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# IFRS Notes

## ITFG clarifications' bulletin 17

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## Introduction

The Ind AS Technical Facilitation Group (ITFG) of the Institute of Chartered Accountants of India (ICAI) issued its ITFG clarifications' bulletin 17 on 19 December 2018. It provides clarifications on 11 issues relating to various Ind AS.

This edition of IFRS Notes provides an overview of 11 issues clarified by ITFG.

## Overview of ITFG clarifications' bulletin 17

### 1. Classification of interest related to delay in payment of taxes (Issue 8)

An entity ABC Ltd. was required to pay certain taxes levied by a local authority. Interest was levied at a variable rate ranging from one per cent to three per cent per month depending upon the length of period of delay.

The ITFG considered an issue from the perspective of classification of interest levied due to delay in payment of taxes in the statement of profit and loss i.e. whether it would form part of finance cost or would be classified as part of 'other expenses'.

In accordance with Note 4 of the general instructions for the preparation of the statement of profit and loss, Division II of Schedule III to the Companies Act, 2013 (2013 Act), the finance costs are classified as below:

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 this case, local taxes not paid by due date represent interest bearing liabilities. Therefore, an 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. Thus, judgement is required to be exercised based on the evaluation of facts and circumstances of each case.

On the basis of evaluation, if an entity concluded that interest was compensatory in nature then such an interest would be required to be included in finance cost. On the other hand, if interest on delayed payment of taxes was penal in nature, then it would be classified as 'other expenses'.

### 2. Guidance for accounting treatment in accordance with Ind AS 20

#### (a) Amendments to Ind AS 20[1] (Issue 1)

Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance* has been recently amended. It now provides an entity with a choice for accounting of government grants in the form of non-monetary assets. Accordingly, an entity can either present the non-monetary asset and grant at fair value or record both asset and grant at a nominal amount.

X Ltd., a government company[2] in which 100 per cent of its paid-up capital is held by the Government of India, received certain 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

[1]Ind AS 20, has been amended and consequential amendments made to certain other Ind AS by a notification dated 20 September 2018 issued by the Ministry of Corporate Affairs, Government of India.

[2] It is pertinent to note here 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 per cent 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 also 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.

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with specified terms and conditions. In accordance with the then applicable AS 12, *Accounting for Government Grants*, the land was recorded at a nominal value of INR1.

The ITFG considered two scenarios – i.e. one where X Ltd. is considered as a first-time adopter of Ind AS and in the second one as an entity that complies with Ind AS.

**i. X Ltd. is a first-time adopter of Ind AS and its first Ind AS reporting period is financial year 2018-19**

As mentioned above, under the amended Ind AS 20, X Ltd. has a choice of recognising the grant and the asset (i.e., land in this case), initially either at fair value or at a nominal amount.

Ind AS 101, *First-time Adoption of Indian Accounting Standards*, contains requirements applicable to first set of Ind AS financial statements of an entity as well as certain mandatory exceptions and voluntary exemptions for first time adopter of Ind AS.

Ind AS 101 further states the following with respect to opening Ind AS balance sheet:

a) An entity is required to prepare and present an opening Ind AS balance sheet at the date of transition to Ind AS.

b) An entity is required to 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 would comply with each Ind AS effective at the end of its first Ind AS reporting period. Generally those accounting policies are applied on a retrospective basis.

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 1 April 2017.

Additionally, under Ind AS 101, there is no mandatory exception or voluntary exemption 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 AS (and consequently in subsequent accounting periods).

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

As X Ltd. transitioned to Ind AS a few years back, therefore, it is following an accounting policy of recognising government grant and the related asset at fair value.

Ind AS 20 has been amended recently, therefore, an issue may arise whether for the financial year 2018-19, X Ltd. is required or permitted to change its accounting policy relating to government grant.

In accordance with Ind AS 8, A*ccounting Policies, Changes in Accounting Estimates and Errors,* an entity would 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.

The amended Ind AS 20 now provides an entity an accounting policy 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 FY. However, X Ltd. is permitted to change its accounting policy voluntarily.

