

Ind AS Technical Facilitation Group Clarification Bulletin 17

Ind AS Technical Facilitation Group' (ITFG) of Ind AS Implementation Group has been constituted for providing clarifications on timely basis on various issues related to the applicability and /or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015, raised by preparers, users and other stakeholders. Ind AS Technical Facilitation Group (ITFG) considered some issues received from members and decided to issue following clarifications¹ on December 19, 2018:

Issue 1: Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, has recently been amended in certain respects and consequential amendments have been made to certain other Ind ASs vide notification dated 20th September, 2018 ('the notification') issued by the Ministry of Corporate Affairs, Government of India.

One of the amendments made to Ind AS 20 has the effect of allowing an entity to initially recognise a government grant in the form of a non-monetary asset either at a fair value or at a nominal amount. As per the pre-amended (or original) standard, such a grant was necessarily required to be initially recognised at fair value.

The amendments made by the notification apply for the annual periods beginning on or after April 1, 2018.

X Ltd., a government company having 100% of its paid-up capital held by the Government of India received land in the year 2008 from the government to construct and operate a mass rapid transit system (MRTS) in a metropolitan city. The land was received free of cost subject to compliance with specified terms and conditions. In accordance with AS 12, Accounting for Government Grants, the land was recorded at a nominal value of Re.1-.

In the following scenarios, at what amount will the aforesaid land be included in financial statements of X Ltd. in accordance with Ind AS 20?

- (i) X Ltd. is a first-time adopter of Ind ASs and its first Ind AS reporting period is financial year 2018-19.**
- (ii) X Ltd. is not a first time adopter of Ind ASs and financial year 2018-19 is its second (or third) reporting period under Ind ASs.**

¹ Clarifications given or views expressed by the Ind AS Technical Facilitation Group (ITFG) represent the views of the ITFG and are not necessarily the views of the Ind AS Implementation Group or the Council of the Institute. The clarifications/views are based on the accounting principles as on the date the Group finalises the particular clarification. The date of finalisation of this Bulletin is December 19, 2018. The clarification must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of clarifications by the ITFG. The clarifications given are only for the accounting purpose. The commercial substance of the transaction and other legal and regulatory aspects has not been considered and may have to be evaluated on case to case basis.

Response: *[It may be noted that Ind AS 20 specifically scopes out the participation by the government in the ownership of an entity. In this fact pattern, Government of India has 100% shareholding in the entity, but it has been assumed that the land provided has been evaluated as not being in the nature of owners' contribution and hence, it is in the nature of a government grant as per Ind AS 20.*

Further, it has been assumed that the above arrangement has been evaluated as not being within the scope of Appendix D, Service Concession Arrangements of Ind AS 115, Revenue from Contracts with Customers or scope of Appendix A, Service Concession Arrangements of Ind AS 18, Revenue, as the case may be.]

Paragraph 18 of Ind AS 20 states that, “**Grants related to non-depreciable assets may also require the fulfilment of certain obligations and would then be recognised in profit or loss over the periods that bear the cost of meeting the obligations. As an example, a grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognise the grant in profit or loss over the life of the building.**”

Further, paragraph 23 of Ind AS 20 relating to non-monetary government grants states the following:

*“A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. In these circumstances, **it is usual to assess the fair value of the non-monetary asset and to account for both grant and asset at that fair value. An alternative course that is sometimes followed is to record both asset and grant at a nominal amount.**”*

(i) If X Ltd. is a first-time adopter of Ind AS for the reporting period 2018-19

Ind AS 101, *First-time Adoption of Indian Accounting Standards*, contains requirements applicable to first Ind AS financial statements of an entity and the relevant provisions in the above context are as follows:.

Paragraph 3 of Ind AS 101 states the following:

“An entity’s first Ind AS financial statements are the first annual financial statements in which the entity adopts Ind ASs, in accordance with Ind ASs notified under the Companies Act, 2013 and makes an explicit and unreserved statement in those financial statements of compliance with Ind ASs.”

In accordance with the above, the financial statements of X Ltd for the financial year 2018-19 are its first Ind AS financial statements.

