expense on pension liabilities	
Profit before income tax	
Income tax expense	Income taxes
Profit from continuing operations	
Loss from discontinued operations	Discontinued operations
Profit for the year	

*Applicable to an entity that does not have a main business activity of investing in assets and/or providing financing to customers.

New items Required items

Disclosure of specified expense by nature

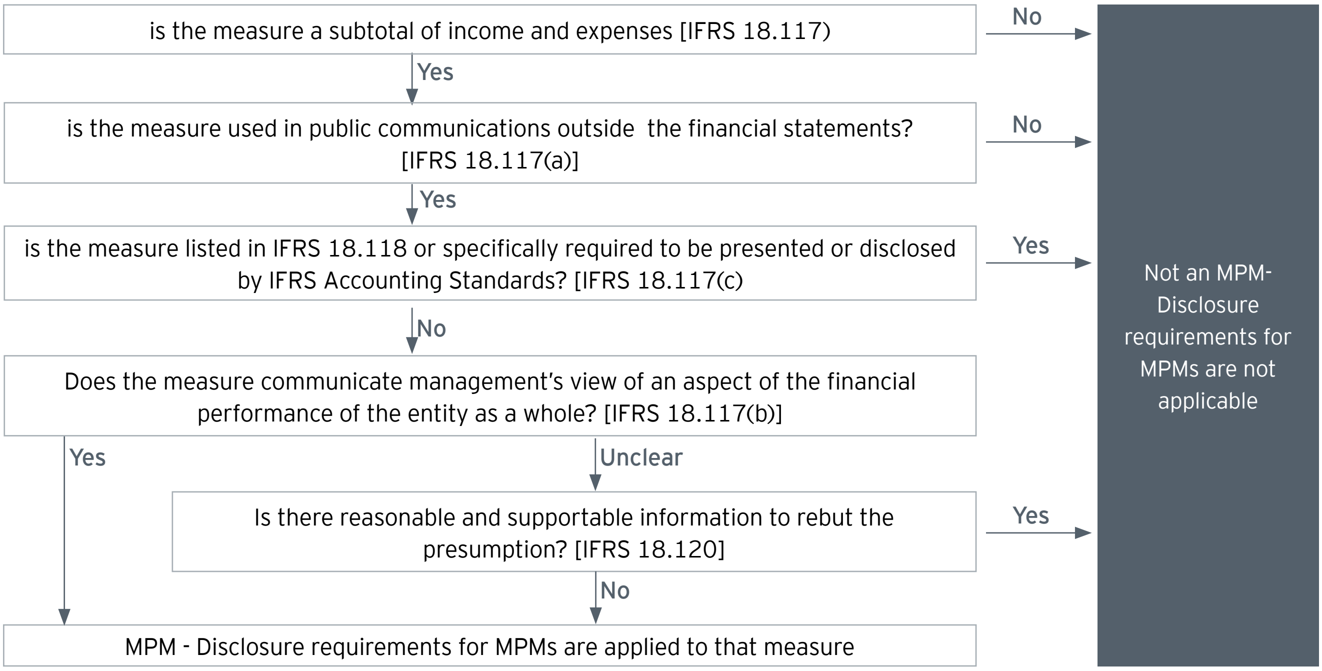
Expenses in the 'operating' category in the statement of profit or loss can be continued to be classified by nature (for example, salaries, depreciation, etc.) or by function (for example, administration, selling etc.), or both. Entities may choose a presentation method that provides the most useful information to users.

Management-defined performance measures ('MPMs')

Many entities currently use alternative performance measures to communicate management's view of an aspect of entity's performance. These may be included in press release, strategic report, management discussion and analysis, etc. IFRS 18 introduces the concept of MPMs and defines it as a subtotal of income and expenses that an entity uses in public communications outside financial statement. IFRS 18 has limited its scope to MPMs only. IFRS 18 explicitly notes that subtotals required by an IFRS Accounting Standard, including IFRS 18 itself, are not MPMs. IFRS 18.118 also lists some other subtotals that are not MPMs, e.g., "gross profit or loss (revenue minus cost of sales) and similar subtotals".

The following figure, based on Figure 6 in the Illustrative Examples to IFRS 18, provides an overview of how an entity identifies an MPM:

Figure 6: Identifying MPMs



There is a rebuttable presumption that a subtotal of income and expenses used in public communications communicates management's view.

