

PAPER

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**FINAL COURSE  
STUDY MATERIAL  
GROUP-I  
FINANCIAL  
REPORTING  
MODULE 3 OF 4**



**Board of Studies (Academic)**  
**The Institute of Chartered  
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## **CHAPTER 11 – ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS**

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# IND AS ON LIABILITIES OF THE FINANCIAL STATEMENTS



## UNIT 1: INDIAN ACCOUNTING STANDARD 19: EMPLOYEE BENEFITS

### LEARNING OUTCOMES

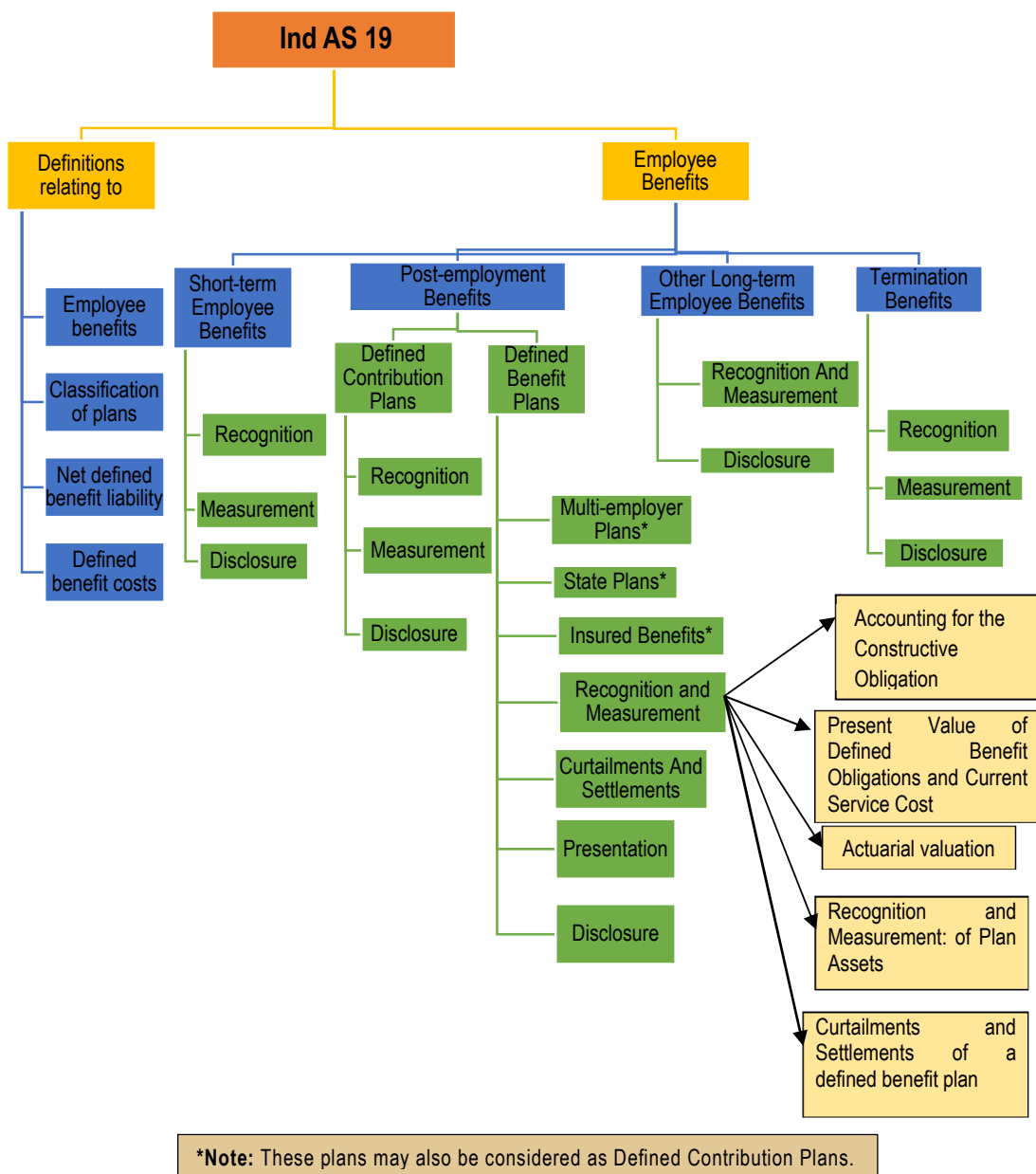
After studying this unit, you will be able to:

- ☐ State the objective and scope of Ind AS 19
- ☐ Define the terms relating to employee benefits, classification of plans, net defined benefit liability (asset) and defined benefit cost
- ☐ Examine the four categories of employee benefits (short-term, post-employment, other long-term and termination benefits)
- ☐ Recognise and measure all short term employee benefits, short term paid absences and account for profit sharing and bonus plans
- ☐ Distinguish between defined contribution plans and defined benefit plans
- ☐ Account for multiemployer plans, state plans and insured benefits
- ☐ Recognise and measure defined benefit plans that share risks between entities under common control
- ☐ Recognise, measure and disclose defined contribution plans
- ☐ Account for the constructive obligation plans under defined benefit plan



- ❑ Apply actuarial valuations in recognition and measurement of defined benefit plans
- ❑ Remeasure the net defined benefit liability (asset) using the current fair value of plan assets and current actuarial assumptions
- ❑ Determine past service cost, or a gain or loss on settlement,
- ❑ Recognise the components of defined benefit cost
- ❑ Present and disclose employee benefits in the financial statements as per Ind AS 19

## UNIT OVERVIEW



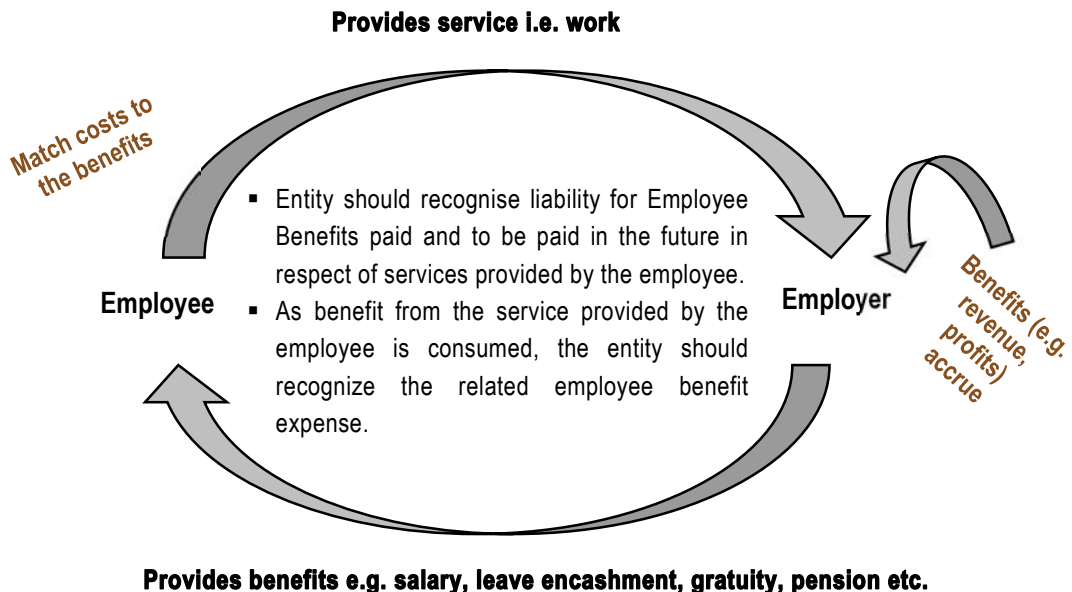


## 1.1 OBJECTIVE OF IND AS 19

- ❖ The objective of this standard is to prescribe the accounting and disclosure for employee benefits.
- ❖ Ind AS 19 requires an entity to recognise:
  - (a) a liability for the services received from an employee; and
  - (b) an expense for consumption of economic benefits arising from the service provided by an employee in exchange for employee benefits.

Financial statements are prepared on the accrual basis of accounting. Under this basis, the **effects** of transactions and other events are recognised **when they occur** (and not when cash or its equivalent is received or paid) and they are **recorded** in the accounting records and reported in the financial statements of the **periods to which they relate**. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.

When employees provide services to their employer during a period, their services lead to generation of benefits (revenues or profits or increased efficiency), directly or indirectly, for their employers for that period. The underlying assumption of accrual requires that for the benefit earned in a particular period, the costs incurred in earning that benefit need to be recognised entirely. Adherence to this requirement of the framework is what is addressed by Ind AS 19.





## 1.2 SCOPE

The concept of 'Employee Benefits' has evolved over the years to encompass more than just the salaries, wages and social welfare contributions. The companies of today – established or start-ups – provide a host of benefits to its employees including, but not limited to, Employees' Stock Option Plans, jubilee bonuses, long-term disability benefits etc. In fact, companies like Google even provide unusual benefits such as 'death benefits', which involve paying the deceased's spouse or domestic partner 50% of their salary for 10 years after death of the employee.

- ❖ This Standard shall be applied by an employer in **accounting for all employee benefits** except those to which Ind AS 102, *Share-based Payment*, is applicable (e.g. Employees Stock Option Plans).
- ❖ This Standard does not deal with reporting by employee benefit plans.
- ❖ Employee benefits to which this Standard applies include those provided
  - under formal plans/agreements between an entity and its individual employees/group of employees/their representatives,
  - as required by law or as required by any type of industry arrangements whereby an entity is required to contribute to any nation/state/industry or other multi-employer plans; or
  - by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits.

Example of a constructive obligation - Where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

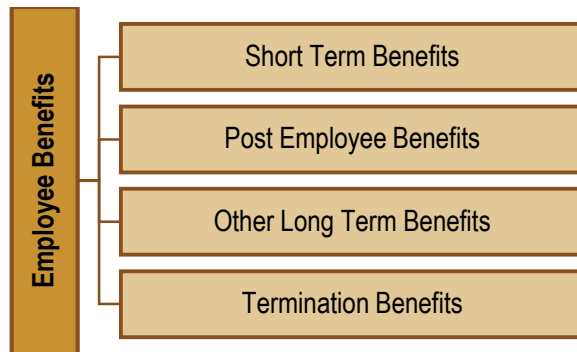


## 1.3 EMPLOYEE BENEFITS

**Employee benefits include:**

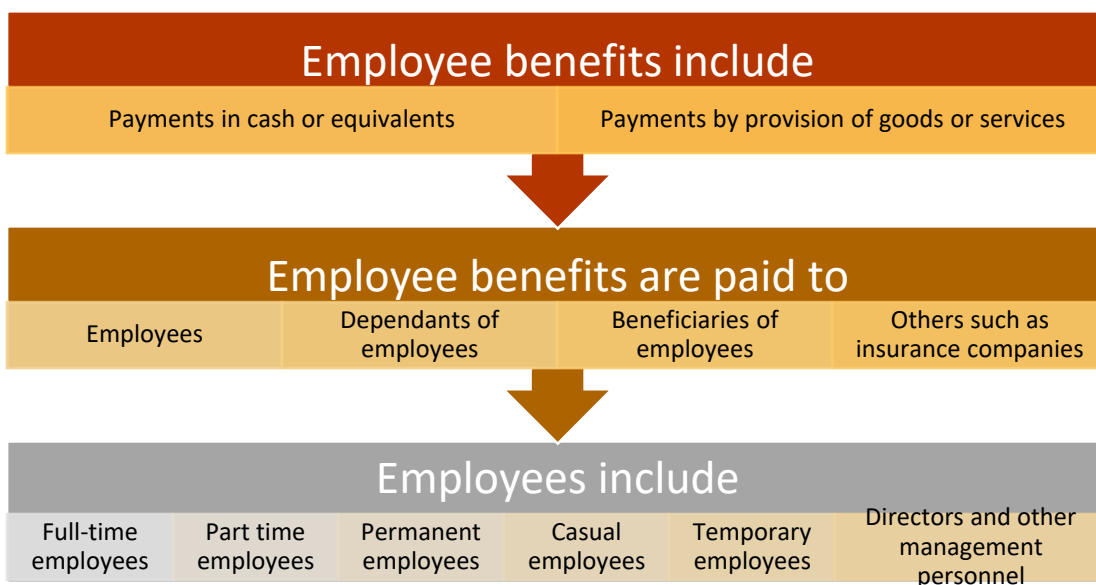
- (i) short employee benefits,
- (ii) post-employment benefits,
- (iii) other long term employee benefits and
- (iv) termination benefits.

All these categories have different characteristics and hence the Standard has specified separate accounting requirements for each such category.



- ❖ Employee benefits include benefits provided either to
  - employees; or
  - their dependants; or
  - their beneficiaries.
- ❖ Employee benefits may be settled by payments (or the provision of goods or services) made either directly
  - directly to the employees; or
  - to their spouses; or
  - to their children; or
  - to their other dependants; or
  - others, such as insurance companies.
- ❖ An employee may provide services to an entity on a
  - full-time; or
  - part-time; or
  - permanent; or
  - casual; or
  - temporarybasis.

**Note:** For the purpose of this Standard, employees include directors and other management personnel.



## 1.4 DEFINITIONS

### 1.4.1 Definitions of employee benefits

1. **Employee Benefits:** All forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.
2. **Short-term Employee Benefits:** Employee benefits (other than termination benefits) that are expected to be settled wholly **before twelve months** after the end of the annual reporting period in which the employees render the related service.

**Example :** Wages, salaries, social security contributions (PF / ESI), paid annual leave / sick leave.

3. **Post-employment Benefits:** Employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

**Example :** Pensions, lumpsum payments on retirement.

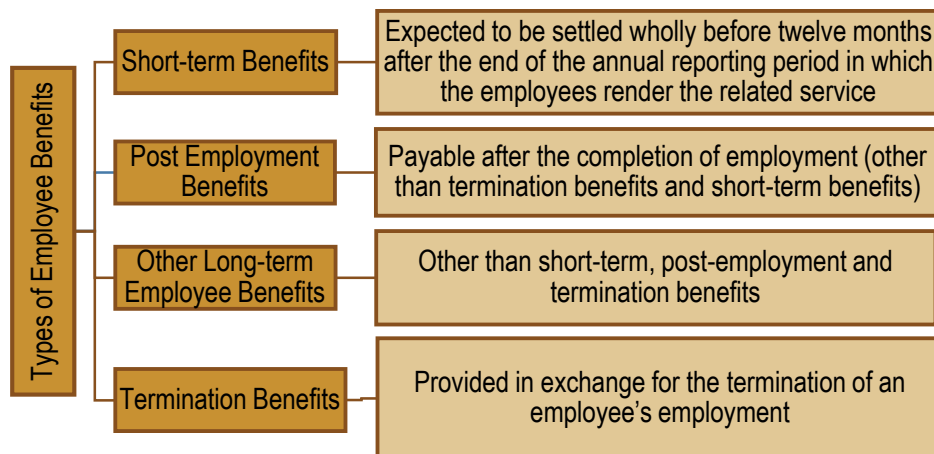
4. **Other long-term employee benefits** are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

**Example :** Long-term paid absences such as long-service leave or sabbatical leave, jubilee or other long-service benefits.

5. **Termination benefits** are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

- (a) an entity's decision to terminate an employee's employment before the normal retirement date; or
- (b) an employee's decision to accept an offer of benefits in exchange for the termination of employment.

**Example :** VRS compensation or Retrenchment compensation



### 1.4.2 Definitions relating to classification of plans

1. **Post-employment Benefit Plans:** These plans are **formal** or **informal** arrangements under which an entity provides post-employment benefits for one or more employees.

Under these plans, the benefits are given to the employees after employment, like gratuity, pension, provident fund etc.

**Note:** Defined contribution plans and defined benefit plans are two categories of post-employment benefits plans.

2. **Defined Contribution Plans:** They are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a Fund) and will have **no** legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

In these plans, the contribution is defined i.e. contribution is fixed and known to the entity.

**Example :** Provident Fund contribution by the employer to the Employees' Provident Fund Organisation under Ministry of Labour & Employment, Government of India.

3. **Defined Benefit Plans:** Post-employment benefit plans other than defined contribution plans.