Ind AS 101 further states the following:-

“Opening Ind AS Balance Sheet

- 6 *An entity shall prepare and present an opening Ind AS Balance Sheet at the date of transition to Ind ASs. This is the starting point for its accounting in accordance with Ind ASs subject to the requirements of paragraphs D13AA and D22.*
- 7 *An entity shall use the same accounting policies in its opening Ind AS Balance Sheet and throughout all periods presented in its first Ind AS financial statements. Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, except as specified in paragraphs 13–19 and Appendices B–D.*
- 8 *An entity shall not apply different versions of Ind ASs that were effective at earlier dates. An entity may apply a new Ind AS that is not yet mandatory if that Ind AS permits early application.”*

Accordingly, X Ltd is required to apply the amended Ind AS 20 for all periods presented in its financial statements for 2018-19, including in preparing its opening Ind AS balance sheet as at April 1, 2017.

Further, as can be seen from above requirements of Ind AS 101, the general requirement in Ind AS 101 is that accounting policies followed in the opening Ind AS balance sheet and in reporting other periods included in first Ind AS financial statements should comply with all Ind ASs that are effective at the end of the first Ind AS reporting period. Generally, those accounting policies are applied on a retrospective basis. However, as a departure from this general requirement, Ind AS 101 provides certain mandatory exceptions and voluntary exemptions from retrospective application of some aspects/requirements of other Ind ASs. Ind AS 101 does not contain any mandatory exceptions or voluntary exemptions from retrospective application of Ind AS 20. Consequently, X Ltd is required to apply the requirements of Ind AS 20, retrospectively at the date of transition to Ind ASs (and consequently in subsequent accounting periods).

It is pertinent to note that under the amended Ind AS 20, X Ltd has a choice of recognising the grant and the asset (i.e., land in the given case), initially either at fair value or at a nominal amount.

(ii) If X Ltd. is not a first-time adopter of Ind AS and financial year 2018-19 is its second (or third) Ind AS reporting period

Financial year 2018-19 is the second (or third) Ind AS reporting period of X Ltd. Consequently, Ind AS 101 does not apply in preparing the financial statements for the financial year 2018-19.

In the previous financial year, in accordance with the pre-amended standard, X Ltd followed the accounting policy of recognising the land and the government grant initially at fair value by setting up the grant as deferred income to be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate. Hence, the financial statements of X Ltd for the financial year 2017-18 already include the land and the grant, both measured in accordance with the accounting policy as stated above.

It is to be noted that the amended Ind AS 20 provides a choice to entities to recognise the grant and related asset initially either at fair value or at a nominal amount. The issue is whether, in view of the amended Ind AS 20 being applicable for the financial year 2018-19, X Ltd is required or permitted to change its aforesaid accounting policy in preparing the financial statements for the year 2018-19.

The requirements relating to changes in accounting policies are primarily contained in Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Paragraph 19 of Ind AS 8 states as follows:

Applying changes in accounting policies

19 Subject to paragraph 23:

- (a) an entity shall account for a change in accounting policy resulting from the initial application of an Ind AS in accordance with the specific transitional provisions, if any, in that Ind AS; and*
- (b) when an entity changes an accounting policy upon initial application of an Ind AS that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the change retrospectively.*

The amended Ind AS 20 does not contain any specific transitional provisions. Accordingly, X Ltd. has to apply the change retrospectively, if it is permitted by Ind AS 8, and decides to voluntarily change its accounting policy (from fair value to nominal amount).

As regards circumstances in which an accounting policy should, or can, be changed, paragraphs 14-15 of Ind AS 8 state the following:

“14 An entity shall change an accounting policy only if the change:

- (a) is required by an Ind AS; or*
- (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity’s financial position, financial performance or cash flows.*

15 Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the criteria in paragraph 14.”

It may be noted that the amended Ind AS 20 provides an entity a choice between recognising the grant and the asset initially either at fair value or at a nominal amount. Thus, X Ltd is not required to change the accounting policy relating to the grant as applied by it in preparing its financial statements for the previous financial year. The issue then is whether X Ltd. can change its accounting policy voluntarily.

A change in accounting policy other than a change required by an Ind AS can be made by an entity only if it is permitted to do so under paragraph 14(b) of Ind AS 20. According to paragraph 14(b), a voluntary change in an accounting policy can be made only if the change “results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity’s financial position, financial performance or cash flows.” Thus, paragraph 14 lays down two requirements that must be complied with in order to make a voluntary change in an accounting policy. First, the information resulting from application of the changed (i.e., the new) accounting policy must be reliable. Second, the changed accounting policy must result in “more relevant” information being presented in the financial statements.

