

Query No. 3

Subject: Amortisation of goodwill in respect of subsidiaries and jointly controlled entities recognised as an asset in consolidated financial statements.¹

A. Facts of the Case

1. A public limited company (hereinafter referred to as the ‘company’), which is a wholly owned subsidiary of a listed government company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India.

2. The company operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. Globally, Exploration and Production (E&P) business is carried out by way of joint arrangements or investments in form of subsidiaries/associates. The company was following Indian Generally Accepted Accounting Principles (IGAAPs) (presumably, by IGAAPs, querist meant Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006) until 31st March, 2016. However, in accordance with the requirement of Ministry of Corporate Affairs (MCA) notification dated 16th February, 2015, the company has adopted Indian Accounting Standards (Ind ASs) with effect from 1st April, 2016 (Transition Date: 1st April, 2015).

3. Usually the legal regimes applicable in most of the countries provide that the ownership of mineral resources (hydrocarbons) is with respective governments. Accordingly, the host governments grant the rights to explore, develop and produce hydrocarbons in certain specified geographical areas within their territories (hereinafter referred to as ‘mineral rights’) to companies on some equitable consideration under various regimes. The activities of the company thus include securing such mineral rights and then to explore, develop and produce hydrocarbons as under:

- (a) direct acquisition of mineral rights in properties, exploration (including prospecting), development and production of oil and gas solely or in joint operations with some other parties;
- (b) indirectly through acquisition of shares in a jointly controlled entity owning such mineral rights;
- (c) indirectly through acquisition of shares in a subsidiary owning such mineral rights.

4. Mineral rights are granted by the host governments in accordance with the applicable legal and fiscal regime in the host country which are incorporated into the binding contractual arrangements entered into with the host governments. Mineral rights can be granted through direct license or through production sharing agreement (PSA), under which the host government having ownership rights over the hydrocarbons, grants the rights to a company or consortium (usually called contractor) subject to certain obligations/ payments by the contractor including sharing of hydrocarbons, with the government or its nominated agency as per principles contained in PSA.

5. The overseas oil and gas operations are generally conducted in joint arrangements with other partners. Main reason for holding mineral rights through jointly controlled entities/subsidiaries is because of host country’s regulations and / or various business

¹ Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

considerations (strategic/risk management/financing etc.). When the project is already in existence through a corporate structure and the company joins the project later on, the investment in jointly controlled entities /subsidiaries is a legacy issue.

6. The company has been preparing its consolidated financial statements for the group comprising of standalone financial statements of the company, its subsidiaries and jointly controlled entities in accordance with the applicable Accounting Standards (AS).

Accounting Treatment accorded by the company under IGAAP

7. The querist has stated that under IGAAPs, the company accounted for the investments in subsidiaries and jointly controlled entities in its standalone financial statements in accordance with the requirement of Accounting Standard (AS) 13, 'Accounting for Investments'. In consolidated financial statements of the company, the company was consolidating financial statements of its subsidiaries on a line by line basis following the consolidation procedures mentioned in paragraph 13 of Accounting Standard (AS) 21, 'Consolidated Financial Statements'. Similarly, in its consolidated financial statements, the company was reporting its interest in jointly controlled entities using proportionate consolidation as per the requirements of paragraphs 29 to 39 of Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures'.

8. Further, the company recognised goodwill in respect of subsidiaries and jointly controlled entities in accordance with the requirements of paragraph 13(b) of AS 21 and paragraph 36 of AS 27 respectively in its consolidated financial statements, as according to the querist, there was no specific guidance in the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) as well as the Guidance Note on Accounting for Oil & Gas Producing Activities (Revised 2013) regarding the amortisation of such goodwill under IGAAPs.

9. The company considered that such goodwill mainly arises due to corporate structure and the line by line consolidation of subsidiaries' / proportionate consolidation of jointly controlled entities' financial statements prepared on historical costs convention which do not take into consideration the valuation of underlying oil and gas reserves for which excess amount (i.e. goodwill calculated as per the relevant AS requirements) has been paid by the company at the time of acquisition.