**Example:** Gratuity.

4. **Multi-employer Plans:** Defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:
- (a) pool the assets contributed by various entities that are not under common control; and
  - (b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees.

### 1.4.3 Definitions relating to the net defined benefit liability (asset)

---

1. **Net defined benefit liability (asset):** The deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.
2. **Deficit or surplus:**
  - (a) the present value of the defined benefit obligation **less**
  - (b) the fair value of plan assets (if any).
3. **Asset ceiling:** The present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.
4. **Present value of a defined benefit obligation:** Present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.
5. **Plan assets** comprise:
  - (a) assets held by a long-term employee benefit fund; and
  - (b) qualifying insurance policies.
6. **Assets held by a long-term employee benefit fund:** Assets (other than non-transferable financial instruments issued by the reporting entity) that:
  - (a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and
  - (b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:
    - (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or
    - (ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.
7. **Qualifying Insurance Policy:** Insurance policy issued by an insurer that is not a related party (as defined in Ind AS 24, *Related Party Disclosures*) of the reporting entity, if the proceeds of the policy:



- (a) can be used only to pay or fund employee benefits under a defined benefit plan; and
- (b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:
  - (i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or
  - (ii) the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

**8. Fair Value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Ind AS 113, Fair Value Measurement.)

### 1.4.4 Definitions relating to defined benefit cost

---

**1. Service cost** comprises:

- (a) *Current service cost*, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period;
- (b) *Past service cost*, which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and
- (c) any gain or loss on settlement.

**2. Net interest on the net defined benefit liability (asset):** The change during the period in the net defined benefit liability (asset) that arises from the passage of time.

**3. Remeasurements of the net defined benefit liability (asset)** comprise:

- (a) actuarial gains and losses;
- (b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and
- (c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

**4. Actuarial gains and losses** are changes in the present value of the defined benefit obligation resulting from:

- (a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
- (b) the effects of changes in actuarial assumptions.

5. **Return on plan assets:** Interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets,

Less:

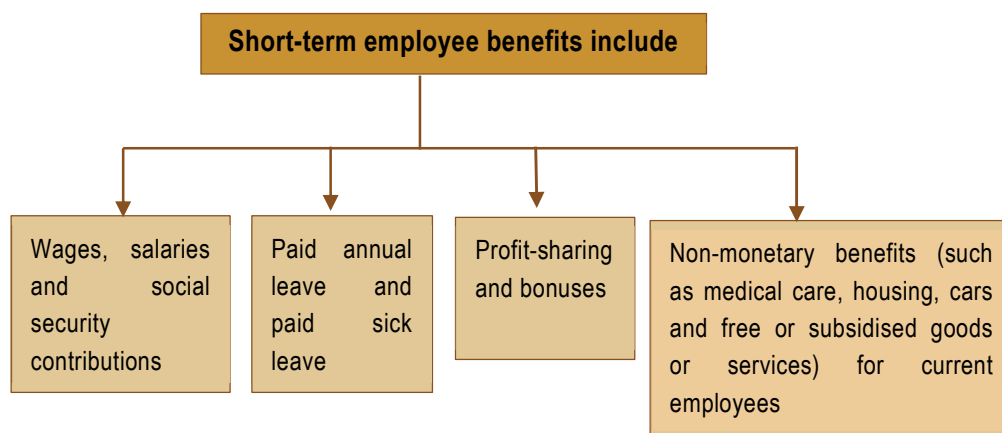
- (a) any costs of managing plan assets; and
- (b) any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation.

6. **Settlement:** A transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.



## 1.5 SHORT-TERM EMPLOYEE BENEFITS

- ❖ Short-term employee benefits include items expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services.
- ❖ It includes
  - (a) wages, salaries and social security contributions;
  - (b) paid annual leave and paid sick leave;
  - (c) profit-sharing and bonuses; and
  - (d) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.



- ❖ Reclassification of a short-term employee benefit is not required if the entity's expectations of the timing of settlement of such benefits change temporarily.

- ❖ Reclassification may be considered-
  - if the characteristics of the benefit change (such as a change from a non-accumulating benefit to an accumulating benefit) or
  - if a change in expectations of the timing of settlement is not temporary.

### 1.5.1 Recognition and measurement of short-term benefits

Accounting for short term benefits has two characteristics:

- (a) short-term benefits are measured on an undiscounted basis; and
- (b) they don't involve any actuarial valuation for their measurement.

The undiscounted amount of short-term employee benefits expected to be paid in exchange for that service shall be recognised:

- (a) as a liability (accrued expense), after deducting any amount already paid.  
If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and
- (b) as an expense, if it doesn't form part of the cost of an asset as per any other Ind AS (e.g. Ind AS 2, *Inventories* or Ind AS 16 *Property, Plant and Equipment*).

**Note:** Recognition of short-term employee benefit is in the form of either paid expenses or profit sharing or bonus plans.

### 1.5.2 Short-term paid absences

An employer may compensate an employee for absence for various reasons including holidays, sickness and short-term disability, maternity or paternity, jury service and military service. Entitlement to paid absences (i.e. compensated balances) fall into two categories and are recognized as follows:

- (a) **Accumulating** paid absences - recognized when the employees render service that increases their entitlement to future paid absences; and
- (b) **Non-accumulating** paid absences - recognized when the absences occur.

#### 1.5.2.1 Accumulating paid absences

- ❖ These are the absences that are carried forward and can be used in future periods if the employee is not able to use them in current reporting period of the employer. They can be either:
  - (i) **Vesting:** In this case, employees are **entitled to a cash-payment** for the unutilised entitlement at the time of leaving the entity; and
  - (ii) **Non-vesting:** In this case, employees are **not entitled to a cash payment** for unused entitlement on leaving.

- ❖ This obligation exists and is recognized, even if the paid (compensated) absences are non-vesting. However, in case an employee leaves the entity before they use an accumulated non-vesting entitlement, it will affect the measurement of this obligation.
- ❖ An entity shall measure the expected cost of accumulating paid (compensated) absences as the **additional amount that the entity expects to pay as a result of the unused entitlement** that has accumulated at the end of the reporting period.

#### Illustration 1: Vested Accumulating Benefits

*Mr. Rajan is working for Infotech Ltd. Consider the following particulars:*

*Annual salary of Mr. Rajan = ₹ 30,00,000*

*Total working days in 20X0-20X1 = 300 days*

*Leaves allowed in 20X0-20X1 as per company policy = 10 days*

*Leaves utilized by Mr. Rajan in 20X0-20X1 = 8 days*

*The unutilized leaves are settled by way of payment and accordingly, carry forward of such leaves to the subsequent period is not allowed.*

*Compute the total employee benefit expense for Infotech Ltd. in respect of 20X0-20X1.*

#### Solution

Mr Rajan is entitled to a salary of ₹ 30,00,000 for 300 total working days.

Thus, per day salary works out to ₹ 30,00,000 ÷ 300 days = ₹ 10,000 per day

In the year 20X0-20X1, Mr. Rajan availed 8 out of 10 leaves allowed by the company.

Accordingly, leaves unutilized = 10 – 8 = 2 days

In line with the company policy, Infotech Ltd. will pay Mr. Rajan for the unutilized leave.

Thus, total expense for 20X0-20X1 = ₹ 30,00,000 + (2 days unutilized leaves x ₹ 10,000 per day) = ₹ 30,20,000.

\*\*\*\*\*

#### Illustration 2: Non-Vested Accumulating Benefits

*Mr. Niranjan is working for Infotech Ltd. Consider the following particulars:*

|                                               | Year 20X0-20X1 | Year 20X1-20X2 |
|-----------------------------------------------|----------------|----------------|
| Annual salary                                 | ₹ 30,00,000    | ₹ 30,00,000    |
| No. of working days during the year           | 300 days       | 300 days       |
| Leave allowed                                 | 10 days        | 10 days        |
| Leave taken                                   | 7 days         | 13 days        |
| Leave unutilized carried forward to next year | 3 days         | NIL            |

Based on past experience, Infotech Ltd. assumes that Mr. Niranjan will avail the unutilized leaves of 3 days of 20X0-20X1 in 20X1-20X2.

Infotech Ltd. contends that it will record ₹ 30,00,000 as employee benefits expense in each of the years 20X0-20X1 and 20X1-20X2, stating that the leaves will, in any case, be utilized by 20X1-20X2.

Comment on the accounting treatment proposed to be followed by Infotech Ltd. Also pass journal entries for both the years.

### Solution

| Particulars                                        | Year 20X0-20X1 | Year 20X1-20X2 |
|----------------------------------------------------|----------------|----------------|
| Annual Salary                                      | ₹ 30,00,000    | ₹ 30,00,000    |
| No. of working days (A)                            | 300 days       | 300 days       |
| Leaves Allowed                                     | 10 days        | 10 days        |
| Leaves Taken (B)                                   | 7 days         | 13 days        |
| Therefore, number of days worked (A – B)           | 293 days       | 287 days       |
| Expense proposed to be recognized by Infotech Ltd. | ₹ 30,00,000    | ₹ 30,00,000    |

Based on the evaluation above, Mr. Niranjan has worked for 6 days more (293 days – 287 days) in 20X0-20X1 as compared to 20X1-20X2.

Since he has worked more in 20X0-20X1 as compared to 20X1-20X2, the accrual concept requires that the expenditure to be recognized in 20X0-20X1 should be more as compared to 20X1-20X2.

Thus, if Infotech Ltd. recognizes the same expenditure of ₹ 30,00,000 for each year, it would be in violation of the accrual concept.

The expenditure to be recognized will be as under:

| Particulars                                                                                                                                          | Year 20X0-20X1   | Year 20X1-20X2   |
|------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|------------------|
| Annual salary (A)                                                                                                                                    | ₹ 30,00,000      | ₹ 30,00,000      |
| No. of working days (B)                                                                                                                              | 300 days         | 300 days         |
| Salary cost per day (A ÷ B)                                                                                                                          | ₹ 10,000 per day | ₹ 10,000 per day |
| No. of days worked (from above)                                                                                                                      | 293 days         | 287 days         |
| <b>Expense to be recognised:</b><br>In 20X0-20X1: ₹ 30,00,000 + [₹ 10,000 per day x 3 days (leaves unutilized expected to be utilized subsequently)] | ₹ 30,30,000      |                  |
| In 20X1-20X2: ₹ 30,00,000 – [₹ 10,000 per day – 3 days (excess leave utilized in 20X1-20X2)]                                                         |                  | ₹ 29,70,000      |

**Journal Entry for 20X0-20X1**

|                                   |     |           |           |
|-----------------------------------|-----|-----------|-----------|
| Employee Benefits Expense Account | Dr. | 30,30,000 |           |
| To Bank Account                   |     |           | 30,00,000 |
| To Provision for Leave Encashment |     |           | 30,000    |

**Journal Entry for 20X1-20X2**

|                                        |     |           |           |
|----------------------------------------|-----|-----------|-----------|
| Employee Benefits Expense Account      | Dr. | 29,70,000 |           |
| Provision for Leave Encashment Account | Dr. | 30,000    |           |
| To Bank Account                        |     |           | 30,00,000 |

\*\*\*\*\*

**Illustration 3: Non-Vested Accumulating Benefits**

Assume same information as in Illustration 2.

Based on past experience, Infotech Ltd. assumes that Mr. Niranjana will avail the unutilized leaves of 2 days of 20X0-20X1 subsequently.

However, in 20X1-20X2, Mr. Niranjana availed in actual all 3 days of brought forward leave.

Compute the expense to be recognised in 20X0-20X1 and 20X1-20X2. Also pass journal entries for both the years.

**Solution**

The expenditure to be recognized will be as under:

| Particulars                                                                                                                                                              | Year 20X0-20X1   | Year 20X1-20X2   |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|------------------|
| Annual salary (A)                                                                                                                                                        | ₹ 30,00,000      | ₹ 30,00,000      |
| No. of working days (B)                                                                                                                                                  | 300 days         | 300 days         |
| Salary cost per day (A ÷ B)                                                                                                                                              | ₹ 10,000 per day | ₹ 10,000 per day |
| No. of days worked (from above)                                                                                                                                          | 293 days         | 287 days         |
| <b>Expense to be recognised:</b><br><b>In 20X0-20X1:</b> ₹ 30,00,000 + [₹ 10,000 per day x 2 days (leaves unutilized expected to be utilized subsequently)]              | ₹ 30,20,000      |                  |
| <b>In 20X1-20X2:</b> ₹ 30,00,000 – [₹ 10,000 per day x 3 days (excess leave utilized in 20X1-20X2)] + ₹ 10,000 (additional expense due to change in accounting estimate) |                  | ₹ 29,80,000      |

The additional ₹ 10,000 booked as an expense in 20X1-20X2 represents a change in accounting estimate (i.e. as against the entity's estimation that 2 days of unutilized leave

would be utilized subsequently, actually 3 days were utilized subsequently), for which a prospective effect needs to be given, in line with Para 36 of Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

#### Journal Entry for 20X0-20X1

|                                   |     |           |           |
|-----------------------------------|-----|-----------|-----------|
| Employee Benefits Expense Account | Dr. | 30,20,000 |           |
| To Bank Account                   |     |           | 30,00,000 |
| To Provision for Leave Encashment |     |           | 20,000    |

#### Journal Entry for 20X1-20X2

|                                        |     |           |           |
|----------------------------------------|-----|-----------|-----------|
| Employee Benefits Expense Account      | Dr. | 29,80,000 |           |
| Provision for Leave Encashment Account | Dr. | 20,000    |           |
| To Bank Account                        |     |           | 30,00,000 |

\*\*\*\*\*

#### Illustration 4:

*Sunderam Pvt. Ltd. has a headcount of 100 employees in 20X0-20X1. As per the employee policy, the employees are entitled to:*

- 30 casual leaves out of which 10 casual leaves may be carried forward to the next year; and
- 10 sick leaves out of which 2 sick leaves may be carried forward as paid leave.

*At 31<sup>st</sup> March, 20X1, the average unused entitlement is 5 days per employee for casual leaves and 1 day per employee for sick leave. On an average, it is found that the number of such employees who would be claiming casual leaves would be 30 and 10 employees who would claim sick leaves.*

*Compute the liability to be recognised in respect of sick leaves and casual leaves by the entity at the end of the financial year 20X0-20X1.*

#### Solution

| Type of leave<br>(A) | Leave Entitlement<br>(B) | Leaves c/f permissible<br>(C) | Average leaves Unutilized<br>(D) | No. of Employees<br>(E) | Liability<br>(F = D x E) |
|----------------------|--------------------------|-------------------------------|----------------------------------|-------------------------|--------------------------|
| Casual Leave         | 30 days                  | 10 days                       | 5 days                           | 30                      | 150 days salary          |
| Sick Leave           | 10 days                  | 2 days                        | 1 days                           | 10                      | 10 days salary           |

The entity will recognise liability in the books equal to 150 (30 x 5) days of paid casual leaves and 10 (10 x 1) days of paid sick leaves.