Whether a changed accounting policy results in reliable and more relevant financial information is a matter of assessment in the particular facts and circumstances of each case. In order to ensure that such an assessment is made judiciously (such that a voluntary change in an accounting policy does not effectively become a matter of free choice), paragraph 29 of the standard requires an entity making a voluntary change in an accounting policy to disclose, *inter alia*, “the reasons why applying the new accounting policy provides reliable and more relevant information”.

In accordance with the above, a voluntary change in accounting policy by X Ltd can be made only if the change results in the financial statements providing *reliable and more relevant information* about the effects of transactions, other events or conditions on its financial position, financial performance or cash flows.

Issue 2: During its current financial year, ABC Ltd. has issued cumulative redeemable preference shares which carry a dividend of 10% per annum. The preference shares are redeemable at a specified premium at the end of 8 years from the date of their issue. On a consideration of the substance of the terms and conditions of issue of the preference shares, including the stipulations as to dividends and premium payable on redemption, ABC Ltd has determined that the preference shares qualify for classification as a financial liability in their entirety under Ind AS 32, *Financial Instruments: Presentation*.

ABC Ltd is a ‘domestic company’ within the meaning of this term under the Income-tax Act 1961 (‘the Act’). Accordingly, dividend on the preference shares (within the

meaning of the term ‘dividend’ under section 2(22) of the Act) is subject to provisions relating to Dividend Distribution Tax (DDT) contained in section 115-O of the Act.

In accounting for the preference shares in accordance with Ind AS 109, would DDT be included in calculating effective interest rate (EIR) on the preference shares?

Response: With regard to the treatment of ‘dividend’ on a financial instrument, paragraphs 35 and 36 of Ind AS 32, *Financial Instruments Presentation* reproduced hereunder may be noted:

- “35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.
- 36 The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in profit or loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.”

In view of the above, if a financial instrument is classified as financial liability in its entirety (as is the position in the case under discussion), the ‘dividend’ thereon is in the nature of interest and is accordingly charged to profit or loss.

Further, paragraphs B5.4.4 and B5.4.8 of Ind AS 109, *Financial Instruments*, state as follows:

“B5.4.4 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts that are included in the calculation of the effective interest rate over the expected life of the financial instrument.....”

The Guidance Note on Division II - Ind AS Schedule III to the Companies Act, 2013 issued by of the Institute of Chartered Accountants of India provides the following guidance in respect of dividend on preference shares:

“Dividend on preferences shares, whether redeemable or convertible, is of the nature of ‘Interest expense’, only where there is no discretion of the issuer over the payment of such dividends. In such case, the portion of dividend as determined by applying the effective interest method should be presented as ‘Interest expense’ under ‘Finance cost’. Accordingly, the corresponding Dividend Distribution Tax on such portion of non-discretionary dividends should also be presented in the Statement of Profit and Loss under ‘Interest expense’.

Furthermore, FAQ regarding DDT issued by the Accounting Standards Board of the Institute of Chartered Accountants of India *inter-alia* states that, “*presentation of DDT paid on the dividends should be consistent with the presentation of the transaction that creates those income tax consequences. Therefore, DDT should be charged to profit or loss, if the dividend itself is charged to profit or loss. If the dividend is recognised in equity, the presentation of DDT should be consistent with the presentation of the dividend, i.e., to be recognised in equity.*”

In the given case, the preference shares are classified as a liability in their entirety and ‘dividend’ thereon is therefore considered to be in the nature of interest. Accordingly, the related dividend distribution tax should be regarded as part of interest cost and should therefore form part of EIR calculation.

Issue 3: MNC Ltd. is a registered SEZ/STP unit which receives benefits in the form of exemption from payment of taxes and duties on import/export of goods upon fulfilment of certain conditions under a scheme of Government of India. Whether the benefit being received by MNC Ltd. is a government grant or a government assistance other than government grant under Ind AS 20, *Government Grants and Disclosure of Government Assistance*? If it is a government grant, whether it is a grant related to asset or grant related to income and how is the same to be accounted for.

Response: Paragraph 3 of Ind AS 20, *Government Grants and Disclosure of Government Assistance*, states as follows:

“3 Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.”

Further paragraph 9 of Ind AS 20 states that, “*the manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government.*”

In accordance with the above, in the given case, the benefit of exemption from payment of taxes and duties levied by the government is a government grant and should be accounted for as per the provisions of Ind AS 20.

It is pertinent to note that the classification of the grant as related to an asset or to income will require exercise of judgement and careful examination of the facts, objective and conditions attached to the scheme. The purpose of the grant and the costs for which the grant is intended to compensate would also be required to be ascertained carefully.