10. The company further considered that in oil and gas E&P companies, the goodwill generated on acquisition of mineral rights either through jointly controlled entities or subsidiaries, inherently derives its value from the underlying mineral rights and, accordingly, value of such goodwill depletes as the underlying mineral resources are extracted.

11. According to the querist, in case of acquisition directly or through joint operations, the goodwill, so calculated, would have been accounted for as 'acquisition costs' as defined in the Guidance Note on Accounting for Oil and Gas Producing Activities and accordingly would have been amortised over the life of the reserves using Unit of Production (UOP) method considering related proved oil and gas reserves.

12. Therefore, taking a prudent approach and considering the above substance, the company framed the accounting policy under IGAAPs for amortisation of the goodwill in respect of its subsidiaries/jointly controlled assets over the life of the underlying mineral rights using UOP method as under:

“Goodwill Amortisation: The company amortises goodwill (on consolidation) based on 'Unit of Production Method' considering the related Proved Reserves.”

13. This allowed the company to utilise the value of goodwill over the life of mineral rights and completely charging off the goodwill over the life of the reserves.

Change under Indian Accounting Standards (Ind ASs) regime

14. The querist has stated that Indian Accounting Standards (Ind ASs), as notified by the Ministry of Corporate Affairs (MCA), are mandatorily applicable for periods beginning on or after 1st April, 2016, with comparatives for the period ending 31st March, 2016. Also, the ICAI has issued revised 'Guidance Note on Accounting for Oil and Gas Producing Activities (Ind AS)' to align the oil and gas accounting under Ind AS regime.

15. The querist has further stated that the company had availed transition exemption under Ind AS 101, 'First-time Adoption of Indian Accounting Standards' and has not applied the principles of Ind AS 103, 'Business Combinations' retrospectively and, therefore, did not fair value the acquisition of shares in joint ventures (jointly controlled entities under IGAAPs) / subsidiaries which happened before the transition date of 1st April, 2015. The carrying amount of goodwill at the date of transition to Ind AS in accordance with previous GAAPs (IGAAPs) has been taken as carrying value of the goodwill in the opening Ind AS balance sheet in accordance with the para C4 (g) and (h) contained in Appendix C to Ind AS 101.

16. According to the querist, prospectively from the transition date, i.e., 1st April, 2015, acquisition of interest/ share in subsidiary will be accounted for in accordance with Ind AS 103 and acquisition of interest /share in joint venture /associate will be accounted for in accordance with Ind AS 28, 'Investments in Associates and Joint Ventures'.

17. The company understands that paragraph 32(a) of Ind AS 28 specifically prohibits amortisation of goodwill relating to an associate or a joint venture. It is noticed that there is no such specific prohibition laid down by Ind AS 103. It is also noticed that paragraph 10 (b) of Ind AS 36, Impairment of Assets requires testing of goodwill acquired in a business combination for impairment, annually.

18. Accordingly, as per the querist, by simple reading of the applicable Ind ASs, it appears that Ind ASs envisage testing of goodwill annually for impairment rather than its amortisation. This seems to align with the concept of fair valuation of acquired assets and liabilities and goodwill/capital reserve being a residual amount. This however may not be the case where goodwill is carried at historical value in the manner as stated above. Accordingly, considering the substance over form of the goodwill to be in the nature of 'acquisition costs' (as discussed in paragraphs 8 to 13 above), the company intends to continue amortisation of the goodwill recognised under IGAAPs in respect of its subsidiaries/ joint ventures (jointly controlled entities under IGAAPs) over the life of the underlying mineral rights using Unit of Production method, under Ind ASs also post transition date in accordance with the same accounting policy as under:

“Goodwill amortisation: The company amortises goodwill (on consolidation) based on 'Unit of Production Method' considering the related proved reserves.”

B. Query

19. In view of the above facts, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the appropriate accounting treatment under Ind ASs for amortisation of the goodwill by the company, viz., whether:

- (i) the accounting treatment as suggested in paragraph 18 in respect of amortisation of goodwill by the company is appropriate; or

- (ii) there is any other appropriate accounting treatment for amortisation of goodwill.