IFRS 18 intentionally limits the definition of MPMs to subtotals of income and expenses. This intentionally narrow definition results in MPMs being a subset of other performance measures (e.g., alternative performance measures), as illustrated in the following diagram based on a presentation by the IASB Staff:

Performance measures			
Financial performance measures			**Non-financial performance measures -e.g.,**
Subtotal of income and expenses		**Other measures that are not subtotal of income and expenses -e.g.,**	
MPMs e.g.,	**IFRS-defined/ specified -e.g.,**		
▶ Adjusted profit or loss ▶ Adjusted operating profit ▶ Adjusted EBITDA	▶ Operating profit ▶ Operating profit before depreciation amortization and specified impairment	▶ Free cash flow ▶ Return on equity ▶ Net debt ▶ Adjusted revenue	▶ Number of subscribers ▶ Customer satisfaction score ▶ Store surface

To improve transparency around these measures, IFRS 18 requires an entity to disclose information about all of its MPMs in a single note to the financial statements. The standard also lists several disclosures to be made, including:

- How the measure is calculated
- How it provides useful information, and
- A reconciliation to the most comparable subtotal specified by IFRS 18 or another IFRS Accounting Standard

IFRS 18 does not prohibit presentation of MPM in the Statement of Profit and Loss. However, the IASB noted that an entity presenting an MPM in the statement of profit and loss will need to comply with the requirements set out in IFRS 18.24 for additional subtotals presented in the statement. An entity that presents an MPM in the statement of profit and loss would also need to disclose all the information required for MPMs in a single note, even if this results in duplication.

An entity presents additional subtotals and line items if they are necessary to provide a useful structured summary in the primary financial statements.

Location of information, aggregation, and disaggregation

The standard differentiates between 'presenting' information in the PFS and 'disclosing' it in the notes and introduces a principle for determining the location of information based on the identified 'roles' of the PFS and the notes. An entity is required to 'present' information in the PFS to provide structured summaries of the entity's income, expenses, assets, liabilities, equity and cash flows that are useful to users. The entity will also need to 'disclose' other material financial information in the notes to supplement the PFS.

IFRS 18 requires aggregation and disaggregation of information to be performed with reference to similar and dissimilar characteristics while keeping the identified roles of the PFS and the notes in mind. Since the purpose of the PFS is to provide a useful structured summary, an entity will, by design, aggregate material items on the face of the PFS, and then need to disaggregate them in the notes.

IFRS 18 also includes guidance on determining meaningful descriptions, or labels, for items that are aggregated in the financial statements and it requires disclosure of further information regarding items labeled as 'other'.

Consequential amendment to IAS 7

The amended IAS 7, once effective, will require all entities to use the 'operating profit' subtotal as the starting point for determining cash flows from operating activities under the indirect method. It is expected that the use of the operating profit subtotal as a consistent starting point will make the statement of cash flows more consistent and help investors analyze and compare companies' operating cash flows. The change in the starting point is also simplifies the presentation of cash flows from operating activities as it will eliminate some reconciling items that are used at present.

The amendments will also remove the optionality around the classification of cash flows from dividends and interest in the statement of cash flows currently available under IAS 7. That removal aims to increase comparability between entities and provide more meaningful information as, currently, the different classifications of these cash flows do not necessarily convey information about the role of interest and dividends in an entity's business activities. The table below, based on Table 4 in the IASB's Effects Analysis of IFRS 18, presents the comparison of the IAS 7 requirements before and after the amendments:

<table>
<tr><th rowspan="2">Cash flow item</th><th rowspan="2">Classification before amendments to IAS 7</th><th colspan="2">Classification after .amendments to IAS 7</th></tr>
<tr><th>Companies without specified main business activities</th><th>Companies with specified main business activities</th></tr>
<tr><td>Interest received</td><td>Operating or investing</td><td>Investing</td><td rowspan="3">A single category for the total of each operating cash flow* - operating, investing or financing,</td></tr>
<tr><td>Interest paid</td><td>Operating or financing</td><td>Financing</td></tr>
<tr><td>Dividends received</td><td>Operating or investing</td><td>Investing</td></tr>
<tr><td>Dividends paid</td><td>Operating or financing</td><td>Financing</td><td>Financing</td></tr>
</table>

* Classification of these types of cash flows for entities with a specified main business will be impacted by how the related income and expenses are classified in the statement of profit or loss.

Transition and effective date

IFRS 18 will be effective for annual reporting periods beginning on or after 1 January 2027. Earlier application is permitted and must be disclosed in the notes. An entity is required to apply the consequential amendments to other IFRS Accounting Standards when it applies IFRS 18.