\*\*\*\*\*

**Illustration 5**

*An entity has 100 employees, who are each entitled to ten working days of paid sick leave for each year. Unused sick leave may be carried forward for one financial year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis).*

*At 31<sup>st</sup> March 20X1, the average unused entitlement is two days per employee. Based on past experience, the management expects that only 20% of the employees will use 1 day from their carried forward leave. Salary per day is ₹ 2,500.*

*Compute the expenses in respect of the short-term compensated absences, if they are assumed to be (a) vested short-term compensated absences, and (b) non-vested short-term compensated absences.*

**Solution**

Vested short-term compensated absences:

Employee Benefit Expense = 100 Employees x 2 Days x ₹ 2,500 = ₹ 5,00,000

Non-vested short-term compensated absences:

Employee Benefit Expense = 100 Employees x 20% x 1 Day x ₹ 2,500 = ₹ 50,000

\*\*\*\*\*

**Illustration 6**

*Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates observed during past 10 years represents 6% per annum. Acer Ltd. provides the following benefits to all its employees:*

*Paid vacation - 10 days per year regardless of date of hiring. Compensation for paid vacation is 100% of employee's salary and unused vacation can be carried forward for 1 year. As of 31<sup>st</sup> March, 20X1, unused vacation carried forward was 3 days per employee, average salary was ₹ 15,000 per day and accrued expense for unused vacation in 20X0-20X1 was ₹ 65,00,000. During 20X1-20X2, employees took 9 days of vacation in average. Salary increases in 20X1-20X2 was 10%.*

*Analyse how would Acer Ltd. recognize liabilities and expenses for these benefits as of 31<sup>st</sup> March, 20X2. Pass the journal entry to show the accounting treatment.*



**Solution****Paid Vacation:****Step 1: Calculation of Unused Vacation in man-days as on 31<sup>st</sup> March, 20X2:**

A. No. of Employees in service for the whole year (94%):

| Particulars                                                                                                         | Man-days                     |
|---------------------------------------------------------------------------------------------------------------------|------------------------------|
| Unused vacation as on 31 <sup>st</sup> March, 20X1                                                                  | 3 days per employee          |
| Entitlement to vacation for 20X1-20X2                                                                               | 10 days per employee         |
| Average vacation availed in 20X1-20X2                                                                               | <u>(9) days per employee</u> |
| <b>Unused vacation as on 31<sup>st</sup> March, 20X2</b><br>(being unused leaves of 20X1-20X2 on FIFO basis)        | <b>4 days per employee</b>   |
| <b>Total Unused vacation as on 31<sup>st</sup> March, 20X2 - (A)</b><br>(350 employees x 94% x 4 days per employee) | <b>1,316 man-days</b>        |

B. Newcomers (6%):

| Particulars                                                                                                       | Man-days                     |
|-------------------------------------------------------------------------------------------------------------------|------------------------------|
| Entitlement to vacation for 20X1-20X2                                                                             | 10 days per employee         |
| Average vacation availed in 20X1-20X2                                                                             | <u>(9) days per employee</u> |
| <b>Unused vacation as on 31<sup>st</sup> March, 20X2</b><br>(being unused leaves of 20X1-20X2 on FIFO basis)      | <b>1 day per employee</b>    |
| <b>Total Unused vacation as on 31<sup>st</sup> March, 20X2 - (B)</b><br>(350 employees x 6% x 1 day per employee) | <b>21 man-days</b>           |
| <b>Total unused vacation as on 31<sup>st</sup> March, 20X2 (A + B)</b>                                            | <b>1,337 man-days</b>        |

**Step 2: Calculation of average salary per day:**

| Particulars                                                     | Amount (₹)    |
|-----------------------------------------------------------------|---------------|
| Average salary per day as on 31 <sup>st</sup> March, 20X1       | 15,000        |
| Salary increase in 20X1-20X2                                    | 10%           |
| <b>Average salary per day as on 31<sup>st</sup> March, 20X2</b> | <b>16,500</b> |

**Step 3: Calculation of provision for unused paid vacation:**

| Particulars                                                                                 | Amount (₹)  |
|---------------------------------------------------------------------------------------------|-------------|
| Calculation of provision for unused paid vacation 20X1-20X2:<br>(1,337 man-days x ₹ 16,500) | 2,20,60,500 |
| Provision for unused paid vacation 20X0-20X1                                                | 65,00,000   |

#### Step 4: Accounting treatment

##### Provision for 20X1-20X2

|                                   |     |             |             |
|-----------------------------------|-----|-------------|-------------|
| Employee Benefits Expenses A/c    | Dr. | 2,20,60,500 |             |
| To Provision for Leave Encashment |     |             | 2,20,60,500 |

##### Settlement of Liability of 20X0-20X1

|                                    |     |           |           |
|------------------------------------|-----|-----------|-----------|
| Provision for Leave Encashment A/c | Dr. | 65,00,000 |           |
| To Cash / Bank                     |     |           | 65,00,000 |

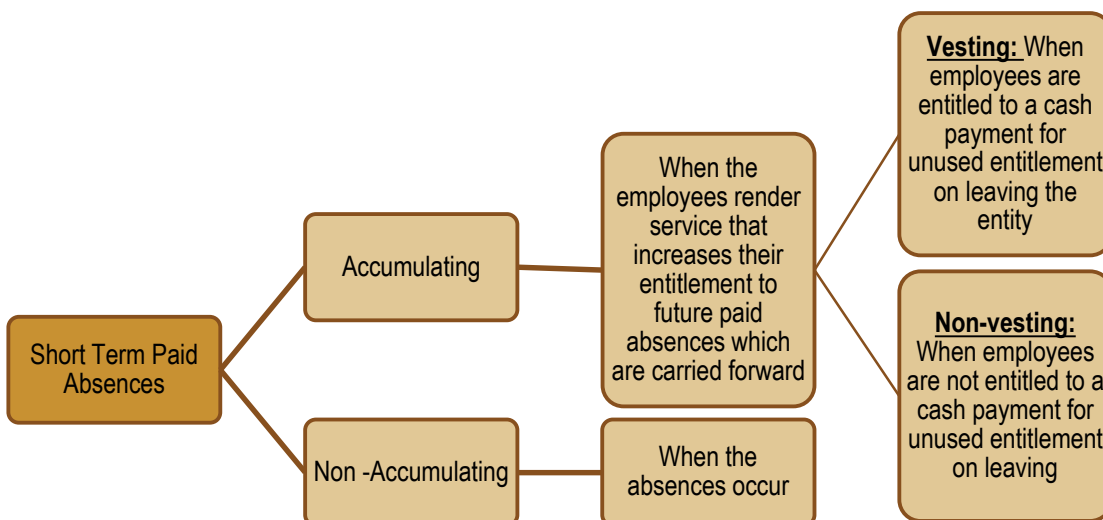
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#### 1.5.2.2 Non-accumulating paid absences:

- ❖ These are the absences that do not carry forward and they will lapse if the current period's entitlement is not used in full by the employee; and
- ❖ They do not entitle employees to a cash payment for unused entitlement on leaving the entity.

**Example:** Sick pay (to the extent that unused past entitlement does not increase future entitlement).

- ❖ An entity shall recognise no liability or expense until the time of the absence because the employee service does not increase the amount of the benefit.



#### 1.5.3 Profit-sharing and bonus plans

- ❖ Expected costs of profit-sharing and bonus plans shall be recognised when and only when:

- (a) the entity has a present legal or constructive obligation to make such payments as a result of past events; and
  - (b) a reliable estimate of the obligation can be made by the entity.
- ❖ A present obligation exists when, and only when, an entity has no realistic alternative but to make the payments in lieu of profits and bonuses to its employees.
  - ❖ Under some profit-sharing plans, employees receive a share of the profit only if they remain with the entity for a specified period. Such plans create a constructive obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such constructive obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.
  - ❖ An entity may have no legal obligation to pay a bonus. Nevertheless, in some cases, an entity has a practice of paying bonuses. In such cases, the entity has a constructive obligation because the entity has no realistic alternative but to pay the bonus. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.
  - ❖ An entity can make a reliable estimate of its legal or constructive obligation under a profit-sharing or bonus plan when, and only when:
    - (a) the formal terms of the plan contain a formula for determining the amount of the benefit;
    - (b) the entity determines the amounts to be paid before the financial statements are approved for issue; or
    - (c) past practice gives clear evidence of the amount of the entity's constructive obligation.
  - ❖ An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the entity's owners. **Hence, an entity recognises the cost of profit-sharing and bonus plans not as a distribution of profit but as an expense.**

#### Illustration 7

*Laxmi Mills is a profit-making entity and has reported profit of ₹ 200 crore in the financial year 20X1-20X2. According to its profit-sharing plan, it distributes and pays 5% as its portion of profit to its employees if they complete 1 year with the organisation.*

*Under this plan, an entity is under an obligation to pay if the employees complete a specified period with the organisation. Laxmi Mills has estimated that due to staff turnover in the organisation, the estimated pay-out would be around 4.5%.*

*Compute the liability and expense of the company under this plan.*

### Solution

The company shall recognize a liability and an expense of an amount of ₹ 9 crores for the financial year 20X1-20X2 (i.e. 4.5% of ₹ 200 crores).

\*\*\*\*\*

### Illustration 8

Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates as observed during past 10 years represents 6% per annum. Acer provides the following benefits to all its employees:

Annual bonus - during past 10 years.

Acer paid bonus to all employees who were in service during the entire financial year. Bonus was paid in June following the financial year-end. Amount of bonus for 20X1-20X2 paid in June 20X2 represented ₹ 1,25,000 per employee. Acer Ltd. used to increase amount of bonus based on official inflation rate which is 8.5% for 20X2-20X3, although there was no legal obligation to increase the bonus by such inflation rate.

Determine how would Acer Ltd. recognize liabilities and expenses for these employee benefits as on 31<sup>st</sup> March, 20X3. Pass the journal entry to show the accounting treatment.

### Solution

| Particulars                                                                         | Amount (₹)            |
|-------------------------------------------------------------------------------------|-----------------------|
| Bonus paid for 20X1-20X2                                                            | 1,25,000 per employee |
| Bonus for 20X2-20X3 - increased by inflation of 8.5%:<br>[1,25,000 x (100% + 8.5%)] | 1,35,625 per employee |
| No. of employees in staff during the whole year [350 x (100-6%)]                    | 329 employees         |
| <b>Provision for Bonus for 20X2-20X3</b>                                            | <b>4,46,20,625</b>    |

### Accounting Treatment:

#### Provision for Bonus for 20X2-20X3

|                                  |     |             |             |
|----------------------------------|-----|-------------|-------------|
| Employee Benefits Expenses A/c   | Dr. | 4,46,20,625 |             |
| To Provision for Bonus 20X2-20X3 |     |             | 4,46,20,625 |

### Note:

It is given that the company is under no legal obligation to increase the bonus by the official inflation rate. However, the company has been increasing the bonus by the inflation rate over the past years. This has given rise to a constructive obligation for Acer Ltd. Informal practices, such as these, give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits. Accordingly, provision is made for the amount considering the inflation rate.

\*\*\*\*\*

- ❖ If profit-sharing and bonus payments are **not settled wholly before the twelve months after the end of the reporting period** in which the employees render the related service, those payments are **considered as other long-term employee benefits**.

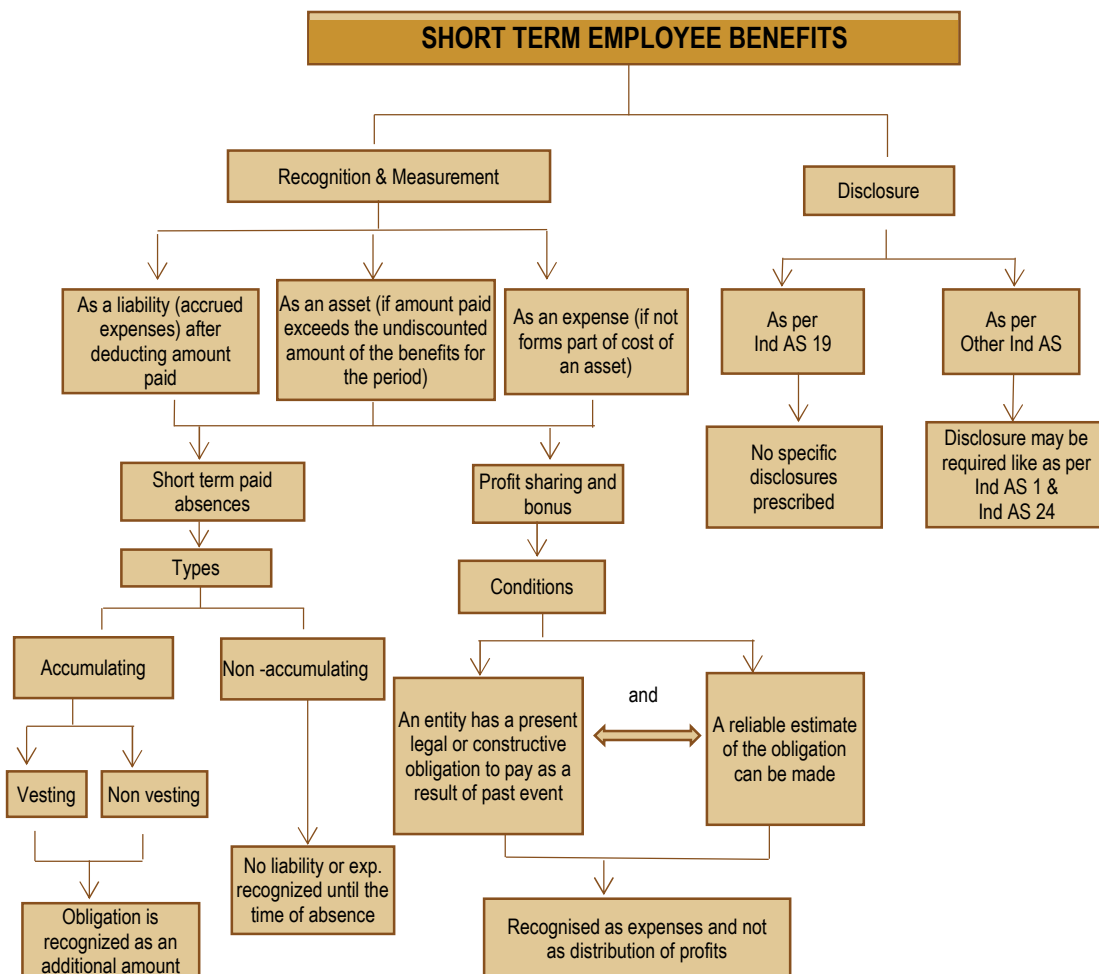
### 1.5.4 Disclosure

- ❖ This Standard does not require specific disclosures about short-term employee benefits.
- ❖ However, other Ind AS may require disclosures.

#### Examples:

 Ind AS 24 requires disclosures about employee benefits for key management personnel.

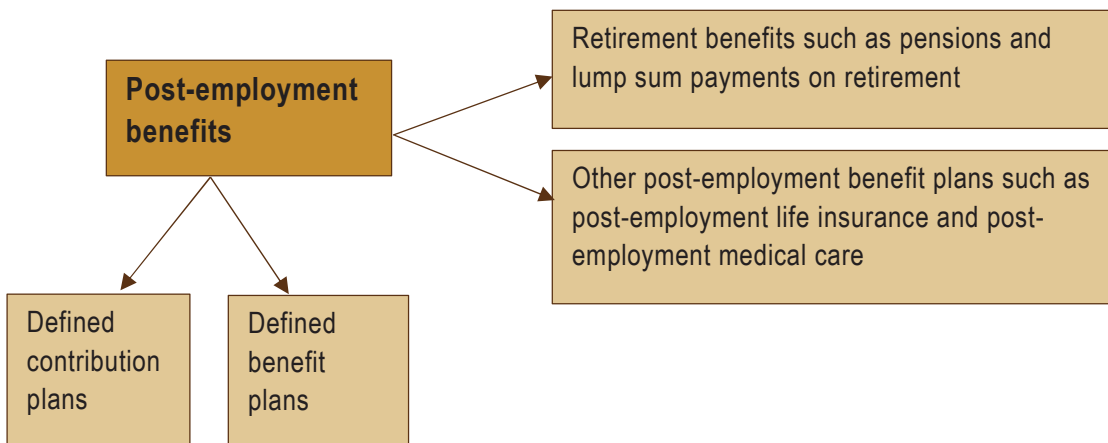
 Ind AS 1, Presentation of Financial Statements, requires disclosure of employee benefits expense.



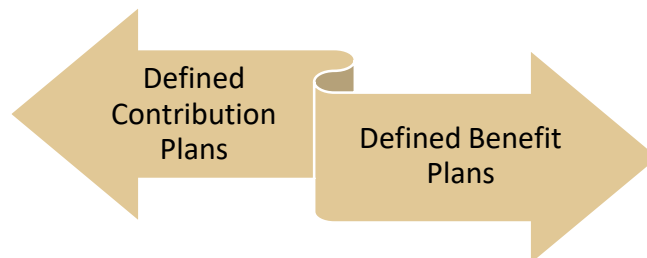


## 1.6 POST-EMPLOYMENT BENEFITS

- ❖ Post-employment benefits include:
  - (a) Retirement benefits such as pensions and lump sum payments on retirement; and
  - (b) Other post-employment benefit such as post-employment life insurance and post-employment medical care.
- ❖ Depending upon the economic substance of the plan which is derived from its principal terms and conditions, post-employment benefit plans are classified as
  - (i) **either** defined contribution plans
  - (ii) **or** defined benefit plans.