Ind AS 8 lays down following two requirements that must be complied with in order to make a voluntary change in an accounting policy:

a) The information resulting from application of the changed (i.e. the new) accounting policy must be reliable.

b) The changed accounting policy must result in 'more relevant' information being presented in the financial statements.

## Overview of ITFG clarifications' bulletin 17 (cont.)

Whether a change in an accounting policy results in reliable and more relevant financial information is a matter of assessment based on 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), Ind AS 8 further 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, X Ltd. could make a voluntary change in an accounting policy only if such a change results in its 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.

### (b) Export benefits under a scheme of the Government of India (Issue 3)

The ITFG has considered and clarified on whether  the benefit received by an entity (which is a registered unit in Special Economic Zone (SEZ) is a government grant or a government assistance other than government grant under Ind AS 20. The benefit from the government may be 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 the Government of India.

In accordance with the guidance given in Ind AS 20, ITFG clarified that 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[3].

Further, classification of a grant as related to an asset or to income would 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 whether it is a grant related to an asset or a grant related to income and how is the same to be accounted for.

The ITFG pointed out that this issue has earlier been clarified as issue 5 in the ITFG clarifications' bulletin 11 as below:

- **Export of goods:** If the grant received is to compensate the import cost of assets, and is subject to export obligation as prescribed in the EPCG scheme, then the recognition of the grant would be linked to fulfilment of the associated export obligations and would be treated as grants related to income and such a grant will be presented in the statement of profit and loss, either separately or under a general heading such as 'other income'. Alternatively, it may be deducted in reporting the related expenses.
- **Compensate import cost of an asset:** If the grant received is to compensate the import cost of the asset, and it can be reasonably concluded that conditions relating to export of goods are subsidiary conditions, then it is appropriate to treat such grant as grants related to assets and present it as deferred income by recognising such grants in profit or loss over the life of the underlying asset.

### 3. Disclosures related to related party transactions (Issue 6)

An entity S Ltd., a wholly owned subsidiary of another entity P Ltd., is the sole distributor of electricity to consumers in a specified geographical area. A manufacturing facility of P Ltd. was located in the same geographical area. Consequently P Ltd. is also a consumer of electricity supplied by S Ltd.

The issue considered was 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.

In accordance with Ind AS 24, each parent, subsidiary and fellow subsidiary in a 'group' is related to the other members of the group. In this case P Ltd. is a related party of S Ltd. from the perspective of financial statements of S Ltd.

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[3]Education Material on Ind AS 115, *Revenue from Contracts with Customers,* issued by Ind AS Implementation Group in August 2018 has also given guidance on similar lines.

## Overview of ITFG clarifications' bulletin 17 (cont.)

S Ltd. is a public utility (being engaged in distribution of electricity), but it is also a subsidiary of P Ltd. Thus, there is a dual relationship between S Ltd. and P Ltd. - as a supplier and consumer and as subsidiary and holding company. The subsidiary and holding company relationship covered within the related party relationships to which the disclosure requirements of Ind AS 24 would apply.

Therefore, ITFG clarified that the supply of electricity by S Ltd. to P Ltd. is a related party transaction that attracts the disclosure requirements contained in Ind AS 24. This would be 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). This is because Ind AS 24 does not exempt an entity from disclosing related party transactions merely because they have been carried out at an arm's length basis.

### 4. Equity accounting in the CFS of investor in case of loss of control (Issue 5)

An entity B Ltd., a subsidiary of another entity A Ltd., (parent), owned an investment property that was measured at cost in accordance with Ind AS 40, *Investment Property*. A Ltd. sold a portion of its equity shareholding in B Ltd., and consequently B Ltd. became a joint venture between A Ltd. and another entity Z Ltd.

In accordance with the requirements of Ind AS 28, *Investments in Associates and Joint Ventures*, equity method is required to be applied in the Consolidated Financial Statements (CFS) of A Ltd. to account for its investment in the joint venture (i.e. B Ltd.). Thus, in CFS of A Ltd., equity method requires the identifiable assets and liabilities of the investee (i.e. B Ltd.) be fair valued and appropriate adjustments be made to an entity's (i.e. A Ltd.'s) share of investee's profit or loss, such as those for depreciation/ amortisation based on aforesaid fair values of identifiable assets and liabilities at an acquisition date.