The guidance given under ITFG Clarification Bulletin 11 (Issue 5) may also be referred in making this assessment.

Issue 4: How should ‘dividend income’ on an investment on a debt instrument be recognised in the books of the investor?

Response: Issue 9 in ITFG Clarification Bulletin 8 deals with a situation where the legal form of income received by an investor on an investment in a financial instrument is that of ‘dividend’:

In the said clarification it is stated that the recognition of income will depend on the classification of the instrument as FVTPL (at fair value through profit or loss), amortised cost or FVOCI (at fair value through other comprehensive income) as determined in accordance with the requirements of Ind AS 109, *Financial Instruments*.

The following further clarification on the issue may be noted.

Under Ind AS 109, a financial asset cannot be classified under ‘amortised cost’ or ‘FVOCI (debt)’ category if it does not meet the following conditions:

- (i) Business Model Test; and
- (ii) Contractual Cash flow Characteristic test (SPPI test).

If the SPPI test is met, the issue whether the financial asset would be classified under ‘amortised cost’ category or under ‘FVOCI (debt)’ category is also determined by considering the business model within which the financial asset is held.

Paragraph B4.1.7A of Ind AS 109 provides guidance on the SPPI test and states as below:

*“Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the **time value of money** (see paragraphs B4.1.9A–B4.1.9E) and **credit risk** are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as **exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.**”*

An example of a debt instrument having legal form of income as dividend is redeemable preference share. In the case of a redeemable preference share, the issue whether the SPPI test is met or not requires consideration of whether payment of dividend on the preference share is non-discretionary (i.e., obligatory) or at the discretion of the issuer. Where payment of dividend is not at the discretion of the issuer, the contractual cash flows (dividends and redemption proceeds) associated with the preference share would be akin to those associated with a plain-vanilla loan or other plain-vanilla debt instrument unless the cash flows do not meet the SPPI test mentioned in previous paragraphs. On the other hand, where the payment of dividend on the preference share, whether cumulative or non-cumulative, is at the discretion of the issuer, the contractual cash flows characteristics in such cases differ from those of a basic lending arrangement inasmuch as interest is also a contractual flow in a basic lending arrangement. Accordingly, a preference share with a discretionary dividend feature cannot be said to represent a basic lending arrangement. Hence, such a preference shares fails the SPPI test and cannot therefore be classified as at amortised cost or FVOCI. The appropriate classification of such preference share is therefore as at FVTPL.

Determining whether or not the payment of dividend on a preference share is at the discretion of the issuer requires consideration of applicable legal provisions in the relevant jurisdiction and also the specific terms and conditions associated with the preference share.

If the preference shares meet the SPPI test and business model test then the dividend income will be accounted for using effective interest rate method provided the instrument is classified under either at amortised cost or FVOCI. If it does not meet above tests or the entity has chosen the fair value option, the instrument will be classified at FVTPL and the entity will give disclosures for its accounting policy in accordance with paragraph B5 (e) of Ind AS 107, *Financial Instruments: Disclosures*.

Issue 5: Company B, a subsidiary of Company A (parent) owns an investment property that is measured at cost in accordance with Ind AS 40, *Investment Property*. Company A sells a portion of its equity shareholding in Company B, as a result of which Company B becomes a joint venture between Company A and Company Z. As per the requirements of Ind AS 28, equity method is required to be applied in the consolidated financial statements of Company A to account for its investment in the joint venture (i.e., Company B).

Ind AS 40, *Investment Property*, does not allow an investment property to be measured at fair value. On the other hand, in applying the equity method in consolidated financial statements of the investor, as per Ind AS 28, identifiable assets and liabilities of the investee are required to be fair valued and appropriate adjustments are required to be made to entity's share of investee's profit or loss, such as those for depreciation/amortisation based on aforesaid fair values at acquisition date.

- (i) Whether there is any contradiction between Ind AS 40 and Ind AS 28?**
- (ii) Also, whether the adjustments arising out of fair valuation of investment property as required under Ind AS 28 should be made in the consolidated financial statements of the investor?**

Response:

(i) While the above issue has been raised in the context of a situation where a former subsidiary becomes a joint venture and the investee owns an investment property that is measured at cost in accordance with Ind AS 40, it has a wider applicability, e.g., a similar issue also arises when an investor makes an investment that gives rise to a parent-subsidiary or an investor-joint venture or an investor-associate relationship between the investor and the investee.