### 1.6.1 Classification of post-employment Benefit Plans into Defined Contribution Plan vs Defined Benefit Plans



#### 1.6.1.1 Under defined contribution plans

- (a) The entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund.

- (b) Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions.
- (c) As a result of this, actuarial risk (which means that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall, in substance on the employee (and not on the entity like in defined benefit plan).

### Exception:

There are cases where an entity's obligation is not limited to the amount that it agrees to contribute to the fund as the entity has a legal or constructive obligation. Examples of such cases are listed below:

- (a) a plan benefit formula that is not linked solely to the amount of contributions and requires the entity to provide further contributions if assets are insufficient to meet the benefits in the plan benefit formula;
- (b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or
- (c) informal practices that give rise to a constructive obligation.

For example, a constructive obligation may arise where an entity has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

### 1.6.1.2 Under defined benefit plans

- (a) The entity's obligation is to provide the agreed benefits to current and former employees; and
- (b) Actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity (and not on the employee like in the case of defined contribution plan).
- (c) Thus, if actuarial or investment experience are worse than expected, the entity's obligation may be increased.

The above differences can be summarized as follows:

| S. No. | Particulars                | Defined Contribution Plans                                                                                              | Defined Benefit Plans                                                                             |
|--------|----------------------------|-------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|
| 1.     | <i>Entity's obligation</i> | The entity's legal or constructive obligation <b>is limited to the amount</b> that it agrees to contribute to the fund. | The entity's obligation is to <b>provide the agreed benefits</b> to current and former employees. |

|    |                                                               |                                                                                                                                                          |                                                                                                                                                |
|----|---------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------|
| 2. | <i>Risk bearer</i>                                            | Actuarial risk and investment risk <b>fall on the employee</b> and not on the entity.                                                                    | Actuarial risk and investment risk <b>fall on the entity</b> and not on the employee.                                                          |
| 3. | <i>Change in the obligation</i>                               | Generally, no change in the contribution of an entity is made except in certain cases.                                                                   | If actuarial or investment experience are worse than expected, <b>the entity's obligation may be increased</b> for providing to the employees. |
| 4. | <i>Determination of the amount of post-employment benefit</i> | The amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity and employee as well. | Pre-determined / Agreed post-employment benefits are received by the employee.                                                                 |

#### Illustration 9

*A company pays each employee a lump-sum one-time benefit upon retirement. This benefit is computed based on the employee's years in service in the company and the final salary prior to retirement. To cover its liabilities from this remuneration, the company contributes 3% of annual gross salaries to the fund.*

*Comment whether this obligation represent a defined contribution plan or a defined benefit plan and why?*

#### Solution

##### Defined benefit plan

**Reason:** Although the Company pays contributions to the fund to cover its liabilities, amount of remuneration is determined in advance and Company will have to carry the risk in case the fund's assets are not sufficient to cover remuneration in full.

\*\*\*\*\*

#### Illustration 10

*In accordance with applicable legislation, company contributes 12% and employees 12% of annual gross salaries to the provident and pension fund. Upon retirement, the employees will get the accumulated balance that is calculated based on employee's years of service and his average salary for past 15 years before retirement. The pension will be paid out of the state fund assets and the company has no further obligation except to make contributions.*

*Analyse whether this obligation represent a defined contribution plan or a defined benefit plan.*



**Solution****Defined contribution plan**

**Reason:** Although employee's pension is determined in advance by the formula (and thus employees neither carry actuarial nor investment risks), Company's liability is limited to contributions to the fund. In this case, as pension will be paid out of the state fund, it is a state fund which carries all the risks.

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## 1.6.2 Multi-employer plans

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- ❖ An entity shall classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any constructive obligation that goes beyond the formal terms).
- ❖ In the case of a multi-employer defined benefit plan, normally
  - The amount of contributions is decided keeping in mind the amount of benefits that an entity is required to pay in the same period and
  - The future benefits that an entity gets during the current period will be paid out of future contributions.
  - Employers have no realistic means of withdrawing from the plan without paying a contribution for the benefits earned.
  - Employees' benefits are determined by the length of their service in the entity as a future amount which is required to be paid to them. Such a plan would create actuarial risk to the entity (i.e. if the ultimate cost of benefits already earned at the end of the reporting period is more than expected, the entity will have to either increase its contributions or to persuade employees to accept a reduction in benefits).
- ❖ In case the multi-employer plan is a defined benefit plan, an entity shall:
  - (a) account for its proportionate share of the
    - (i) defined benefit obligation;
    - (ii) plan assets; and
    - (iii) cost associated with the plan
 in the same way as for any other defined benefit plan; and
  - (b) disclose the information required.
- ❖ When sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, an entity shall:
  - (a) account for the plan as if it were a defined contribution plan;

- (b) disclose:
  - (i) the fact that the plan is a defined benefit plan;
  - (ii) the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan; and
  - (iii) the expected contributions to the plan for the next annual reporting period; and
- (c) to the extent that a surplus or deficit in the plan may affect the amount of future contributions, disclose:
  - (i) available information about that surplus or deficit;
  - (ii) the basis used to determine that surplus or deficit; and
  - (iii) the implications, if any, for the entity.
- ❖ The reasons that an entity is not able to term its plan as a defined benefit plan and has to account for a plan as multi-employer defined contribution plan, this may occur if:
  - the entity does not have access to sufficient information about the plan to satisfy the requirements of this Standard; or
  - the plan exposes the entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan.
- ❖ There may be a contractual agreement between the multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants (or the deficit funded). A participant in a multi-employer plan with such an agreement that accounts for the plan as a defined contribution plan shall recognise
  - the asset or liability that arises from the contractual agreement and
  - the resulting income or expense in profit or loss.
- ❖ In determining when to recognise, and how to measure, a liability relating to the wind-up of a multi-employer defined benefit plan, or the entity's withdrawal from a multi-employer defined benefit plan, an entity shall apply Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

### Example 1

*Paras Pvt. Ltd. does not have sufficient information about a defined benefit plan and thus accounts for the plan as if it were defined contribution plan.*

*In the plan, there is a contractual agreement between Paras Pvt. Ltd. and its participants to share the deficit amongst all. The funding valuation shows a deficit of ₹ 500 million in the plan. The plan has agreed under contract a schedule of contributions with the participating employers in the plan that will eliminate the deficit over the next 10 years. The entity's total contributions*

under the contract are ₹ 30 million.

*As per Ind AS 19, Paras Pvt. Ltd. should recognise a liability for the contributions adjusted for the time value of money and an equal expense in profit or loss.*

### 1.6.3 Group administration plans

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- ❖ A group administration plan is merely an aggregation of single employer plans combined to allow participating employers to pool their assets for investment purposes and reduce investment management and administration costs.
- ❖ The claims of different employers are segregated for the sole benefit of their own employees. In other words, the individual identities of the employees and their entities are preserved, unlike in case of multi-employer plans wherein the identity of the employees and the entities are lost in the common pool.
- ❖ Group administration plans pose no particular accounting problems because information is readily available to treat them in the same way as any other single employer plan. This is because such plans do not expose the participating entities to actuarial risks associated with the current and former employees of other entities.
- ❖ An entity should classify a group administration plan as a defined contribution plan or a defined benefit plan in accordance with the terms of the plan (including any constructive obligation that goes beyond the formal terms)

### 1.6.4 Defined benefit plans that share risks between entities under common control

---

- ❖ Defined benefit plans that share risks between entities under common control, for example, a parent and its subsidiaries, are not multi-employer plans.
- ❖ An entity who is participating in such a plan shall obtain information about the plan as a whole on the basis of assumptions that it applies to the plan as a whole.
- ❖ The entity shall, in its separate or individual financial statements, recognise the net defined benefit cost it charged, if there is a contractual agreement or stated policy for charging the net defined benefit cost for the whole plan to individual group entities.
- ❖ In case there is no such agreement or policy, the net defined benefit cost shall be recognised in the separate or individual financial statements of the group entity that is legally the sponsoring employer for the plan.
- ❖ The other group entities shall, in their separate or individual financial statements, recognise a cost equal to their contribution payable for the period.
- ❖ Participation in such kind of plan is a related party transaction for each individual group entity. Therefore, following **disclosures** are required by an entity in its separate or

individual financial statements:

- (a) the contractual agreement or stated policy according to which net defined benefit cost has been charged by the individual entity or the fact that there is no such policy.
- (b) the policy for determining the contribution to be paid by the entity.
- (c) if the entity accounts for an allocation of the net defined benefit cost, then disclosure has to be made for information about the whole plan.
- (d) if the entity accounts for the contribution payable for the period, the information about the plan also needs to be disclosed for the plan as a whole.

### 1.6.5 State plans

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- ❖ A state plan is accounted for in the same way as a multi-employer plan.
- ❖ State plans are normally established by legislation to cover all entities (or all entities in a particular category, for example, a specific industry) and are operated by national or local government or by another body (for example, an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting entity.
- ❖ Some plans established by an entity provide both compulsory benefits, as a substitute for benefits that would otherwise be covered under a state plan, and additional voluntary benefits. Such plans are not state plans.
- ❖ State plans are characterised as defined benefit or defined contribution, depending on the entity's obligation under the plan.
- ❖ Many state plans are funded on a pay-as-you-go basis which implies that contributions are set at a level that is expected to be sufficient to pay the required benefits falling due in the same period. In such kind of a case, future benefits earned during the current period will be paid out of future contributions.
- ❖ In most of the state plans, the entity has no legal or constructive obligation to pay those future benefits as its only obligation as an entity is to pay the contributions as they fall due and in case the entity does not employ members of the state plan, it will have no obligation to pay the benefits earned by its own employees in previous years. For this reason, state plans are normally defined contribution plans.

### 1.6.6 Insured benefits

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- ❖ An entity normally pays insurance premiums for funding a post-employment benefit plan. The entity shall treat such a plan as a defined contribution plan.
- ❖ The entity shall treat the plan as a defined benefit plan in case an entity has (either directly, or indirectly through the plan) retained a legal or constructive obligation, either to pay:

- (a) the employee benefits directly when they fall due; or
  - (b) further amounts if the insurer does not pay all future employee benefits which are relating to employee service in the current and prior periods.
- ❖ Where an entity is funding a post-employment benefit obligation and contributes to an insurance policy under which the entity retains a legal or constructive obligation, in this case the payment of the premiums does not amount to a defined contribution arrangement. This can be either directly or indirectly through the plan, through the mechanism for setting future premiums or through a related party relationship with the insurer. Hence the entity shall:
    - (a) account for a qualifying insurance policy as a plan asset; and
    - (b) recognise other insurance policies as reimbursement rights.
  - ❖ The entity has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits where an insurance policy is in the name of a specified plan participant or a group of plan participants and the entity does not have any legal or constructive obligation to cover any loss on the policy.
  - ❖ The payment of fixed premiums under such kind of arrangement is a settlement of the employee benefit obligation rather than an investment to meet the obligation. Therefore, an entity treats such payments as contributions to a defined contribution plan.



## 1.7 ACCOUNTING FOR DEFINED CONTRIBUTION PLANS

- ❖ The reporting entity's obligation for each period is determined by the amounts to be contributed for that period.
- ❖ No actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss.
- ❖ The obligations are measured on an undiscounted basis.

### Exception:

Discounting is done where the obligation falls due after twelve months after the end of the annual reporting period in which the employees render the related service.

### 1.7.1 Recognition and measurement

When an employee has rendered service to an entity during a period, the entity shall **recognise the contribution payable** to a defined contribution plan in exchange for that service:

- (a) as a liability (accrued expense), after deducting any contribution already paid.

In case the amount of contribution already paid under a defined contribution plan exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, a reduction in future payments or a cash refund; and

- (b) as an expense if not included in the cost of an asset as per other Ind AS (for example, according to Ind AS 2 and Ind AS 16).

Where contributions to a defined contribution plan do not fall due wholly before twelve months after the end of the annual reporting period in which the employees render the related service, the contributions shall be discounted using the discount rate as specified in this Standard.

### 1.7.2 Disclosure

- ❖ An entity shall disclose the amount recognised as an expense for defined contribution plans.
- ❖ An entity shall disclose information about contributions to defined contribution plans for key management personnel where required as per Ind AS 24.

#### Illustration 11

*Acer Ltd. provides lump-sum remuneration upon retirement to its employees. Remuneration is paid out of the fund to which Acer Ltd. contributes 12% of annual gross salaries. Contributions are made twice a year i.e. in November of the related financial year and in June after the financial year-end. Total annual gross salaries for 20X0-X1 amounted to ₹ 50 crores. Contribution made by Acer Ltd. in November 20X0 was ₹ 2.8 crores. Remuneration depends on the number of employee's service and amount of cash in the fund at retirement date (Acer Ltd. has no further obligations except for contributions).*

*How should this transaction appear in the financial statements of Acer Ltd. as of 31<sup>st</sup> March 20X1?*

#### Solution

##### 1. Calculation of accrual for contributions in 20X0-20X1:

|                                                    |                |
|----------------------------------------------------|----------------|
| Annual gross salaries in 20X0-20X1:                | ₹ 50.00 crores |
| Amount of total contributions for 20X0-20X1 (12%): | ₹ 6.00 crores  |
| Contributions already made in November 20X0:       | ₹ 2.80 crores  |
| Accrual (₹ 6 crores - ₹ 2.8 crores)                | ₹ 3.20 crores  |

##### 2. Accounting Treatment:

|                                    |     |             |             |
|------------------------------------|-----|-------------|-------------|
| Employee Benefits Expenses Account | Dr. | 6.00 crores |             |
| To Bank Account                    |     |             | 2.80 crores |
| To Contribution Payable            |     |             | 3.20 crores |

The contribution of ₹ 6 crores will be debited to the statement profit and loss. The contribution payable of ₹ 3.20 crores will appear as a liability as at 31<sup>st</sup> March, 20X1.

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## 1.8 ACCOUNTING FOR DEFINED BENEFIT PLANS

Accounting for defined benefit plans is complex because -

- actuarial assumptions are required to measure the obligation and the expense;
- there is a possibility of actuarial gains and losses;
- the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

### Illustration 12

*Dinkar Ltd., a large IT company, accounts for gratuity on payment basis, and supports such accounting policy by making the following disclosure in the Financial Statements:*

*“Due to high labour turnover, a large degree of uncertainty is involved in estimating the liability of gratuity. Accordingly, the management opines that as the estimates of the uncertainty would confuse the readers by complicating the financial statements, such liability would be recorded on payment basis.”*

*The management opines that by making the above disclosures, the company is complying with the requirements of all the Ind AS, as a disclosure to the effect of the above is given. The management is also willing to specifically highlight the above aspect by making it conspicuous in the financial statements.*

*Is the contention of management correct as per the provisions of Ind AS?*

### Solution

Gratuity represents a payment being made to an employee upon retirement / resignation from the organization. The amount is determined in accordance with the provisions of the Gratuity Act, 1972, which applies to Dinkar Ltd. Since the amount is determined pursuant to a formula laid down under the statute, the gratuity payable represents a Defined Benefit Plan that is to be paid to the employees, with the actuarial risk and investment risk both belonging to the employer. Thus, Dinkar Ltd. must comply with Ind AS 19 and provide for the gratuity on an annual basis.

In estimating the liability for gratuity, there would be several assumptions involved such as

mortality rate, staff attrition rate, salary at the time of retirement / resignation, discount rate etc., all of which have to be considered by Dinkar Ltd. The complexity involved in this exercise does not provide Dinkar Ltd. with an excuse to avoid accrual accounting.

Dinkar Ltd. has stated that it would be willing to make a disclosure to the effect of the departure from Ind AS 8 requirements. In terms of Para 19 of Ind AS 1, departure is permitted in **extremely rare** circumstances wherein the management concludes that compliance with an Ind AS requirement would be so **misleading** that it would **conflict** with the objective of the Financial Statements set out in the Framework.

In the given case, compliance with Ind AS would not be a conflict, as the compliance with Ind AS 19 would ensure that the accrual assumption laid down in the Framework is complied with. Further, a disclosure cannot be a remedy for non-compliance. Therefore, the company have to state that the Ind AS have not been complied with by the company in the preparation and presentation of its Financial Statements.