Ind AS 40, on the other hand, does not allow an investment property to be measured at fair value.

The ITFG considered two accounting issues as following:

**i. Whether there is any contradiction between Ind AS 40 and Ind AS 28**

While considering the issue ITFG considered that though the above 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 AS 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 AS prohibit the recognition of certain assets such as internally-generated goodwill and brands.

From the perspective of an investor who acquires, a controlling interest in an entity (or an interest giving the investor joint control or significant influence over the investee), Ind AS requires 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 would 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 Ind AS 28 (or Ind AS 110, *Consolidated Financial Statements* 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, ITFG has clarified that there does not seem any contradiction between Ind AS 40 and Ind AS 28.

## Overview of ITFG clarifications' bulletin 17 (cont.)

**ii. Whether the adjustments arising out of fair valuation of investment property as required under Ind AS 28 should be made in the CFS of the investor**

In accordance with Ind AS 110, 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).

Further Ind AS 28 provides that 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.

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 would be made in the CFS of the investor.

### 5. Debt-equity classification of financial instruments

**(a) Optionally convertible preference shares with discretionary dividend and an embedded call option (Issue 9)**

An entity (entity K) issued 12 per cent, five year, optionally convertible preference shares with discretionary non-cumulative dividend, at par in its functional currency. As per the terms of issue:

(i) The holder of the preference shares had an option to convert them into fixed number of equity shares at the end of five years

(ii) If the conversion option was not exercised, then the preference shares would be redeemed at par

(iii) Throughout the five year period, the holder had an option to put the preference shares back to entity K at its par amount [4].

The issue under consideration was the classification and measurement of preference shares in accordance with Ind AS 32, *Financial Instruments: Presentation.*

Ind AS 32 prescribes that on initial recognition, all financial instruments or components thereof should be classified as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement, and the relevant definitions.

Financial instruments may contain both, a liability and an equity component - i.e. a component that creates a financial liability of the entity, and that grants an option to the holder of the instrument to convert it into fixed number of equity instruments. The ITFG clarified, that considering the terms of the preference shares issued, and the guidance provided in Ind AS 32, the economic effect of issuing the

[4] For the purpose of this issue, ITFG assumed that issuance of preference shares on these terms was permissible in the relevant jurisdiction. Further, transaction costs were assumed to be negligible.

## Overview of ITFG clarifications' bulletin 17 (cont.)

above instrument was substantially the same as issuing simultaneously a debt instrument with early settlement provision and warrants to purchase ordinary shares. Accordingly, the components of the preference shares would be required to be classified and presented separately.

The ITFG stated, that in accordance with Ind AS 32, the initial carrying amount of the compound financial instrument would be allocated to its equity and liability components. Accordingly, entity K would be required to 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 would be the residual amount, computed by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole. The value of the derivative feature embedded in the compound financial instrument (the call option in this case), would be included in the liability component.

However, ITFG noted that in the given case, entity K had a contractual obligation to pay the par amount to the holder of a preference share at any point in time, hence, the liability component had a demand feature attached. Thus, while measuring the fair value of the liability component, reference to Ind AS 113, *Fair Value Measurement* would be required to be made. As per Ind AS 113, the fair value of a financial liability with a demand feature (e.g. 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.

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

### (b) Issue of rights offer (Issue 10)

An issue was considered, wherein an entity (entity X), with INR as its functional currency had two classes of non-puttable equity shares - Class A and Class B. Post the date of transition to Ind AS, entity X made a rights offer to all holders of Class B equity shares. The terms of the right offer were:

- For each equity share of Class B held, the shareholder is entitled to subscribe to 100 equity shares of Class A
- The rights offer price was fixed at:
  - INR60 per Class A share for Indian shareholders, and
  - USD1 per Class A share for overseas shareholders.
- The rights offer was valid for six months.

The ITFG considered whether from the perspective of entity X, the rights offer to Class B shareholders to acquire Class A shares is an equity instrument or a (derivative) financial liability.