Ind ASs require the application of a mixed measurement model in preparing the balance sheet of an entity – some assets and liabilities are measured at fair value while other assets and liabilities are measured on a different basis (or bases) such as historical cost. Besides, Ind ASs prohibit the recognition of certain assets such as internally-generated goodwill and brands.

From the perspective of an investor who acquires, say, a controlling interest in an entity (or an interest giving the investor joint control or significant influence over the investee), Ind ASs require the investor to identify whether it has made a bargain purchase gain or whether the consideration includes an element of payment for goodwill. The amount of any bargain purchase gain or of any payment for goodwill can be appropriately determined only with reference to the fair values of the identifiable assets and liabilities of the investee as at the acquisition date and not with reference to their book values as at that date. Accordingly, the relevant standard (e.g., Ind AS 28 in the case of a joint venture or an associate) requires determination of fair values of identifiable assets and liabilities of the investee for this purpose. This does not *per se* indicate a contradiction between 28 (or Ind AS 110 in case of acquisition of a controlling interest) on the one hand and the standards that require a cost-based measurement in the balance sheet of the investee on the other.

Therefore, there does not seem any contradiction between Ind AS 40 and Ind AS 28.

(ii) As per paragraph 25 of Ind AS 110, *Consolidated Financial Statements*, if a parent loses control of a subsidiary, it recognises any investment retained in the former subsidiary at its fair value when control is lost. Such fair value is regarded as the cost on initial recognition of an investment in a joint venture (or an associate).

Paragraph 32 of Ind AS 28, *Investments in Associates and Joint Ventures* states as under:

*“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 added)*

In accordance with the above, 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 recognised in the manner stated above. The fair value of identifiable assets and liabilities are considered to be the cost of the assets and liabilities for the investor to the extent of its share in the investee. Accordingly, appropriate adjustments arising out of fair valuation of assets/liabilities impacting profit or loss should be made in the consolidated financial statements of Company A.

Issue 6: S Ltd., a wholly owned subsidiary of P Ltd is the sole distributor of electricity to consumers in a specified geographical area. A manufacturing facility of P Ltd is located in the said geographical area and, accordingly, P Ltd is also a consumer of electricity supplied by S Ltd. The electricity tariffs for the geographical area are determined by an independent rate-setting authority and are applicable to all consumers of S Ltd, including P Ltd.

Whether the above transaction is required to be disclosed as a related party transaction as per Ind AS 24, *Related Party Disclosures* in the financial statements of S Ltd.?

Response: As per paragraph 9(b)(i) of Ind AS 24, each parent, subsidiary and fellow subsidiary in a 'group' is related to the other members of the group. Thus, in the case under discussion, P Ltd is a related party of S Ltd from the perspective of financial statements of S Ltd.

Paragraph 11 of Ind AS 24 states as follows:

“In the context of this Standard, the following are not related parties:

(a) two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

(b) two joint venturers simply because they share joint control of a joint venture.

(c) (i) providers of finance,

(ii) trade unions,

(iii) public utilities, and

(iv) departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity,

simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process). [Emphasis added]

(d) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.”

Being engaged in distribution of electricity, S Ltd is a public utility. Had the only relationship between S Ltd and P Ltd been that of a supplier and a consumer of electricity, P Ltd would not have been regarded as a related party of S Ltd. However, as per the facts of the given case, this is not the only relationship between S Ltd and P Ltd. Apart from being a supplier of electricity to P Ltd., S Ltd is also a subsidiary of P Ltd; this is a relationship that is covered within the related party relationships to which the disclosure requirements of the standard apply.

In view of the above, the supply of electricity by S Ltd to P Ltd is a related party transaction that attracts the disclosure requirements contained in paragraph 18 and other relevant requirements of the standard. This is notwithstanding the fact that P Ltd is charged the electricity tariffs determined by an independent rate-setting authority (i.e., the terms of supply to P Ltd are at par with those applicable to other consumers) – Ind AS 24 does not exempt an entity from disclosing related party transactions merely because they have been carried out on an arm’s length basis.

Issue 7: Z Ltd. had purchased land as capital asset as on 1.1.2007. On 1.1.2016, Z Ltd. converted the land into stock-in-trade. It is required to adopt Ind AS from 1.4.2018 being the transition date on 01.04.2017. On the date of transition, Z Limited continues to recognise land at historical cost, i.e., there is no change in its carrying amount. Whether, on the date of transition, the company is required to create deferred tax on the differential land value on 01.01.2016, the date on which capital asset (Land) was converted into stock in trade. Further, in case, the company needs to create deferred tax based on the fair value as on 01.1.2016 then again there will be difference in book base and tax base of inventory (Land) on the date of transition. Whether Z Ltd is also required to create deferred tax on the Stock-in-trade?