Hence, the company will have to suitably modify the financial statements considering the materiality and pervasiveness of the non-compliance.

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### 1.8.1 Recognition and measurement

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- ❖ Defined benefit plans can be:
  - Unfunded; or
  - Wholly or partly fundedby contributions by an entity, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting entity and from which the employee benefits are paid.
- ❖ The payment of funded benefits when they fall due depends on
  - the financial position and the investment performance of the fund; and
  - an entity's ability (and willingness) to make good any shortfall in the fund's assets.
- ❖ Therefore, the entity, in substance, underwrites the actuarial and investment risks associated with the plan.
- ❖ Hence the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period.



### 1.8.1.1 Steps involved in accounting by an entity for defined benefit plans



|                                                                           |                                                                                                                                                              |
|---------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Determine the deficit or surplus                                          | <ul style="list-style-type: none"> <li>• PUCM (Projected Unit Credit Method)</li> <li>• Discounting</li> <li>• Fair value of plan assets</li> </ul>          |
| Determine the amount of the net defined benefit liability (asset)         | <ul style="list-style-type: none"> <li>• As the amount of the deficit or surplus</li> </ul>                                                                  |
| Determine the amounts to be recognised in Profit or Loss                  | <ul style="list-style-type: none"> <li>• Current service cost</li> <li>• Past service cost</li> <li>• Net interest</li> </ul>                                |
| Determine the remeasurements of the net defined benefit liability (asset) | <ul style="list-style-type: none"> <li>• Actuarial Gain or Loss</li> <li>• Return on Plan Assets</li> <li>• Any Change in effect of Asset Ceiling</li> </ul> |
|                                                                           |                                                                                                                                                              |
|                                                                           |                                                                                                                                                              |
|                                                                           |                                                                                                                                                              |

#### Step I: Determining the Deficit or Surplus

This involves:

- (a) using actuarial techniques, the projected unit credit method, to make a reliable estimate of the amount of benefit that employees have earned in return for their service in the current and prior periods.

This requires an entity to -

- (i) determine how much benefit is attributable to the current and prior periods and
- (ii) make estimates (actuarial assumptions) about
  - demographic variables (such as employee turnover and mortality); and
  - financial variables (such as future increases in salaries and medical costs)

that will influence the cost of the benefit;

- (b) discounting that benefit in order to determine the present value of the defined benefit obligation; and the current service cost
- (c) deducting the fair value of any plan assets from the present value of the defined benefit obligation.

**Step II: Determining the amount of the net defined benefit liability (asset)**

Determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in step I above, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

**Step III: Determining amounts to be recognised in profit or loss:**

- (i) current service cost.
- (ii) any past service cost and gain or loss on settlement.
- (iii) net interest on the net defined benefit liability (asset).

**Step IV: Determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:**

- (i) actuarial gains and losses;
- (ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and
- (iii) any change in the effect of the asset ceiling, **excluding** amounts included in net interest on the net defined benefit liability (asset).

In case an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.

An entity shall determine the net defined benefit liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

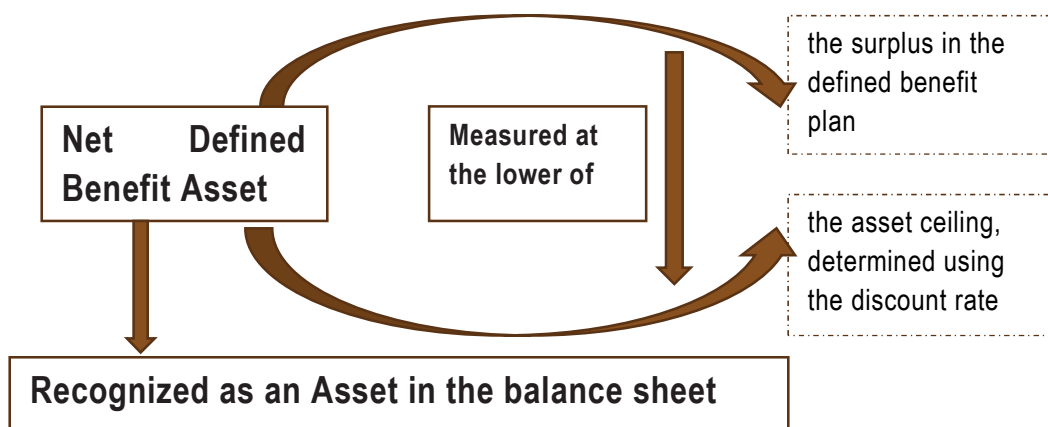
### **1.8.2 Accounting for the constructive obligation**

- ❖ Accounting for any constructive obligation will also be done by an entity that arises from the entity's informal practices.
- ❖ Constructive obligation arises due to informal practices where the entity has no realistic alternative but to pay employee benefits.  

Example - Where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees
- ❖ The formal terms of a defined benefit plan may permit an entity to terminate its obligation under the plan. Nevertheless, it is usually difficult for an entity to terminate its obligation under a plan (without payment) if employees are to be retained.
- ❖ Hence accounting for post-employment benefits assumes that an entity which is currently promising such benefits will continue to do so over the remaining working lives of employees, in the absence of evidence to the contrary.

### 1.8.3 Balance sheet

- ❖ An entity shall recognise the net defined benefit liability (asset) in the balance sheet.
- ❖ When an entity has a surplus in a defined benefit plan, it shall measure the net defined benefit asset **at the lower of**:
  - (a) the surplus in the defined benefit plan; and
  - (b) the asset ceiling, determined using the discount rate.
- ❖ A net defined benefit asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are arisen. An entity recognises a net defined benefit asset in such cases because:
  - (a) the entity controls a resource, which is the ability to use the surplus to generate future benefits;
  - (b) that control is a result of past events (contributions paid by the entity and service rendered by the employee); and
  - (c) future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit. The asset ceiling is the present value of those future benefits.



#### Comparison with recognition of Deferred Tax Asset under Ind AS 12 *Income Taxes*:

As per para 24 of Ind AS 12 *Income Taxes*, 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.

The principle of taxable profit being available for future utilization of deductible temporary difference is essential under Ind AS 12 in order to recognise Deferred Tax Assets. However, in Ind AS 19, no such principle of establishing probability is required as the Plan

Assets represent actual investments which are held by the entity (albeit through a separate trust specially formed).

**Illustration 13**

*How will the following information be presented in the Balance Sheet of Udyog Ltd.?*

| <b>Particulars</b>                       | <b>₹ in lakhs</b> |
|------------------------------------------|-------------------|
| <i>PV of Defined Benefit Obligations</i> | 3,500             |
| <i>Fair Value of Plan Assets</i>         | 3,332             |

**Solution**

| <b>Particulars</b>                                                                                                              | <b>₹ in lakhs</b> |
|---------------------------------------------------------------------------------------------------------------------------------|-------------------|
| PV of Defined Benefit Obligations                                                                                               | 3,500             |
| Less: Fair Value of Plan Assets                                                                                                 | (3,332)           |
| <b>Deficit, to be treated as Net Defined Benefit Liability under Non-current Liabilities as Provisions in the Balance Sheet</b> | <b>168</b>        |

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**Illustration 14**

*How will the following information be presented in the Balance Sheet of Udyog Ltd.?*

| <b>Particulars</b>                       | <b>₹ in lakhs</b> |
|------------------------------------------|-------------------|
| <i>PV of defined benefit obligations</i> | 2,750             |
| <i>Fair value of plan assets</i>         | 2,975             |
| <i>Asset ceiling</i>                     | 175               |

**Solution**

| <b>Particulars</b>                                                                                                        | <b>₹ in lakhs</b> |
|---------------------------------------------------------------------------------------------------------------------------|-------------------|
| PV of defined benefit obligations                                                                                         | 2,750             |
| Less: Fair value of plan assets                                                                                           | (2,975)           |
| <b>Surplus, to be treated as net defined benefit asset</b>                                                                | <b>225</b>        |
| Asset ceiling as per Ind AS 19                                                                                            | 175               |
| <b>Least of above is surplus to be treated as net defined benefit asset under non-current assets in the Balance Sheet</b> | <b>175</b>        |

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## 1.9 RECOGNITION AND MEASUREMENT: PRESENT VALUE OF DEFINED BENEFIT OBLIGATIONS AND CURRENT SERVICE COST

The cost of a defined benefit plan is influenced by many variables, such as

- final salaries;
- employee turnover and mortality;
- employee contributions; and
- medical cost trends.

Hence the ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time.

In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary to:

- (a) apply an actuarial valuation method;
- (b) attribute benefit to periods of service; and
- (c) make actuarial assumptions.

### 1.9.1 Actuarial valuation method

- ❖ Projected Unit Credit Method (PUCM) is used by an entity to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.
- ❖ The Projected Unit Credit Method (which is also sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) perceives each period of service as which gives rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.

#### Illustration 15

*AJ Ltd is engaged in the business of trading of chemicals having a net worth of ₹ 150 crores. The company's profitability is good and hence the company has introduced various benefits for its employees to keep them motivated and to ensure that they stay with the organization. The company is an associate of RJ Ltd which is listed on Bombay Stock Exchange in India.*

*The company initially did not have any HR function but over the last 2 years, the management set up that function and now HR department takes care of all the benefits*

related to the employees and how they can be structured in a manner beneficial to both the employees and the objectives of the company.

One of the employee benefits involves a lump sum payment to employee on termination of service and that is equal to 1 per cent of final salary for each year of service. Consider the salary in year 1 is ₹ 10,000 and is assumed to increase at 7 per cent (compound) each year.

Taking a discount rate at 10 per cent per year, you are required to compute

- benefits attributed (year on year) and
- the obligation in respect of this benefit (year on year)

For an employee who is expected to leave at the end of year 5

Following assumptions may be taken to solve this:

- There are no changes in actuarial assumptions.
- No additional adjustments are needed to reflect the probability that the employee may leave the entity at an earlier or later date.

### Solution

- Computation of benefit attributed to prior years and current year:

Amount in ₹

| Year                                 | 1          | 2          | 3          | 4          | 5          |
|--------------------------------------|------------|------------|------------|------------|------------|
| Benefit attributed to:               |            |            |            |            |            |
| - Prior years                        | -          | 131        | 262        | 393        | 524        |
| - Current year (Refer W.N.1)         | <u>131</u> | <u>131</u> | <u>131</u> | <u>131</u> | <u>131</u> |
| Total (i.e. current and prior years) | <u>131</u> | <u>262</u> | <u>393</u> | <u>524</u> | <u>655</u> |

- Computation of the obligation for an employee who is expected to leave at the end of year 5 (taking discount rate of 10% p.a.)

Amount in ₹

| Year                                  | 1         | 2          | 3          | 4          | 5          |
|---------------------------------------|-----------|------------|------------|------------|------------|
| Opening obligation (A)                | -         | 89         | 196        | 324        | 475        |
| Interest at 10% (B = A X 10%)         | -         | 9          | 20         | 32         | 47         |
| Current service cost (C) (Refer WN 2) | <u>89</u> | <u>98</u>  | <u>108</u> | <u>119</u> | <u>131</u> |
| Closing obligation D = (A+B+C)        | <u>89</u> | <u>196</u> | <u>324</u> | <u>475</u> | <u>653</u> |

Figures have been rounded off in the above table.

**Working Notes:**

1. A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service. The salary in year 1 is ₹ 10,000 and is assumed to increase at 7 per cent (compound) each year.

The year on year salary would be as follows:

Amount in ₹

| Year   | 1      | 2                  | 3                  | 4                  | 5                  |
|--------|--------|--------------------|--------------------|--------------------|--------------------|
| Salary | 10,000 | 10,700             | 11,449             | 12,250             | 13,108             |
|        |        | (10,000 x<br>107%) | (10,700 x<br>107%) | (11,449 x<br>107%) | (12,250 x<br>107%) |

Accordingly, for the purpose of above-mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

2. Computation of current service cost:

Amount in ₹

| Year                                                               | 1                  | 2                  | 3                   | 4                   | 5                   |
|--------------------------------------------------------------------|--------------------|--------------------|---------------------|---------------------|---------------------|
| 1% salary at the end of year 5                                     | -                  | -                  | -                   | -                   | 131                 |
| PV factor at the end of each year to be considered at 10% p.a. (E) | 0.683              | 0.751              | 0.826               | 0.909               | 1.000               |
| PV at the end of each year                                         | 89<br>(131 x<br>E) | 98<br>(131 x<br>E) | 108<br>(131 x<br>E) | 119<br>(131 x<br>E) | 131<br>(131 x<br>E) |

Accordingly, for the purpose of above-mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

\*\*\*\*\*

- ❖ An entity discounts the whole of a post-employment benefit obligation, even if part of the obligation is expected to be settled before twelve months after the reporting period.

### 1.9.2 Attributing benefit to periods of service

- ❖ An entity shall attribute benefit to periods of service under the plan's benefit formula, in determining the present value of its defined benefit obligations and the related current service cost, and, where applicable, past service cost.
- ❖ However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis from:
  - (a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service) until

- (b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.
- ❖ The Projected Unit Credit Method requires an entity to attribute benefit to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations).
- An entity will attribute benefit to periods in which the obligation to provide post-employment benefits arises as employees render services in return for post-employment benefits which an entity expects to pay in future reporting periods.
- ❖ These kind of actuarial techniques allow an entity to measure that obligation with sufficient reliability to justify recognition of a liability.

### Example 2

A defined benefit plan provides a lump-sum benefit of ₹ 200 payable on retirement for each year of service. A benefit of ₹ 200 is attributed to each year. The current service cost is the present value of ₹ 200. The present value of the defined benefit obligation is the present value of ₹ 200, multiplied by the number of years of service up to the end of the reporting period.

If the benefit is payable immediately when the employee leaves the entity, the current service cost and the present value of the defined benefit obligation reflect the date at which the employee is expected to leave. Thus, because of the effect of discounting, they are less than the amounts that would be determined if the employee left at the end of the reporting period.

- ❖ Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (***in other words they are not vested***).
- ❖ Employee service given the vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. An entity considers the probability that some employees may not satisfy any vesting requirements in measuring its defined benefit obligation.
- ❖ Although, certain post-employment benefits, for example, post-employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs.

The probability that the specified event will occur affects the measurement of the obligation but does not determine whether the obligation exists.



**Illustration 16**

*A plan pays a benefit of ₹ 150 for each year of service. The benefits vest after ten years of service. Compute the benefit to be attributed each year?*

**Solution**

1. A benefit of ₹ 150 is attributed to each year.
2. In each of the first ten years, the current service cost and the present value of the obligation reflect the probability that the employee may not complete ten years of service. This is because the benefits vest at a future date (i.e. after ten years of service).

\*\*\*\*\*

**Illustration 17**

*A plan pays a benefit of ₹ 150 for each year of service, excluding service before the age of 25. The benefits vest immediately. Compute the benefit to be attributed each year?*

**Solution**

1. No benefit is attributed to the service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional).
2. A benefit of ₹ 150 is attributed to each subsequent year. There is no requirement to reflect any probability of completion as the benefits vest immediately.

\*\*\*\*\*

- ❖ The obligation increases till the date when further service by the employee will lead to no material amount of further benefits. Therefore, all benefit is attributed to periods ending on or before that date. Benefit is attributed to individual accounting periods under the plan's benefit formula.

However, in case an employee renders service in later years which will lead to a materially higher level of benefit than in earlier years, an entity will attribute benefit on a straight-line basis until the date when further service by the employee will lead to no material amount of further benefits. That is because the employee's service throughout the entire period will ultimately lead to benefit at that higher level.