Ind AS 32 lays down the principles for the classification of financial instruments as financial assets, financial liabilities or equity instruments from the issuer's perspective. The definition of financial liabilities *inter alia* states that a financial liability is any liability that is a derivative that would 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…'

Considering the above definition, ITFG evaluated the terms of the rights issued as below:

- The rights offer was for acquiring a fixed number of the entity's own equity instruments (i.e. for each equity share of Class B held, the shareholder was entitled to subscribe to 100 equity shares of Class A)

- The right exercise price was a fixed amount - i.e. INR60 per share for Indian shareholders and USD1 per share for overseas shareholders

- Entity X had made the rights offer to all the existing shareholders of Class B equity shares pro-rata to their holding of Class B equity shares.

## Overview of ITFG clarifications' bulletin 17 (cont.)

On the basis of the above evaluation, since all the conditions for equity classification were met, ITFG concluded, that the rights offer to Class B shareholders to acquire Class A shares should be classified as an equity instrument.

### (c) Preference shares issued in foreign currency (Issue 11)

The ITFG considered an issue wherein an entity (entity Y), with INR as its functional currency, issued preference shares with three years term denominated in a foreign currency to an overseas investor. As per the terms of issue, at the end of three years, entity Y had an option to either redeem each preference share at USD10 or get it converted into three equity shares of entity Y.

The issue under consideration was whether entity Y would classify the equity conversion option forming part of terms of issue of preference shares as an equity instrument or a (derivative) financial liability.

The ITFG noted that 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' referred to an amount of cash fixed in the 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, Ind AS 32 regards an equity conversion option embedded in a convertible bond denominated in a foreign currency to acquire a fixed number of the entity's own equity instruments to be an equity instrument if the exercise price was fixed in *any* currency (i.e. functional or foreign currency)[5].

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

Accordingly, ITFG concluded that the equity conversion option forming part of terms of issue of preference shares under discussion would be a (derivative) financial liability of entity Y Ltd.

### 6. Inclusion of Dividend Distribution Tax (DDT) on preference shares in Effective Interest Rate (EIR) (Issue 2)

An entity ABC Ltd. issued cumulative redeemable preference shares carrying a fixed rate of dividend per annum. The preference shares are redeemable at a specified premium at the end of eight 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. determined that the preference shares would qualify for classification as a financial liability in their entirety under Ind AS 32.

The ITFG considered that in case preference shares are accounted for in accordance with Ind AS 109, *Financial Instruments,* would DDT on such shares be included in computing EIR thereon.

In accordance with the guidance contained in Ind AS 32, if a financial instrument is classified as a financial liability in its entirety the 'dividend' thereon is in the nature of interest and is accordingly charged to the statement profit and loss.

Further, Ind AS 109 provides that when applying the EIR 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 EIR over the expected life of the financial instrument.

[5] Currently, IAS 32, *Financial Instruments: Presentation*, does not have this exception, and a conversion option denominated in a foreign currency does not meet the 'fixed amount of cash' criterion.

## Overview of ITFG clarifications' bulletin 17 (cont.)

Additionally, the Guidance Note on Division II - Ind AS Schedule III to the Companies Act, 2013 issued by of the ICAI provides guidance in respect of dividend on preference shares. The guidance is as follows:

'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 a case, the portion of dividend as determined by applying the effective interest method should be presented as an 'interest expense' under 'finance cost'. Accordingly, the corresponding DDT on such portion of non-discretionary dividends should also be presented in the statement of profit and loss under 'interest expense'.'

Frequently Asked Questions (FAQs) regarding DDT issued by the Accounting Standards Board (ASB) of the ICAI provide 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.

Accordingly, ITFG clarified that in this 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 DDT should be regarded as part of interest cost and should form part of EIR calculation.

### 7. Recognition of dividend income on an investment on a debt instrument in the books of the investor (Issue 4)

The ITFG has earlier considered an issue where legal form of income received by an investor or an investment in a financial instrument considered as dividend.

In that clarification, it was stated that the recognition of income will depend on the classification of the instrument as at Fair Value Through Profit or Loss (FVTPL), at amortised cost or at Fair Value Through Other Comprehensive Income (FVOCI) as determined in accordance with the requirements of Ind AS 109.