C. Points considered by the Committee

20. The Committee notes that the basic issue raised in the query relates to amortisation of carrying amount of goodwill under Ind ASs after the date of transition. Accordingly, the Committee has considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, initial recognition of goodwill arising on consolidation under Accounting Standards notified under Companies (Accounting Standards) Rules, 2006 and its valuation, correctness of determination of goodwill, etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter, is in the context of Indian Accounting Standards (Ind ASs) and not in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and the same is with regard to accounting treatment in Consolidated Financial Statements of the Company and not separate Financial Statement. The Committee also wishes to point out that although the querist has used the terms, 'jointly controlled entity', 'joint operations' and 'jointly controlled assets' interchangeably in respect of joint ventures for foreign based oil and gas operations, it is presumed that these joint ventures are 'jointly controlled entities' in accordance with the requirements of AS 27. The Committee also presumes from the Facts of the Case that the acquisitions of mineral rights/business in the extant case is within the purview of the requirements of Ind AS 103, 'Business Combinations'.

21. The Committee notes from the facts of the case that the company has availed transition exemption under Ind AS 101, First-time Adoption on Indian Accounting Standards and has not applied Ind AS 103, Business Combinations principles retrospectively. The Committee further notes that the following paragraphs of Appendix C, 'Exemptions for business combinations' to Ind AS 101, First-time Adoption of Indian Accounting Standards would be relevant in this regard:

"C4 If a first-time adopter does not apply Ind AS 103 retrospectively to a past business combination, this has the following consequences for that business combination:

...

(c) The first-time adopter shall exclude from its opening Ind AS Balance Sheet any item recognised in accordance with previous GAAP that does not qualify for recognition as an asset or liability under Ind ASs. The first-time adopter shall account for the resulting change as follows:

(i) the first-time adopter may have classified a past business combination as an acquisition and recognised as an intangible asset an item that does not qualify for recognition as an asset in accordance with Ind AS 38, *Intangible Assets*. It shall reclassify that item (and, if any, the related deferred tax and non-controlling interests) as part of goodwill (unless it deducted goodwill directly from equity in accordance with previous GAAP, see (g)(i) and (i) below) or capital reserve to the extent not exceeding the balance available in that reserve.

...

(g) The carrying amount of goodwill or capital reserve in the opening Ind AS Balance Sheet shall be its carrying amount in accordance

with previous GAAP at the date of transition to Ind ASs, after the following two adjustments:

- (i) If required by (c)(i) above, the first-time adopter shall increase the carrying amount of goodwill or decrease the carrying amount of capital reserve when it reclassifies an item that it recognised as an intangible asset in accordance with previous GAAP. Similarly, if (f) above requires the first-time adopter to recognise an intangible asset that was subsumed in recognised goodwill or capital reserve in accordance with previous GAAP, the first-time adopter shall decrease the carrying amount of goodwill or increase the carrying amount of capital reserve accordingly (and, if applicable, adjust deferred tax and non-controlling interests).
 - (ii) Regardless of whether there is any indication that the goodwill may be impaired, the first-time adopter shall apply Ind AS 36 in testing the goodwill for impairment at the date of transition to Ind ASs and in recognising any resulting impairment loss in retained earnings (or, if so required by Ind AS 36, in revaluation surplus). The impairment test shall be based on conditions at the date of transition to Ind ASs.
- (h) *No other adjustments shall be made to the carrying amount of goodwill / capital reserve at the date of transition to Ind ASs. For example, the first-time adopter shall not restate the carrying amount of goodwill / capital reserve:*

- (i)
 - (ii) to adjust previous amortisation of goodwill;
- ...”

(Emphasis supplied by the Committee)

22. The Committee notes from above that Ind AS 101 specifically provides that if a first-time adopter does not apply Ind AS 103 retrospectively to a past business combination then the carrying amount of goodwill in the opening Ind AS balance sheet shall be its carrying amount in accordance with previous GAAP at the date of transition to Ind ASs and no adjustments apart from as required by paragraph C4(c)(i) of Ind AS 101 shall be made to such carrying amount. Further, the company shall apply Ind AS 36 in testing the goodwill for impairment at the date of transition to Ind ASs, regardless of whether there is any indication that the goodwill may be impaired (refer paragraph C4(g)(ii) reproduced above). In this context, the Committee notes paragraph 10 (b) of Ind AS 36, ‘Impairment of Assets’, which provides as follows:

“10 Irrespective of whether there is any indication of impairment, an entity shall also:

- (a) ...
- (b) **test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80–99.”**

The Committee further notes from paragraph 3 and B86 of Ind AS 110, 'Consolidated Financial Statements' that Ind AS 110 does not deal with the goodwill arising on a business combination; rather refers to Ind AS 103, 'Business Combinations'. Similarly, the Committee notes that paragraph 3(f) of Ind AS 38, 'Intangible Assets' also states that it does not apply to goodwill acquired in business combination and refers to Ind AS 103.

23. The Committee further notes the following paragraph of Ind AS 103, 'Business Combinations':

“B63 Examples of other Ind ASs that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination include:

- (a) Ind AS 38 prescribes the accounting for identifiable intangible assets acquired in a business combination. The acquirer measures goodwill at the amount recognised at the acquisition date less any accumulated impairment losses. Ind AS 36, *Impairment of Assets*, prescribes the accounting for impairment losses.

...”

From the above, the Committee notes that Ind AS 103 specifically requires the carrying amount of goodwill or goodwill acquired under business combination to be tested for impairment. However, the Committee notes that it does not contain any specific requirement for amortisation of goodwill arising on acquisition. Similarly, the Committee notes the following requirements of Ind AS 28, 'Investments in Associates and Joint Ventures':

“32 An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:

- (a) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. **Amortisation of that goodwill is not permitted.**
- (b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is recognised directly in equity as capital reserve in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made for impairment losses such as for goodwill or property, plant and equipment.”
(Emphasis supplied by the Committee.)

From the above, the Committee note that according to Ind AS 28 Goodwill is not separately accounted rather included as part of carrying amount of Investment. Further, the Standard specifically clarifies that amortisation of goodwill relating to a joint venture is not permitted.

24. In the context of joint ventures, the Committee also notes the following requirements of Ind AS 101, 'First-time Adoption of Indian Accounting Standards':

“D1 An entity may elect to use one or more of the following exemptions:

(a) ...;

...

(r) joint arrangements (paragraphs D31-D31AL);

(s) ...”

“Joint ventures - transition from proportionate consolidation to the equity method

D31AA When changing from proportionate consolidation to the equity method, an entity shall recognise its investment in the joint venture at transition date to Ind ASs. That initial investment shall be measured as the aggregate of the carrying amounts of the assets and liabilities that the entity had previously proportionately consolidated, including any goodwill arising from acquisition. If the goodwill previously belonged to a larger cash-generating unit, or to a group of cash-generating units, the entity shall allocate goodwill to the joint venture on the basis of the relative carrying amounts of the joint venture and the cash-generating unit or group of cash-generating units to which it belonged.

D31AB The balance of the investment in joint venture at the date of transition to Ind ASs, determined in accordance with paragraph D31AA above is regarded as the deemed cost of the investment at initial recognition.

D31AC A first-time adopter shall test investment in joint venture for impairment in accordance with Ind AS 36 at the date of transition to Ind ASs, regardless of whether there is any indication that the investment may be impaired. Any resulting impairment shall be recognised as an adjustment to retained earnings at the date of transition to Ind ASs. ...”

From the above, the Committee notes that where an entity elects to use the exemption provided under paragraphs D31AA to D31AC of Ind AS 101, as reproduced above also, the Standard requires to test the investment in joint venture which comprises of goodwill for impairment only and does not specify for amortisation.

Accordingly, on a holistic reading of the above paragraphs, the Committee is of the view that the carrying amount of goodwill (arising on consolidation of subsidiary or jointly controlled entity under the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006) on the date of transition cannot be amortised under Ind ASs.

D. Opinion

25. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 19 above:

(i) and (ii) No, the accounting treatment as suggested in paragraph 18 in respect of amortisation of goodwill by the company is not appropriate. The carrying amount of goodwill (arising on consolidation of subsidiary or jointly controlled entity under the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006) on the date of transition

cannot be amortised under Ind ASs and the carrying amount of goodwill or goodwill acquired under business combination will have to be tested for impairment periodically.