**Example 3**

A plan pays a lump-sum retirement benefit of ₹ 4,000 to all employees who are still employed at the age of 55 after twenty years of service, or who are still employed at the age of 65, regardless of their length of service.

| Category of Employee                    | Description                                                                                                                                                                                                                                                                                                                                                   | Benefit attributed per year                                                                                                                                                                                                                                                                                                                                                                                               |
|-----------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Employees who join before the age of 35 | <ul style="list-style-type: none"> <li>These employees will be in service for 20 years at the age of 55. Accordingly, the service leads to benefits at the age of 35 and are conditional of further service.</li> <li>However, service beyond the age of 55 leads to no material amount of further benefits (i.e. benefit will still be the same).</li> </ul> | <ul style="list-style-type: none"> <li>For these employees, the entity attributes benefit of ₹ 200 (₹ 4,000 divided by 20 years) each year from the age of 35 to the age of 55.</li> <li>The current service cost and the present value of the obligation should reflect the probability of an employee not completing the necessary service period.</li> </ul>                                                           |
| Employees who join after the age of 35  | <ul style="list-style-type: none"> <li>These employees will not be in service for 20 years at the age of 55 and must wait till the age of 65, regardless of the years of service.</li> <li>The service leads to benefits at the beginning of employment and service beyond age 65 leads to no material amount of further benefits.</li> </ul>                 | <ul style="list-style-type: none"> <li>For these employees, the entity attributes benefit of ₹ 4,000 ÷ (65 years – whatever age when employment started may be 40, 45, 50...) to each year of service from the start until the age of 65.</li> <li>The current service cost and the present value of the obligation should reflect the probability of an employee not completing the necessary service period.</li> </ul> |

### Illustration 18

*Amra Pvt. Ltd. has a plan for its employees where it has decided to pay a lump-sum benefit of ₹ 2,000 that will vest after ten years of service. However, that plan will provide no further benefit for subsequent service.*

*Compute the benefit attributed for 10 years of service and for the period of service after 10 years?*

### Solution

- In this case, as per the company's plan, a benefit of ₹ 200 (₹ 2,000 ÷ 10 years) is attributed to each of the first 10 years.
- The current service cost in each of the first ten years reflects the probability that the employee may not complete ten years of service. This is because the benefits vest at a future date (i.e. after ten years of service).

No benefit is attributed to subsequent years.

\*\*\*\*\*

**Illustration 19**

*Sanat Pvt. Ltd. has a plan for the employees where employees are entitled to a benefit of 5% of final salary for each year of service before the age of 55.*

*Compute the benefit attributed up to 55 years and after 55?*

**Solution**

Benefit of 5% of estimated final salary is attributed to each year up to the age of 55. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that age.

\*\*\*\*\*

**Illustration 20**

*A post-employment medical plan reimburses 40 percent of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50 per cent of those costs if the employee leaves after twenty or more years of service.*

*Determine how will the benefit be attributed to the years of service.*

**Solution**

1. Under the Plan's Benefit Formula, the entity should attribute 4% of the present value of the expected medical costs ( $40\% \div 10$  years) to each of the first ten years, and 1% ( $10\% \div 10$  years) to each of the second ten years.
2. For employees expected to leave within 10 years, no benefit is attributed.
3. The Current Service Cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits.

\*\*\*\*\*

**Illustration 21**

*A post-employment medical plan reimburses 10 percent of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50 per cent of those costs if the employee leaves after twenty or more years of service.*

*Determine how will the benefit be attributed to the years of service.*

**Solution**

1. Service in later years will lead to a materially higher level of benefit than in earlier year. So, for employees expected to leave after 20 or more years, the entity should attribute benefit on a straight-line basis under Para 71. Service beyond 20 years will lead to no material amount of further benefits. So, the benefit attributed to each of the first 20 years will be 2.5% of the Present Value of the Expected Medical Costs ( $50\% \div 20$  years).
2. For employees expected to leave between 10 and 20 years, the benefit attributed to each

of the first 10 years is 1% ( $10\% \div 10$  years) of the Present Value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

3. For employees expected to leave within ten years, no benefit is attributed.
4. The Current Service Cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits.

\*\*\*\*\*

### Illustration 22

*AKJ Ltd is a listed company engaged in the business of manufacturing of electronic equipment. The company has various branch offices spread out across India and has 1,000 employees.*

*As per the statutory requirements, gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than five years -*

- (a) *on his superannuation, or*
- (b) *on his retirement or resignation, or*
- (c) *on his death or disablement due to accident or disease.*

*The completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement.*

*The amount payable is determined by a formula linked to number of years of service and last drawn salary. The amount payable to an employee shall not exceed ₹ 10,00,000.*

*Compute the amount of employee benefit, if any, attributed to each year of service.*

### Solution

The amount of gratuity would be attributed to each year of service and calculated as follows:

Number of employees not likely to fulfil the eligibility criteria will be ignored.

Other employees will be grouped according to period of service they are expected to render taking into account:

- mortality rate,
- disablement and
- resignation after 5 years.

Gratuity payable will be calculated in accordance with the formula prescribed in the governing statute based on the period of service and the salary at the time of termination of employment, assuming promotion, salary increases etc.

For those employees for whom the amount payable as per the formula does not exceed ₹ 10,00,000, over the expected period of service, the amount payable will be divided by the

expected period of service and the resulting amount will be attributed to each year of the expected period of service, including the period before the stipulated period of 5 years.

In case of the remaining employees, the amount as per the formula exceeds ₹ 10,00,000 over the expected period of service of 10 years (say), and the amount of the threshold of ₹ 10,00,000 is reached at the end of 8 years (assumed) i.e. ₹ 1,25,000 ( $₹ 10,00,000 \div 8$  years) is attributed to each of the first 8 years. In this case, no benefit is attributed to subsequent two years. This is because service beyond 8 years will lead to no material amount of further benefits.

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### 1.9.3 Actuarial assumptions

- ❖ Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits.
- ❖ Actuarial assumptions shall be unbiased and mutually compatible.
- ❖ Actuarial assumptions are unbiased if they are neither imprudent nor excessively conservative.
- ❖ Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, salary increment rate and discount rates.

For example, all assumptions which depend on a particular inflation level (such as assumptions about interest rates and salary and benefit increases) in any given future period assume the same inflation level in that period.

- ❖ Actuarial assumptions comprise:
  - (a) **demographic assumptions** about the future characteristics of current and former employees (and their dependants) who are eligible for benefits. Demographic assumptions deal with matters such as:
    - (i) mortality, both during and after employment;
    - (ii) rates of employee turnover, disability and early retirement;
    - (iii) the proportion of plan members with dependants who will be eligible for benefits;
    - (iv) the proportion of plan members who will select each form of payment option available under the plan terms; and
    - (v) claim rates under medical plans; and
  - (b) **financial assumptions**, dealing with items such as:
    - (i) the discount rate;
    - (ii) future salary and benefit levels;
    - (iii) in the case of medical benefits, future medical costs, including claim handling costs (i.e. the costs that will be incurred in processing and resolving claims, including legal and adjuster's fees); and

- (iv) taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service.
- ❖ An entity determines discount rate and other financial assumptions in nominal (stated) terms unless estimates in real (inflation-adjusted) terms are more reliable. For example, in a hyperinflationary economy, or where the benefit is index-linked and there is a deep market in index-linked bonds of the same currency and term.
- ❖ Financial assumptions are based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled.

### 1.9.3.1 Actuarial assumptions: mortality and discount rate

#### 1. Mortality Assumptions

Entity is required to determine its mortality assumptions by reference to its best estimate of the mortality of plan members both during and after employment.

In order to estimate the ultimate cost of the benefit an entity shall take into consideration the expected changes in mortality, for example by modifying standard mortality tables with estimates of mortality improvements.

#### 2. Discount Rate Assumptions

- ❖ The rate which is used to discount post-employment benefit obligations (both funded and unfunded) is **determined by reference to market yields on government bonds** at the end of the reporting period.
- ❖ **Subsidiaries, associates, joint ventures and branches domiciled outside India** shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate **determined by reference to market yields** at the end of the reporting period **on high quality corporate bonds**.
- ❖ In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries **where there is no deep market in such bonds, the market yields** (at the end of the reporting period) **on government bonds** of that country **shall be used**.
- ❖ The currency and term of the government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations as the pay-outs will happen in same currency only.
- ❖ The discount rate reflects the estimated timing of benefit payments/time value of money and not the actuarial or investment risk. This also does not reflect entity-specific credit risk borne by the entity's creditors.
- ❖ Thus, practically speaking, it is achieved by an entity by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payments and the currency in which the benefits are to be paid.

- ❖ Where there is no deep market in government bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments, an entity uses current market rates of the appropriate term to discount shorter-term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve.
- ❖ **Interest cost is computed by multiplying the discount rate as determined at the start of the period by the present value of the defined benefit obligation** throughout that period and taking account of any material changes in the obligation.

#### 1.9.3.2 Actuarial assumptions: salaries, benefits and medical costs

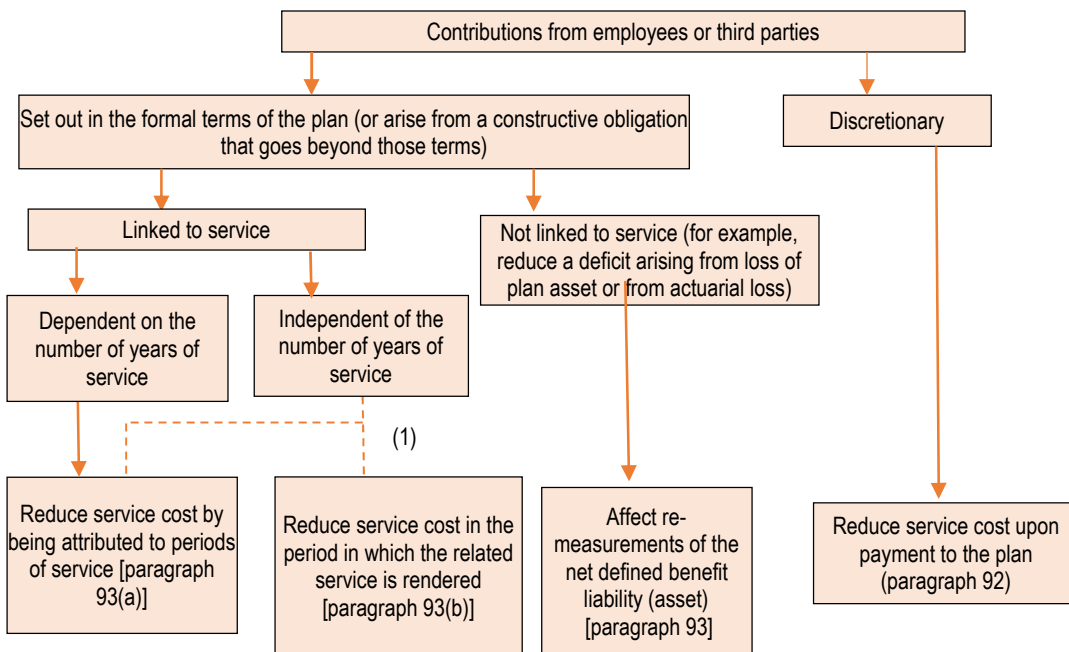
- ❖ Defined benefit obligations shall be measured on a basis that reflects:
  - (a) the benefits set out in the terms of the plan (or resulting from any constructive obligation that goes beyond those terms) at the end of the reporting period;
  - (b) estimated future salary increases;
  - (a) the effect of any limit on the employer's share of the cost of the future benefits;
  - (b) contributions from employees or third parties that reduce the ultimate cost to the entity of those benefits; and
  - (e) estimated future changes in the level of any state benefits that affect the benefits payable under a defined benefit plan, if, and only if, either:
    - (i) those changes were enacted before the end of the reporting period; or
    - (ii) historical data, or other reliable evidence, indicates that those state benefits will change in some predictable manner, for example, in line with future changes in general price levels or general salary levels.
- ❖ Estimates of future salary increases are calculated after taking account inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.
- ❖ The formal terms of the plan (or a constructive obligation that goes beyond those terms) require an entity to consider change in benefits for future periods; the measurement of the obligation reflects those changes at the end of the reporting period will impact actuarial gains and losses.

For examples when:

- (a) entity has a history of increasing benefits, for example, to mitigate the effects of inflation, and there is no indication that this practice will change in the future;
- (b) the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants; or

- (c) benefits vary in response to a performance target or other criteria. For example, the terms of the plan may state that it will pay reduced benefits or require additional contributions from employees if the plan assets are insufficient. The measurement of the obligation reflects the best estimate of the effect of the performance target or other criteria.
- ❖ Further, future benefit changes that are not set out in formal terms of the plan (or a constructive obligation) at the end of the reporting period; will result in impacting past service cost and current service cost for the period after change to the extent of such change in benefits for the service.
  - ❖ Some post-employment benefits are linked to variables such as the level of state retirement benefits or state medical care. The measurement of such benefits reflects expected changes in such variables, based on past history and other reliable evidence.
  - ❖ Assumptions about medical costs shall take into account estimated future changes in the cost of medical services, resulting from both inflation and specific changes in medical costs.
  - ❖ Post-employment medical benefits measurement requires assumptions about the level and frequency of future claims and the cost of meeting those claims. Future medical costs are estimated on the basis of historical data about the entity's own experience and in case some more data is required to analyse the data, this data is gathered as historical data from other entities, insurance companies, medical providers or other sources. Estimates of future medical costs would consider the effect of technological advances, changes in health care utilisation or delivery patterns and changes in the health status of plan participants.
  - ❖ The level and frequency of claims is particularly sensitive to the age, health status and sex of employees (and their dependants) and may be sensitive to other factors such as geographical location. Hence, this historical data is adjusted to the extent that the demographic mix of the population which differs from that of the population used as a basis for the historical data. Also it requires an adjustment where there is reliable evidence that historical trends will not continue.
  - ❖ Some post-employment health care plans also require employees to contribute to the medical costs covered by the plan and thus estimates of future medical costs also take in account of any such contributions which are based on the terms of the plan at the end of the reporting period (or based on any constructive obligation that goes beyond those terms). Changes in those employee contributions result in past service cost or, where applicable, curtailments. The cost of meeting claims may be reduced by benefits from state or other medical providers.





(1) This dotted arrow means that an entity is permitted to choose either accounting.

### 1.9.3.3 Past service cost and gains and losses on settlement

- ❖ When determining past service cost, or a gain or loss on settlement, an entity shall remeasure the net defined benefit liability (asset) using the current fair value of plan assets and current actuarial assumptions (including current market interest rates and other current market prices) reflecting:
  - the benefits offered under the plan and the plan assets before the plan amendment, curtailment or settlement; and
  - the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement.
- ❖ An entity need not distinguish between past service cost resulting from a plan amendment, past service cost resulting from a curtailment and a gain or loss on settlement if these transactions occur together. In some cases, a plan amendment occurs before a settlement, such as when an entity changes the benefits under the plan and settles the amended benefits later. In those cases, an entity recognises past service cost before any gain or loss on settlement.
- ❖ When a plan amendment, curtailment or settlement occurs, an entity shall recognise and measure any past service cost, or a gain or loss on settlement. In doing so, an entity shall not consider the effect of the asset ceiling. An entity shall then determine the effect of the asset ceiling after the plan amendment, curtailment or settlement and shall recognise any change in that effect.

- ❖ A settlement occurs together with a plan amendment and curtailment if a plan is terminated with the result that the obligation is settled and the plan ceases to exist. However, the termination of a plan is not a settlement if the plan is replaced by a new plan that offers benefits that are, in substance, the same.

#### 1.9.3.3.1 Past service cost

- ❖ Change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment is known as past service cost.
- ❖ An entity shall recognise past service cost as an expense at the earlier of the following dates:
  - (a) when the plan amendment or curtailment occurs; and
  - (b) when the entity recognises related restructuring costs (refer Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets) or termination benefits.
- ❖ Plan amendment happens when an entity introduces, or withdraws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan.
- ❖ Curtailment arises when an entity significantly reduces the number of employees covered by a plan. A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan.
- ❖ Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases).
- ❖ In case, an entity reduces benefits payable under an existing defined benefit plan and, at the same time, increases other benefits payable under the plan for the same employees, the entity treats the change as a single net change.
- ❖ Past service cost excludes the following:
  - (a) the effect of differences between actual and previously assumed salary increases on the obligation to pay benefits for service in prior years (there is no past service cost because actuarial assumptions allow for projected salaries);
  - (b) underestimates and overestimates of discretionary pension increases when an entity has a constructive obligation to grant such increases (there is no past service cost because actuarial assumptions allow for such increases);
  - (c) estimates of benefit improvements that result from actuarial gains/ return on plan assets that have been recognised in the financial statements if the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants, even if the benefit increase has not yet been formally awarded (there is no past service cost because the resulting increase in the obligation is an actuarial loss); and

- (d) the increase in vested benefits when, in the absence of new or improved benefits, employees complete vesting requirements (there is no past service cost because the entity recognised the estimated cost of benefits as current service cost as the service was rendered).