In this bulletin, ITFG has further clarified on the situation when a financial asset cannot be classified under amortised cost or FVOCI (debt) category.

In accordance with Ind AS 109, to be classified as amortised cost or FVOCI (debt) category, a financial asset must meet the following two conditions:

i. Business Model Test and

ii. Contractual Cash flow Characteristic test (SPPI test).

Ind AS 109 provides guidance on the SPPI and business model test.

The ITFG considered an example of a redeemable preference shares as a debt instrument with legal form of income as dividend. In order to assess if SPPI test is met for a redeemable preference share, an entity would need to evaluate if the dividend is discretionary or non-discretionary.

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.

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 differ from those of a basic lending arrangement 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 share fails the SPPI test and cannot, therefore, be classified as at amortised cost or FVOCI. Therefore, such preference share would be classified at FVTPL.

An entity would need to consider applicable legal provisions in the relevant jurisdiction and also specific terms and conditions associated with the preference shares.

## Overview of ITFG clarifications' bulletin 17 (cont.)

In case the preference shares meet the SPPI test and business model test then the dividend income would be accounted for using EIR method provided the instrument is classified under either at amortised cost or FVOCI. In case, it does not meet above tests or the entity has chosen the fair value option, the instrument would be classified at FVTPL and the entity would give disclosures for its accounting policy in accordance with disclosure requirements contained in Ind AS 107, *Financial Instruments: Disclosures*.

### 8. Creation of deferred tax on land converted from fixed asset to inventory (Issue 7)

An entity Z Ltd. purchased certain land as fixed asset on 1 January 2007 for INR100 which was subsequently converted to inventory on 1 January 2016. At the date of conversion indexed cost of land was INR150 and its fair value was INR1,000.

Z Ltd. adopted Ind AS from 1 April 2018 and its date of transition was 1 April 2017.

On the date of transition, the land (now classified as inventory) was recognised at its historical cost (i.e. INR100, which was its carrying value).

The issue considered by ITFG was that should Z Ltd. recognize deferred tax on land on the date of transition to Ind AS.

The ITFG pointed out 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 would be as follows:

- **Capital gains tax:** 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.
- **Profit/loss on sale of land as stock-in-trade:** 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. 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 would need to consider deferred tax implications under Ind AS 12, *Income Taxes.* Ind AS 12 provides Deferred Tax Asset (DTA)/Deferred Tax Liability (DTL) would be required 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 [6] respectively. Only in specified situations e.g. if DTA/DTL arises from a transaction that affects neither accounting profit nor taxable profit (tax loss) at the time of the transaction (initial recognition exemption), would it not be recognised. The ITFG pointed out that recognition of DTA would be subject to consideration of prudence.

Ind AS 12 also provides that the measurement of DTL and DTA reflects 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. 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 would require exercise of judgement based on evaluation of facts and circumstances in each case.

[6] The tax base of an asset or liability is the amount attributed to that asset or liability for tax purpose.

## Overview of ITFG clarifications' bulletin 17 (cont.)

Accordingly, ITFG clarified as below:

a) On the date of transition to Ind AS (1 April 2017), a deductible temporary difference existed for Z Ltd. arising out of the carrying amount of asset (which is INR100 as on 1 January 2016) and its tax base (which is INR150 as on 1 January 2016, considering indexation benefit). Thus, on the date of transition, the entity would recognise a DTA for the deductible temporary difference of INR50 in the value of land provided it satisfied DTA recognition criteria under Ind AS 12.

b) The difference between the indexed cost of land on the date of conversion and its fair value, however, would not meet definition of temporary difference under Ind AS 12. Additionally, the business income under the Income-tax Act would be computed as a difference between the sale price of the stock-in-trade (i.e. date of actual sale of inventory) and market value of the capital asset on the date of its conversion into stock-in-trade. Hence, such a tax liability would not arise on the date of transition.

## Our comments

**Classification of interest related to delay in payment of taxes (Issue 8)**

Entities 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. Therefore, judgement is required since facts may vary on a case to case basis.