Response: As per paragraph 5 of Ind AS 12, *Income Taxes*, “Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:

- (a) *taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or*
- (b) *deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.*

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.”

Further paragraphs 15 and 24 of Ind AS 12, state as follows:

- 15 *A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:*
- (a) *the initial recognition of goodwill; or*
 - (b) *the initial recognition of an asset or liability in a transaction which:*
 - (i) *is not a business combination; and*
 - (ii) *at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).*

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.

- 24 *A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:*
- (a) *is not a business combination; and*
 - (b) *at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).*

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

In view of the above provisions of Ind AS 12, it may be noted that deferred tax asset/liability is to be created for all deductible/taxable temporary differences between the carrying amount of an asset or liability in the balance sheet and its tax base,, except in specified situations e.g. if it arises from a transaction that affects neither accounting profit nor taxable profit (tax loss) at the time of the transaction (known as initial recognition exemption). In addition, recognition of deferred tax asset will be subject to consideration of prudence.

Paragraph 51 of Ind AS 12 further states that, *“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.”*

In accordance with the above, it may be noted that deferred tax arises may arise only if a difference exists between the carrying amount of an asset or liability in the balance sheet and its tax base. Also, the creation of deferred tax is dependent upon the tax consequences that will follow from the expected manner of recovery or settlement of the asset/liability by the entity. The expectation of the entity at the end of the reporting period with regard to the manner of recovery or settlement of its assets and liabilities will require exercise of judgement based on evaluation of facts and circumstances in each case.

In the given case, based on the facts provided, Z Ltd. had converted its capital asset into stock-in-trade which will then be sold as inventory.

It is pertinent to note that as per Income tax laws on conversion of a capital asset into stock-in-trade, and thereafter, sale of the stock-in-trade, the tax treatment will be as follows:

(i) There will be capital gains liability in respect of the conversion of capital asset into stock-in-trade, at market value thereof on the date of conversion. Thus, the capital gains will be computed as the difference between the indexed cost of capital asset to the assessee and the fair market value of such capital asset on the date of its conversion into stock-in-trade.

However, the tax will be computed using the capital gains tax rate applicable in the year of actual sale and not in the year of conversion. Also, the capital gains tax will be required to be paid only at the time of sale of the stock-in-trade.

(ii) As regard the sale of the stock-in-trade, any profit realised or loss incurred (i.e., difference between the sale proceeds and fair value on the date of conversion) will be liable to tax as business income. Such profit/loss would accrue and be liable to tax at the time of sale of the stock-in-trade.

(iii) If there is a business loss in the year of sale of stock-in-trade, the Income-tax Act allows the loss to be offset against capital gains arising on conversion. Thus, the liability for capital gain tax on conversion is not sacrosanct and can vary depending on outcome from sale of stock-in-trade.

Considering the above, conversion of capital asset into stock-in-trade does not require the company to recognise any current tax liability. Under the Income-tax Act, the current tax liability will arise only on the sale of stock-in-trade. However, the company needs to consider deferred tax implications under Ind AS 12. The deferred tax implications arise from the fact that while computing long-term capital gains, assessee will be entitled to avail capital indexation benefits provided under the Income Tax Act, 1961. Therefore, on the date of transition to Ind AS (i.e. on 1.4.2017), a deductible temporary difference exists for Z Ltd. arising out of the carrying amount of asset (as on 1.1.2016) and its tax base (calculated as on 1.1.2016, considering indexation benefit). Z Limited should recognise a deferred tax asset for the same if it satisfies deferred tax asset recognition criteria under Ind AS 12. The difference between the indexed cost of land on the date of conversion and its fair value does not meet definition of temporary difference under Ind AS 12. Also, the business income will be computed as a difference between the sale price of the stock-in-trade and market value of the capital asset on the date of its conversion into stock-in-trade. Therefore, no deferred tax at

this stage arises for these two aspects of the transaction. This is explained by way of an example as follows:

Cost of land as on 1.1.2007 was Rs.100. The land will continue to be recognised at the same amount post the date of transition to Ind AS also.

As on 1.1.2016, the fair value of the land was Rs.1000. Indexed cost of land as on 1.1.2016 was Rs.150.

Land is sold in the year 2020 for Rs. 1200.