#### 1.9.3.3.2 Gains and losses on settlement

- ❖ A settlement occurs when an entity enters into a transaction that eliminates all further legal or constructive obligation for part or all of the benefits provided under a defined benefit plan (other than a payment of benefits to, or on behalf of, employees in accordance with the terms of the plan and included in the actuarial assumptions).

For example, a one-off transfer of significant employer obligations under the plan to an insurance company through the purchase of an insurance policy is a settlement; a lump sum cash payment, under the terms of the plan, to plan participants in exchange for their rights to receive specified post-employment benefits is not.

- ❖ The gain or loss on a settlement is the difference between:
  - (a) the present value of the defined benefit obligation being settled, as determined on the date of settlement; and
  - (b) the settlement price, including any plan assets transferred and any payments made directly by the entity in connection with the settlement.
- ❖ Gain or loss on the settlement of a defined benefit plan is recognised by the entity when the settlement occurs.



## 1.10 RECOGNITION AND MEASUREMENT: PLAN ASSETS

### 1.10.1 Fair value of plan assets

- ❖ The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus.
- ❖ Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.
- ❖ Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

### 1.10.2 Reimbursements

- ❖ An entity will recognise its right to reimbursement as a separate asset when, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation. The assets are measured at fair value by the entity and in all other respects, an entity shall treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.
- ❖ Sometimes, an entity is able to look to another party, such as an insurer, to pay part or all of the expenditure required to settle a defined benefit obligation, there an entity accounts for qualifying insurance policies in the same way as for all other plan assets. When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset.
- ❖ Further, when an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. In such a scenario, an entity recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability (asset) and in all other respects, the entity treats that asset in the same way as plan assets.
- ❖ If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, the fair value of the reimbursement right is deemed to be the present value of the related obligation.



## 1.11 COMPONENTS OF DEFINED BENEFIT COST

- ❖ An entity is required to recognise the components of defined benefit cost, except to the extent that another Ind AS (refer Ind AS 2 and Ind AS 16) requires or permits their inclusion in the cost of an asset, as follows:
  - (a) service cost in profit or loss;
  - (b) net interest on the net defined benefit liability (asset) in profit or loss; and
  - (c) remeasurements of the net defined benefit liability (asset) in other comprehensive income.
- ❖ Remeasurements of the net defined benefit liability (asset) recognised in other comprehensive income shall not be reclassified to profit or loss in a subsequent period. However, the entity may transfer those amounts recognised in other comprehensive income within equity.

### Current service cost

- ❖ An entity shall determine current service cost using actuarial assumptions determined at

the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), as discussed above, it shall determine current service cost for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using the actuarial assumptions used to remeasure the net defined benefit liability (asset) in accordance with paragraph 99(b) of Ind AS 19 (i.e. reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement).

### **1.11.1 Net interest on the net defined benefit liability (asset)**

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- ❖ An entity shall determine net interest on the net defined benefit liability (asset) by multiplying the net defined benefit liability (asset) by the discount rate specified for post-employment benefit obligation.
- ❖ To determine net interest in accordance with paragraph mentioned above, an entity shall use the net defined benefit liability (asset) and the discount rate determined at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine net interest for the remainder of the annual reporting period after considering the benefits offered under the plan and the plan asset after the plan amendment, curtailment or settlement using:
  - (a) the net defined benefit liability (asset) ; and
  - (b) the discount rate used to remeasure the net defined benefit liability (asset).

Further, in applying this paragraph, the entity shall also take into account any changes in the net defined benefit liability (asset) during the period resulting from contributions or benefit payments.

- ❖ Net interest on the net defined benefit liability (asset) can be viewed as comprising interest income on plan assets, interest cost on the defined benefit obligation and interest on the effect of the asset ceiling.
- ❖ Interest income on plan assets is a component of the return on plan assets and is determined by multiplying the fair value of the plan assets by the discount rate specified for post-employment benefit obligation. An entity shall determine the fair value of the plan assets at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine interest income for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using the plan assets used to remeasure the net defined benefit liability (asset) reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement). Further, in applying this paragraph, the entity shall also consider any changes in the plan assets held during the period resulting from contributions or benefit payments.

- ❖ The difference between the interest income on plan assets and the return on plan assets is included in the remeasurement of the net defined benefit liability (asset).
- ❖ Interest on the effect of the asset ceiling is part of the total change in the effect of the asset ceiling and is determined by multiplying the effect of the asset ceiling by the discount rate. An entity shall determine the effect of the asset ceiling at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine interest on the effect of the asset ceiling for the remainder of the annual reporting period after the plan amendment, curtailment or settlement considering any change in the effect of the asset ceiling. The difference between interest on the effect of the asset ceiling and the total change in the effect of the asset ceiling is included in the remeasurement of the net defined benefit liability (asset).

### **1.11.2 Remeasurements of the net defined benefit liability (asset)**

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- ❖ Remeasurements of the net defined benefit liability (asset) comprise:
  - (a) actuarial gains and losses;
  - (b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and
  - (c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).
- ❖ Actuarial gains and losses occur from increases or decreases in the present value of the defined benefit obligation because of changes in actuarial assumptions and experience adjustments. Following are the few causes of actuarial gains and losses:
  - (a) unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs;
  - (b) the effect of changes to assumptions concerning benefit payment options;
  - (c) the effect of changes in estimates of future employee turnover, early retirement, or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs; and
  - (d) the effect of changes in the discount rate.
- ❖ Actuarial gains and losses does not include changes in the present value of the defined benefit obligation because of the introduction, amendment, curtailment or settlement of the defined benefit plan, or changes to the benefits payable under the defined benefit plan. Rather such changes shall result in past service cost or gains or losses on settlement.
- ❖ In measuring the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial

assumptions used to measure the defined benefit obligation. Other administration costs are not deducted from the return on plan assets.

### Illustration 23

*Pratap Ltd. belongs to the ship-building industry. The company reviewed an Actuarial Valuation for the first time for its pension scheme which revealed a surplus of ₹ 60 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 20 lakhs instead of ₹ 50 lakhs. The average remaining life of the employees is estimated to be 6 years.*

*Advise the Company in line with Ind AS 19.*

### Solution

1. **Recognition:** As per Ind AS 19, any Actuarial Gains and Losses should be recognized as a re-measurement of the Net Defined Benefit Liability / (Asset) in "Other Comprehensive Income".
2. **Measurement and Presentation:** In the given case, the amount of surplus from Pension Scheme of ₹ 60 lakhs is an Actuarial Gain and should be recognized as a "re-measurement" in "Other Comprehensive Income", and not to be adjusted from the amount of annual contribution in future years.
3. **Disclosure:** The change relating to Actuarial Valuation for the Pension Scheme requires disclosure under Ind AS 8. Disclosures required by Ind AS 19 should also be made in the financial statements.

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### Illustration 24

*RKA Private Ltd is an old company established in 19XX. The company started with a very small capital base and today it is one of the leading companies in India in its industry. The company has an annual turnover of ₹ 11,000 crores and planning to get listed in the next year.*

*The company has a large employee base. The company provided a defined benefit plan to its employees. Following is the information relating to the balances of the fund's assets and liabilities as at 1<sup>st</sup> April, 20X1 and 31<sup>st</sup> March, 20X2.*

| ₹ in lacs                           |                             |                              |
|-------------------------------------|-----------------------------|------------------------------|
| Particulars                         | 1 <sup>st</sup> April, 20X1 | 31 <sup>st</sup> March, 20X2 |
| Present value of benefit obligation | 1,400                       | 1,580                        |
| Fair value of plan assets           | 1,140                       | 1,275                        |

*For the financial year ended 31<sup>st</sup> March, 20X2, service cost was ₹ 55 lacs. The company made a contribution of an amount of ₹ 111 lacs to the plan. No benefits were paid during the year.*

*Consider a discount rate of 8%.*

*You are required to -*

- (a) Compute the balance(s) of the company to be included its balance sheet as on*

31<sup>st</sup> March, 20X2 and amounts to be recognized in the statement of profit and loss and other comprehensive income for the year ended 31<sup>st</sup> March, 20X2.

(b) Provide the journal entries in respect of amount(s) to be recognized.

### Solution

(a) Extract of the Balance Sheet of RKA Private Ltd as at 31<sup>st</sup> March, 20X2

₹ in lacs

Closing net defined liability (1,580 – 1,275) lacs 305

Extract of the Statement of Profit or Loss of RKA Private Ltd for the year ended 31<sup>st</sup> March, 20X2

| Particulars                           | ₹ in lacs         |
|---------------------------------------|-------------------|
| Service cost                          | 55                |
| Net interest ( <i>Refer W.N.1</i> )   | <u>21</u>         |
| <b>Profit or loss</b>                 | <b>76</b>         |
| Other comprehensive income:           |                   |
| Remeasurements ( <i>Refer W.N.2</i> ) | <u>80</u>         |
| <b>Total</b>                          | <b><u>156</u></b> |

(b) Journal entries in the books of RKA Private Ltd

| Particulars                                            | ₹ in lacs | ₹ in lacs |
|--------------------------------------------------------|-----------|-----------|
| Profit & Loss Dr.                                      | 76        |           |
| Other comprehensive income Dr.                         | 80        |           |
| To Cash (Contribution)                                 |           | 111       |
| To Net defined benefit liability ( <i>Refer WN 3</i> ) |           | 45        |

### Working Notes:

#### 1. Computation of Net interest taken to the Statement of Profit or Loss

= Discount rate x Opening net defined benefit liability

= 8% x (1,400 – 1,140) lacs

= 8% x 260 lacs = 21 lacs (Rounded off to nearest lacs)



## 2. Computation of Remeasurements

## Defined Benefit Obligation Account

| Particulars                                 | ₹ in lacs    | Particulars                                      | ₹ in lacs    |
|---------------------------------------------|--------------|--------------------------------------------------|--------------|
| To Balance c/d (given)<br>(closing balance) | 1,580        | By Balance b/d (given)<br>(opening balance)      | 1,400        |
|                                             |              | By Current Service Cost<br>(given)               | 55           |
|                                             |              | By Interest on Opening<br>Liability (1,400 x 8%) | 112          |
|                                             |              | By Actuarial loss (bal. figure)                  | 13           |
|                                             | <u>1,580</u> |                                                  | <u>1,580</u> |

OR

Statement to calculate Actuarial gain or loss on defined benefit liability:

| Particulars                                | ₹ in lacs           |
|--------------------------------------------|---------------------|
| Opening balance of liability               | 1,400               |
| Current service cost                       | 55                  |
| Interest on opening liability (1,400 x 8%) | 112                 |
| Actuarial loss (Bal. fig)                  | 13                  |
| <b>Closing balance of liability</b>        | <b><u>1,580</u></b> |

## Plan Assets Account

| Particulars                                    | ₹ in lacs    | Particulars                                 | ₹ in lacs    |
|------------------------------------------------|--------------|---------------------------------------------|--------------|
| To Balance b/d (given)<br>(opening balance)    | 1,140        | By Balance c/d (given)<br>(closing balance) | 1,275        |
| To Bank Account<br>(contribution for the year) | 111          |                                             |              |
| To Surplus / Actual Return<br>(bal. figure)    | 24           |                                             |              |
|                                                | <u>1,275</u> |                                             | <u>1,275</u> |

OR

Statement to calculate Actual return on plan assets:

| Particulars                     | ₹ in lacs           |
|---------------------------------|---------------------|
| Opening balance of asset        | 1,140               |
| Cash contribution               | 111                 |
| Actual return (Bal. fig)        | <u>24</u>           |
| <b>Closing balance of asset</b> | <b><u>1,275</u></b> |

Net interest on opening balance of plan asset = ₹ 91 lacs (i.e. ₹ 1,140 lacs x 8%)  
(Rounded off to nearest lacs)

Hence there is a decrease in plan assets due to remeasurement for which computation is as follows:

Actual Return – Net interest on opening plan asset

= ₹ 24 lacs – ₹ 91 lacs = ₹ 67 lacs.

**Net remeasurement would be computed as follows:**

Actuarial loss on liability + Loss on return = ₹ 13 lacs + ₹ 67 lacs = ₹ 80 lacs.

### 3. Computation of increase/ decrease in net defined benefit liability:

| Particulars                                         | ₹ in lacs        |
|-----------------------------------------------------|------------------|
| Opening net liability (₹ 1,400 lacs – ₹ 1,140 lacs) | 260              |
| Closing net liability ₹ 1,580 lacs – ₹ 1,275 lacs)  | <u>305</u>       |
| <b>Increase in liability</b>                        | <b><u>45</u></b> |

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## 1.12 PRESENTATION

### 1.12.1 Offset

- ❖ An asset relating to one plan will be offset against a liability relating to another plan when, and only when, the entity:
  - (a) has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and
  - (b) there is an intention either to settle the obligations on a net basis, or to realise the surplus in one plan and settle its obligation under the other plan simultaneously.
- ❖ The offsetting criteria are similar to those established for financial instruments in Ind AS 32, Financial Instruments: Presentation.

### 1.12.2 Current / Non-current distinction

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This Standard does not specify whether an entity should distinguish current and non-current portions of assets and liabilities arising from post-employment benefits.

### 1.12.3 Components of defined benefit costs

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This Standard does not specify how an entity should present current service cost and net interest cost on net defined liability (asset). An entity presents those components in accordance with Ind AS 1 Presentation of Financial Statements.

## 1.13 DISCLOSURE

An entity shall disclose information that enables users of financial statements to evaluate the nature of its defined benefit plans and the financial effects of changes in those plans during the period.

### 1.13.1 General

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- ❖ An entity shall disclose information that:
  - (a) explains the characteristics of its defined benefit plans and risks associated with them;
  - (b) identifies and explains the amounts in its financial statements arising from its defined benefit plans; and
  - (c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.
- ❖ If the disclosures provided in accordance with Ind AS 19 and other Ind AS are insufficient to meet the required objectives, additional information necessary to meet those objectives should be disclosed. For example, an entity might present an analysis of the present value of the defined benefit obligation that distinguishes the nature, characteristics and risks of the obligation. Such a disclosure could distinguish:
  - (a) between amounts owing to active members, deferred members, and pensioners;
  - (b) between vested benefits and accrued but not vested benefits; and
  - (c) between conditional benefits, amounts attributable to future salary increases and other benefits.

### 1.13.2 Characteristics of defined benefit plans and risks associated with them

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An entity shall disclose:

- (a) information about the characteristics of its defined benefit plans, including:
  - (i) the nature of the benefits provided by the plan (e.g. final salary defined benefit plan or contribution-based plan with guarantee);
  - (ii) a description of the regulatory framework in which the plan operates (e.g. the level of any minimum funding requirements, and any effect of the regulatory framework on the plan, such as the asset ceiling); and
  - (iii) a description of any other entity's responsibilities for the governance of the plan (e.g. responsibilities of trustees or of board members of the plan).
- (b) a description of the risks to which the plan exposes the entity, focused on any unusual, entity specific or plan-specific risks, and of any significant concentrations of risk. For example, if plan assets are invested primarily in one class of investments (e.g. property), the plan may expose the entity to a concentration of property market risk; and
- (c) a description of any plan amendments, curtailments and settlements.