**Treatment of export benefits under a scheme of the Government of India (Issue 3)**

The ITFG has clarified that 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 the Government of India would need to be accounted in accordance with Ind AS 20.

Additionally, ITFG again clarified that the classification of the grant as related to an asset or to income would 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 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 accordingly.

**Debt-equity classification of financial instruments (Issues 9, 10 and 11)**

When determining whether to classify a financial instrument as a financial liability or as equity, an entity should assess the substance of a contractual arrangement rather than its legal form. In assessing the substance of a contractual arrangement, the entity needs to consider all of the terms and conditions of the financial instrument, including relevant laws, regulations and entity's governing charter in effect at the date of classification. Therefore, it is possible for instruments that qualify as equity for legal or regulatory purposes to be classified as liabilities for the purposes of financial reporting.

Further, preference shares issued in foreign currency would not meet the exception outlined for an equity conversion option embedded in a convertible bond denominated in a foreign currency.

**Recognition of dividend income on an investment on a debt instrument in the books of the investor (Issue 4)**

In one of its earlier bulletin 8, ITFG has clarified on the above issue. Further clarification has now been provided for entities to carefully consider the business model test and SPPI criterion in order to account for the investment at amortised cost or at FVOCI.

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## KPMG in India's IFRS institute


Visit KPMG in India's IFRS Institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

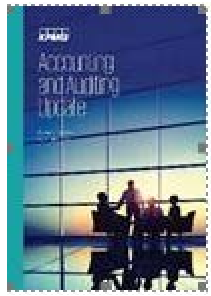
## Voices on Reporting


**KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.**

In a special session held on 7 January 2019, we discussed key financial reporting and regulatory matters relevant for the stakeholders for the quarter ended 31 December 2018.

Click here to access the audio recording (mp3) and presentation (pdf).

## Missed an issue of our Accounting and Auditing Update or First Notes




### Issue no. 29 | December 2018

The auditor's report - the principal communication from the auditor to users of audited financial statements - has undergone a significant change around the world. A more informative auditor's report is the most visible change in auditing in more than 50 years. New auditor's report including communication of key audit matters in the auditor's report is effective in India for audits of financial statements for the periods beginning on or after 1 April 2018. In this edition of the Accounting and Auditing Update (AAU), we have included an article which illustrates sector-wise areas that could be potential key audit matters.

Ind AS 115, *Revenue from Contracts with Customers* changes the core principle that requires companies to evaluate their transactions in a new way. Continuing with our sector series on impact of Ind AS 115, we cover the transport, logistics and leisure sector. Our article highlights the key areas where more judgement and estimation would be required with the help of practical examples.

Banks may advance loans with prepayment clauses. Ind AS 109, *Financial Instruments* provides guidance on classification of financial assets as at amortised cost, Fair Value Through Other Comprehensive Income (FVOCI) and Fair Value Through Profit and Loss (FVTPL). If certain criteria are met, such financial assets could be classified at amortised cost or FVOCI. In case those criteria are not met, then financial assets would be classified at FVTPL. An article on this topic demonstrates the assessment and classification of financial assets with prepayment features with the help of an illustrative.

Our publication also carries a regular synopsis of some recent regulatory updates in India and internationally.


### SEBI proposes norms for direct listing of equity shares within and outside India

**22 December 2018**

On 12 June 2018, the Securities and Exchange Board of India (SEBI) formed an '*Expert committee for listing of equity shares of companies incorporated in India on foreign stock exchanges and of companies incorporated outside India on Indian stock exchanges*' (the committee). The role of the committee, *inter alia*, was to make recommendations for a suitable framework to facilitate direct listing of equity shares of Indian companies on foreign stock exchanges and of foreign companies on Indian stock exchanges.

Accordingly, on 4 December 2018, SEBI released the report of the committee with a proposed framework for such direct listing.

Comments on the proposed framework have been invited up to 24 December 2018.

This issue of First Notes aims to provide an overview of the key recommendations made by the committee with respect to direct listing of equity shares in Indian and foreign stock exchanges.

**Previous editions are available to download from: www.kpmg.com/in**



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