Now, as per tax laws there will be gain of Rs.1050 (Rs.1200-Rs.150) which will be apportioned as follows:

Tax on Gain of Rs. 850/- (Rs.1000-Rs.150) will be charged as Capital gains tax.

Tax on Gain of Rs. 200/- (Rs. 1200-Rs.1000) will be charged as Profits & Gains of Business & Profession (PGBP).

There are differing tax rates for income from capital gains and income from PGBP.

Considering the above, as per Ind AS 12, deferred tax on the date of transition to Ind AS will be computed as below:

Tax base (Indexed cost of land as on 1 January 2016)	Rs. 150
Carrying amount	Rs. 100
Deductible temporary difference	Rs. 50

Deferred tax asset (DTA) should be created for the above deductible difference of Rs. 50 assuming that Ind AS 12 criteria for deferred tax asset recognition are met. Furthermore, the tax base of the land (which has been classified as inventory) for subsequent period would remain the same as indexed cost of the land on the date of such classification (i.e. 1.1.2016). Hence, there will be no change in deductible temporary difference till the year of sale, i.e., year 2020. In any case, Z Ltd. will continue to evaluate recognition and measurement of deferred tax asset based on Ind AS 12 principles.

In the year of sale, current tax as mentioned above will be payable and recognised as such. Also, it will result into reversal/ realisation of deferred tax asset, if any, recognised for land in the earlier periods.

The example above is only for illustrative purposes and should not be considered as an advice for income tax purpose.

Issue 8: ABC Ltd. is required to pay certain taxes levied by a local authority. In case of delay in payment of taxes, interest is leviable at the rate of 1%, 2%, 3%, per month on the amount in default, depending upon the length of period of delay. Whether interest leviable on the entity due to delay in payment of the taxes would form part of finance cost or whether it would be classified as part of ‘other expenses’, in the statement of profit and loss as per the requirements of relevant Ind ASs and/or those of Division II of Schedule III to the Companies Act 2013?

Response: As per Schedule III, Division II, Note 4 of the General Instructions for the Preparation of the Statement of Profit and Loss, the finance costs shall be classified as-

- (a) Interest
- (b) Dividend on redeemable preference shares
- (c) Exchange differences regarded as an adjustment to borrowing costs
- (d) Other borrowing costs (specify nature)

In the given case, local taxes not paid by due date represent interest bearing liabilities. The entity would need to evaluate whether the interest payable for delay in payment of taxes is compensatory in nature for time value of money or penal in nature. This requires exercise of judgment based on evaluation of facts of the case.

Based on such evaluation, if it is concluded that interest is compensatory in nature then it shall be included in finance cost, if it is penal in nature, then it shall be classified under 'other expenses'.

Issue 9: Entity K issues at par preference shares denominated in its functional currency and carrying discretionary non-cumulative dividend of 12% per annum. As per terms of the issue, a holder of preference shares has an option to convert each preference share into a fixed number of equity shares of the entity at the end of 5 year from the date of issue, failing which the preference shares will be redeemed at their par amount. The conversion-vs-redemption option is available independently for each preference share held by a holder. Additionally, throughout the five-year period, a holder of a preference share can put the same back to the entity for its par amount at any time. Issuance of preference shares on these terms is permissible in the relevant jurisdiction. Transaction costs are negligible.

How would the above preference shares be classified (i.e., whether as a liability or as equity) in the financial statements of Entity K?

Response: Ind AS 32, *Financial Instruments: Presentation* lays down the principles for classification of financial instruments, from the perspective of the issuer.

Paragraph 15 of Ind AS 32 states the following:

“The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.”

Paragraphs 28 to 32 of Ind AS 32 deal with the classification of compound financial instruments, i.e., instruments that contain both liability and equity components and state the following:

- “28 The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.
- 29 An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately in its balance sheet.
- 30 Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity’s contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.
- 31 Ind AS 109 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.
- 32 Under the approach described in paragraph 31, the issuer of a bond convertible into ordinary shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. The carrying

amount of the equity instrument represented by the option to convert the instrument into ordinary shares is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.”

In accordance with the above, Entity K would first determine the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. The carrying amount of the equity component ((i.e., the holder’s option to convert the instrument into affixed number of equity shares and the holder’s right to receive any dividends declared on the preference shares would then be determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

As regards the fair value of the liabilities with a demand feature, paragraph 47 of Ind AS 113, *Fair Value Measurement*, states the following:

“The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.”