The standard applies retrospectively. However, an entity is not required to present the quantitative information specified in IAS 8.28(f) (i.e., the adjustment for each financial statement line item affected and the related effect on basic and diluted EPS, for the current period and each prior period presented).

In its annual financial statements, an entity must disclose, for the comparative period immediately preceding the period in which IFRS 18 is first applied, a reconciliation between each item in the statement of profit or loss between:

- The restated amounts presented in accordance with IFRS 18, and
- The amounts previously presented by applying IAS1

An entity is permitted, but not required, to provide the reconciliation for:

- The reporting period in which IFRS 18 is first applied, and/or
- Earlier comparative periods

Applicability in India

The Institute of Chartered Accountants of India (ICAI) has still not issued an exposure draft corresponding to IFRS 18. However, since Indian accounting standards (Ind AS) are largely converged with IFRS, considering India's overall commitment to converge with IFRS and its past experience, we expect that Ind AS corresponding to IFRS 18 to be notified and adopted in due course. We also expect that to ensure consistency and apply IFRS 18 equivalent Ind AS in entirety, consequential amendments to Schedule III to the Companies Act 2013 (as amended), which prescribes format of financial statements for companies in India, and consequential amendment to other Ind AS will also be made.

In addition, Indian entities, which are preparing IFRS financial statements (either for some specific requirements or voluntarily), and entities which are required to do group reporting under IFRS, will also be required to comply with these requirements. If there are significant differences in adoption of IFRS 18 equivalent under Ind AS, such entities may need to maintain dual books or make other system changes.

Practical implication of new requirement

While there appears to be time before IFRS 18 become effective, we believe effective implementation requires advanced preparation, including system changes and user awareness of potential implications in advance. Hence, entities are strongly encouraged to proactively begin preparing for transition. For this, they may consider the following steps:

Readiness assessment:

- Conduct a detailed analysis of IFRS 18, particularly focusing on new categorization requirements. Understanding changes and training team is important for successful implementation.
- For groups of entities with diverse main business activities, evaluate how the categorization of income and expenses will impact group financial reporting and consolidation processes.
- For entities reporting under multiple GAAPs, decide the approach for reporting such as the need for dual books of accounts, templatization, etc.
- Evaluate judgement areas and policy choices available.
- Conduct readiness assessment for availability of relevant data and information.

Evaluate systems, process and controls impacts:

- Entity may need to adjust system and process to capture relevant information to satisfy new requirements, e.g., impact on chart of accounts, groupings, and classifications at the time of transaction accounting.
- Evaluate how to change the classification of income and expenses retrospectively to meet the requirement for comparative periods.
- In India, there is a requirement to maintain audit trail under the Companies Act (as modified). Evaluate potential implications of the system changes or manual data processing on the requirement to maintain audit trail.
- Updating standard operating procedure (SOPs) and controls, if any.

Revisit performance measures:

- Identify MPMs and determine which are within the scope of IFRS 18 requirements.
- Revisit/ reevaluate the presentation of MPMs.
- Develop mechanism for regular tracking of MPMs used in various public communications to comply with IFRS 18 disclosure requirements.
- Entities may need to design new systems/ processes and controls around MPMs due to their inclusion in financial statement.

Effect on contracts or compensation policies:

- Assess impact on contracts or compensation policies: Entities with management remuneration policies based on a particular measure in the statement of profit and loss may need to consider whether IFRS 18 impact determination of such measure. For example, operating profit measurement before and after IFRS 18 application may potentially differ and entities paying remuneration based on such measure may need to consider whether there is also a need for a corresponding change measure the remuneration policy.
- Similar to management remuneration, the application of IFRS 18 may also change the determination of performance measures used in loan agreement and thereby compliance with debt covenants. Entities will also need to evaluate whether there is a need for changes in the loan agreement to avoid potential non-compliance.

Communication strategy:

- Develop a strategy for communicating potential impacts of IFRS 18 adoption to the shareholders and other stakeholders, ensuring transparency and preparedness.
- Monitor changes in local reporting landscape.

Way forward

Although the effective date of IFRS 18 may seem distant, entities are strongly encouraged to start analyzing the new requirements now, especially those involved in group reporting under IFRS. Many entities will need to collect and review information, engage with lenders to align covenants, and adjust KPIs for performance evaluation, which may necessitate updates to internal information systems. Additionally, entities should stay informed about industry-specific developments as practices evolve.

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