In the given case, as per the terms and conditions of issue of the preference shares , Entity K has a contractual obligation to pay the par amount to the holder of a preference share at any point of time (i.e., the instrument contains a financial liability with a demand feature.

Therefore, in accordance with the above, the whole of the issue price of preference shares is allocated to the liability component and no amount is assigned to the equity component.

Issue 10: Entity X, whose functional currency is INR, has two classes of (non-puttable) equity shares, Class A and Class B. On May 1, 2018, the entity makes a rights offer to all holders of Class B equity shares. As per the rights offer, for each one equity share of Class B held by a shareholder, the shareholder is entitled to subscribe to 100 equity shares of Class A. The rights offer price is fixed at INR 60 per Class A share for Indian shareholders, and USD 1 per Class A share for overseas shareholders, holding Class B equity shares. The rights offer is valid for 6 months.

Whether the rights offer to Class B shareholders to acquire Class A shares, as referred to in the above paragraph, is an equity instrument or a (derivative) financial liability from the perspective of Entity X?

Response: Ind AS 32, *Financial Instruments: Presentation* lays down the principles for the classification of financial instruments as financial assets, financial liabilities or equity instruments from the issuer’s perspective.

As per paragraph 11 of Ind AS 32, “A financial liability is any liability that is:

(a) a contractual obligation :

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

*(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. **For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.** Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. [Emphasis added]"*

In the given case, the position regarding compliance with the aforementioned conditions laid down in Ind AS 32 for equity classification of a rights offer is as follows -

(i) *Is the rights offer for acquiring a fixed number of the entity's own equity instruments?*

Yes, the rights offer is for acquiring a fixed number of the entity's own equity instruments, i.e., for each one equity share of Class B held by a shareholder, the shareholder is entitled to subscribe to 100 equity shares of Class A.

(ii) *Is the rights exercise price a fixed amount of any currency?*

Yes, the rights exercise price is fixed at INR 60 per share for Indian shareholders and USD 1 per share for overseas shareholders.

(iii) *Has the entity offered the rights pro rata to all of its existing owners of the same class of its own non-derivative equity instruments?*

Yes, Entity X has made the rights offer to all of the existing holders of its Class B equity shares (non-derivative equity instruments) pro-rata to their holding of Class B equity shares.

As all the conditions for equity classification are met, the rights offer to Class B shareholders to acquire Class A shares is classified by Entity X as an equity instrument.

Issue 11: Entity Y, whose functional currency is INR, has issued a certain number of preference shares to an overseas investor. According to the terms of issue of the preference shares, at the end of three years from the date of issue, the holder has the option to either redeem each preference share for cash payment of USD 10 or to get 3 equity shares of Entity Y in lieu of each preference share.

Whether the equity conversion option forming part of terms of issue of preference shares represents an equity instrument or a (derivative) financial liability of Entity Y?

Response: Ind AS 32, *Financial Instruments: Presentation* lays down the principles for the classification of financial instruments as financial assets, financial liabilities or equity instruments from the issuer's perspective.

As per paragraph 11 of Ind AS 32, "A financial liability is any liability that is:

(a) a contractual obligation :

- (i) to deliver cash or another financial asset to another entity; or
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

- (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
- (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. **Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency.** Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. [Emphasis added]"

As per the above definition, as a general principle, a derivative is a financial liability if it will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. The term 'fixed amount of cash' refers to an amount of cash fixed in functional currency of the reporting entity. Since, an amount fixed in a foreign currency has the potential to vary in terms of functional currency of the reporting entity due to exchange rate fluctuations, it does not represent "a fixed amount of cash" However, as an exception to the above general principle, Ind AS 32 regards **the equity conversion option embedded in a convertible bond** denominated in a foreign currency to acquire a fixed number of entity's own equity instruments to be an equity instrument if the exercise price is fixed in *any* currency, i.e., whether fixed in functional currency of the reporting entity or in a foreign currency. [It may be noted that the corresponding standard under IFRSs (viz., IAS 32) does not contain this exception].

Ind AS 32 makes the above exception only in the case of an equity conversion option embedded in a convertible bond denominated in a foreign currency, even though it explicitly recognises at several places that other instruments can also contain equity conversion options. Given this position, it does not seem that the above exception can be extended by analogy to equity conversion options embedded in other types of financial instruments denominated in a foreign currency such as preference shares.

In view of the above, the equity conversion option forming part of terms of issue of preference shares under discussion would be a (derivative) financial liability of Entity Y.