### **1.13.3 Explanation of amounts in the financial statements**

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- ❖ An entity shall provide a reconciliation from the opening balance to the closing balance for each of the following, if applicable:
  - (a) the net defined benefit liability (asset), showing separate reconciliations for:
    - (i) plan assets;
    - (ii) the present value of the defined benefit obligation; and
    - (iii) the effect of the asset ceiling; and
  - (b) any reimbursement rights. An entity shall also describe the relationship between any reimbursement right and the related obligation.
- ❖ Each reconciliation listed above shall show each of the following, if applicable:
  - (a) current service cost;
  - (b) interest income or expense;
  - (c) remeasurements of the net defined benefit liability (asset), showing separately:
    - (i) the return on plan assets, excluding amounts included in interest in interest income or expense;
    - (ii) actuarial gains and losses arising from changes in demographic assumptions;
    - (iii) actuarial gains and losses arising from changes in financial assumptions; and
    - (iv) changes in the effect of limiting a net defined benefit asset to the asset ceiling, excluding amounts included in interest income or expense. An entity shall also

disclose how it determined the maximum economic benefit available, i.e. whether those benefits would be in the form of refunds, reductions in future contributions or a combination of both;

- (d) past service cost and gains and losses arising from settlements. If permitted by the Standard (i.e., entity need not distinguish between past service cost resulting from a plan amendment), past service cost and gains and losses arising from settlements need not be distinguished if they occur together;
  - (e) the effect of changes in foreign exchange rates;
  - (f) contributions to the plan, showing separately those by the employer and by plan participants;
  - (g) payments from the plan, showing separately the amount paid in respect of any settlements; and
  - (h) the effects of business combinations and disposals.
- ❖ The fair value of the plan assets shall be disaggregated into classes that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market (as defined in Ind AS 113, *Fair Value Measurement*) and those that do not.

For example, and considering the level of general disclosures, an entity might distinguish between:

- (i) cash and cash equivalents;
  - (ii) equity instruments (segregated by industry type, company size, geography etc);
  - (iii) debt instruments (segregated by type of issuer, credit quality, geography etc);
  - (iv) real estate (segregated by geography etc);
  - (v) derivatives (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, credit contracts, longevity swaps etc);
  - (vi) investment funds (segregated by type of fund);
  - (vii) asset-backed securities; and
  - (viii) structured debt.
- ❖ An entity shall disclose:
- (a) the fair value of the entity's own transferable financial instruments held as plan assets; and
  - (b) the fair value of plan assets that are property occupied by, or other assets used by, the entity.

- ❖ An entity shall disclose the significant actuarial assumptions used to determine the present value of the defined benefit obligation. Such disclosure shall be in absolute terms (e.g. as an absolute percentage, and not just as a margin between different percentages and other variables). When an entity provides disclosures in total for a grouping of plans, it shall provide such disclosures in the form of weighted averages or relatively narrow ranges.

#### **1.13.4 Amount, timing and uncertainty of future cash flows**

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- ❖ An entity shall disclose:
  - (a) a sensitivity analysis for each significant actuarial assumption as of the end of the reporting period, showing how the defined benefit obligation would have been affected by changes in the relevant actuarial assumption that were reasonably possible at that date;
  - (b) the methods and assumptions used in preparing these sensitivity analyses and the limitations of those methods; and
  - (c) changes from the previous period in the methods and assumptions used in preparing the sensitivity analyses, and the reasons for such changes.
- ❖ To provide an indication of the effect of the defined benefit plan on the entity's future cash flows, an entity shall disclose:
  - (a) a description of any funding arrangements and funding policy that affect future contributions;
  - (b) the expected contributions to the plan for the next annual reporting period;
  - (c) information about the maturity profile of the defined benefit obligation. This will include the weighted average duration of the defined benefit obligation and may include other information about the distribution of the timing of benefit payments, such as a maturity analysis of the benefit payments.

#### **1.13.5 Multi-employer plans**

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If an entity participates in a multi-employer defined benefit plan, it shall disclose:

- (a) a description of the funding arrangements, including the method used to determine the entity's rate of contributions and any minimum funding requirements;
- (b) a description of the extent to which the entity can be liable to the plan for other entities' obligations under the terms and conditions of the multi-employer plan; and
- (c) a description of any agreed allocation of a deficit or surplus on:
  - (i) wind-up of the plan; or
  - (ii) the entity's withdrawal from the plan.

- (d) if the entity accounts for that plan as if it were a defined contribution plan in accordance with general principles applicable to liabilities and an entities own equity instruments, it shall disclose the following, in addition to the information required by (a)–(c) (refer section 1.13.2) and instead of the information required by paragraphs 139–147 (refer section 1.13.3 to 4):
- (i) the fact that the plan is a defined benefit plan.
  - (ii) the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan.
  - (iii) the expected contributions to the plan for the next annual reporting period.
  - (iv) information about any deficit or surplus in the plan that may affect the amount of future contributions, including the basis used to determine that deficit or surplus and the implications, if any, for the entity.
  - (v) an indication of the level of participation of the entity in the plan compared with other participating entities. Examples of measures that might provide such an indication include the entity's proportion of the total contributions to the plan or the entity's proportion of the total number of active members, retired members, and former members entitled to benefits, if that information is available.

### **1.13.6 Defined benefit plans that share risks between entities under common control**

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If an entity participates in a defined benefit plan that shares risks between entities under common control, it shall disclose:

- (a) the contractual agreement or stated policy for charging the net defined benefit cost or the fact that there is no such policy.
- (b) the policy for determining the contribution to be paid by the entity.
- (c) if the entity accounts for an allocation of the net defined benefit cost as mentioned in section 1.6.3 above, all the information about the plan as a whole as discussed in sections 1.13.1 to 1.13.4.
- (d) if the entity accounts for the contribution payable for the period as noted in section 1.6.3 above, the relevant information about the plan as a whole as mentioned in sections 1.13.1 to 1.13.4.
- (e) The information required by (c) and (d) above can be disclosed by cross-reference to disclosures in another group entity's financial statements if:
  - (a) that group entity's financial statements separately identify and disclose the information required about the plan; and

- (b) that group entity's financial statements are available to users of the financial statements on the same terms as the financial statements of the entity and at the same time as, or earlier than, the financial statements of the entity.

### 1.13.7 Disclosure requirements in other Ind AS

- ❖ Where required by Ind AS 24 *Related Party Disclosures*, an entity discloses information about:
  - (a) related party transactions with post-employment benefit plans; and
  - (b) post-employment benefits for key management personnel.
- ❖ Where required by Ind AS 37 *Provisions, Contingent liabilities and Contingent Assets*, an entity discloses information about contingent liabilities arising from post-employment benefit obligations.



## 1.14 OTHER LONG-TERM EMPLOYEE BENEFITS

- ❖ Other long-term employee benefits are those employee benefits which are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.
- ❖ Other long-term employee benefits include, For example:
  - (a) long-term paid absences such as long-service or sabbatical leave;
  - (b) jubilee or other long-service benefits;
  - (c) long-term disability benefits;
  - (d) profit-sharing and bonuses; and
  - (e) deferred remuneration.
- ❖ The measurement of other long-term employee benefits is not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. It is also there that the introduction of, or changes to, other long-term employee benefits rarely causes a material amount of past service cost. This method does not recognise remeasurements in other comprehensive income as required under the accounting required for post-employment benefits.

### 1.14.1 Recognition and measurement

- ❖ For other long-term employee benefits, an entity shall recognise the net total of the following amounts in profit or loss, except to the extent that another Standard requires or permits their inclusion in the cost of an asset:



- (a) service cost;
  - (b) net interest on the net defined benefit liability (asset); and
  - (c) remeasurements of the net defined benefit liability (asset).
- ❖ One form of other long-term employee benefit is long-term disability benefit. If the level of benefit depends on the length of service, an obligation arises when the service is rendered. Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

### 1.14.2 Disclosure

Though this Standard does not require specific disclosures about other long-term employee benefits, other Standards may require disclosures.

For example:

- a. Where the expense resulting from such benefits is material and so would require disclosure in accordance with Ind AS 1.
- b. When required by Ind AS 24, an entity discloses information about other long-term employee benefits for key management personnel.



## 1.15 TERMINATION BENEFITS

- ❖ This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination of employment rather than employee service.
- ❖ Termination benefits results from either:
  - (a) an entity's decision to terminate the employment or
  - (b) an employee's decision to accept an entity's offer of benefits in exchange for termination of employment.
- ❖ Termination benefits do not include employee benefits resulting from termination of employment at the request of the employee without an entity's offer, or as a result of mandatory retirement requirements, because those benefits are post-employment benefits.
- ❖ Some entities provide a lower level of benefit for termination of employment at the request of the employee (in substance, a post-employment benefit) than for termination of employment at the request of the entity. The difference between the benefit provided for termination of employment at the request of the employee and a higher benefit provided at the request of the entity is a termination benefit.

- ❖ The form of the employee benefit does not determine whether it is provided in exchange for service or in exchange for termination of the employee's employment. Termination benefits are typically lump sum payments, but sometimes also include
  - (a) enhancement of post-employment benefits, either indirectly through an employee benefit plan or directly.
  - (b) salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity.
- ❖ Indicators that an employee benefit is provided in exchange for services include the following:
  - (a) the benefit is conditional on future service being provided (including benefits that increase if further service is provided).
  - (b) the benefit is provided in accordance with the terms of an employee benefit plan.
- ❖ Employee benefits provided in accordance with the terms of an employee benefit plan are termination benefits if they both result from an entity's decision to terminate an employee's employment and are not conditional on future service being provided.
- ❖ Some employee benefits are provided regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits are described in some jurisdictions as termination indemnities or termination gratuities, they are post-employment benefits rather than termination benefits, and an entity accounts for them as post-employment benefits.

### 1.15.1 Recognition

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- ❖ An entity is required to **recognise** a liability and expense for termination benefits **at the earlier of the following dates**:
  - (a) when the entity can no longer withdraw the offer of those benefits; and
  - (b) when the entity recognises costs for a restructuring which is within the scope of Ind AS 37 and involves the payment of termination benefits.
- ❖ For **termination benefits** payable **as a result of an employee's decision to accept an offer of** benefits in exchange for the **termination of employment**, the **time when an entity can no longer withdraw the offer of** termination benefits **is the earlier of**:
  - (a) when the employee accepts the offer; and
  - (b) when a restriction (e.g. a legal, regulatory or contractual requirement or other restriction) on the entity's ability to withdraw the offer takes effect.

- ❖ For termination benefits payable as a result of an entity's decision to terminate an employee's employment, the entity can no longer withdraw the offer when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria:
  - (a) Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.
  - (b) The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations (but the plan need not identify each individual employee) and the expected completion date.
  - (c) The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive when their employment is terminated.
- ❖ Where an entity recognises termination benefits, the entity may also have to account for a curtailment of retirement benefits or other employee benefits.

### 1.15.2 Measurement

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An entity shall measure termination benefits on initial recognition, and shall measure and recognise subsequent changes, in accordance with the nature of the employee benefit, provided that if the termination benefits are an enhancement to post-employment benefits, the entity shall apply the requirements for post-employment benefits. Otherwise:

- (a) If the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognised, the entity shall apply the requirements for short-term employee benefits.
- (b) If the termination benefits are not expected to be settled wholly before twelve months after the end of the annual reporting period, the entity shall apply the requirements for other long-term employee benefits.

Because termination benefits are not provided in exchange for service, the concepts relating to the attribution of the benefit to periods of service as discussed for defined benefit plans are not relevant.

#### Example 4: On Termination Benefits

As a result of a recent acquisition, an entity plans to close a factory in ten months and, at that time, terminate the employment of all of the remaining employees at the factory. Because the entity needs the expertise of the employees at the factory to complete some contracts, it announces a plan of termination as follows.

Each employee who stays and renders service until the closure of the factory will receive on the termination date a cash payment of ₹ 30,000. Employees leaving before closure of the factory will receive ₹ 10,000.

There are 120 employees at the factory. At the time of announcing the plan, the entity expects 20 of them to leave before closure. Therefore, the total expected cash outflows under the plan are ₹ 3,200,000 (i.e.  $(20 \times ₹ 10,000) + (100 \times ₹ 30,000)$ ). As required by paragraph 160, the entity accounts for benefits provided in exchange for termination of employment as termination benefits and accounts for benefits provided in exchange for services as short-term employee benefits.

#### ***Termination benefits***

The benefit provided in exchange for termination of employment is ₹ 10,000. This is the amount that an entity would have to pay for terminating the employment regardless of whether the employees stay and render service until closure of the factory or they leave before closure. Even though the employees can leave before closure, the termination of all employees' employment is a result of the entity's decision to close the factory and terminate their employment (i.e. all employees will leave employment when the factory closes). Therefore, the entity recognises a liability of ₹ 12,00,000 (i.e.  $120 \times ₹ 10,000$ ) for the termination benefits provided in accordance with the employee benefit plan at the earlier of when the plan of termination is announced and when the entity recognises the restructuring costs associated with the closure of the factory.

#### ***Benefits provided in exchange for service***

The incremental benefits that employees will receive if they provide services for the full ten-month period are in exchange for services provided over that period. The entity accounts for them as short-term employee benefits because the entity expects to settle them before twelve months after the end of the annual reporting period. In this example, discounting is not required, so an expense of ₹ 2,00,000 (i.e.  $₹ 20,00,000 \div 10$ ) is recognised in each month during the service period of ten months, with a corresponding increase in the carrying amount of the liability.

### **1.15.3 Disclosure**

This Standard does not require specific disclosures about termination benefits, other Ind AS may require disclosures.

For example:

- a. where required by Ind AS 24 an entity discloses information about termination benefits for key management personnel.
- b. Ind AS 1 requires disclosure of employee benefits expense.



## **1.16 IND AS 19 — THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION**

### **1.16.1 Background**

- ❖ Ind AS 19 limits the measurement of a net defined benefit asset to the lower of the surplus in the defined benefit plan and asset ceiling (i.e. the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan). Questions have arisen about when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists.
- ❖ Minimum funding requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period. Therefore, a minimum funding requirement may limit the ability of the entity to reduce future contributions.
- ❖ Further, the limit on the measurement of a defined benefit asset may cause a minimum funding requirement to be onerous. Normally, a requirement to make contributions to a plan would not affect the measurement of the defined benefit asset or liability. This is because the contributions, once paid, will become plan assets and so the additional net liability is nil. However, a minimum funding requirement may give rise to a liability if the required contributions will not be available to the entity once they have been paid.

### **1.16.2 Scope**

This Appendix applies to all post-employment defined benefits and other long-term employee defined benefits. For the purpose of this Appendix, minimum funding requirements are any requirements to fund a post-employment or other long-term defined benefit plan.

### **1.16.3 Issues**

The issues addressed in this Appendix are:

- (a) when refunds or reductions in future contributions should be regarded as available in accordance with the definition of the asset ceiling.
- (b) how a minimum funding requirement might affect the availability of reductions in future contributions.
- (c) when a minimum funding requirement might give rise to a liability.

## 1.16.4 Principles

### 1.16.4.1 Availability of a refund or reduction in future contributions

- ❖ An entity shall determine the availability of a refund or a reduction in future contributions in accordance with the terms and conditions of the plan and any statutory requirements in the jurisdiction of the plan.
- ❖ An economic benefit is available in the form of a refund or a reduction in future contributions if the entity can realise it at some point during the life of the plan or when the plan liabilities are settled.
- ❖ The economic benefit available does not depend on how the entity intends to use the surplus. An entity shall determine the maximum economic benefit that is available from refunds, reductions in future contributions or a combination of both. An entity shall not recognise economic benefits from a combination of refunds and reductions in future contributions based on assumptions that are mutually exclusive.
- ❖ In accordance with Ind AS 1, the entity shall disclose information about the key sources of estimation uncertainty at the end of the reporting period that have a significant risk of causing a material adjustment to the carrying amount of the net asset or liability recognised in the balance sheet. This might include disclosure of any restrictions on the current realisability of the surplus or disclosure of the basis used to determine the amount of the economic benefit available.

### 1.16.4.2 The economic benefit available as a refund

#### 1. The right to a refund

- ❖ A refund is available to an entity only if the entity has an unconditional right to a refund:
  - (a) during the life of the plan, without assuming that the plan liabilities must be settled in order to obtain the refund (e.g., in some jurisdictions, the entity may have a right to a refund during the life of the plan, irrespective of whether the plan liabilities are settled); or
  - (b) assuming the gradual settlement of the plan liabilities over time until all members have left the plan; or
  - (c) assuming the full settlement of the plan liabilities in a single event (i.e., as a plan wind-up).
- ❖ An unconditional right to a refund can exist whatever the funding level of a plan at the end of the reporting period.
- ❖ If the entity's right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within its control, the entity does not have an unconditional right and shall not recognise an asset.

## 2. Measurement of the economic benefit

- ❖ An entity shall measure the economic benefit available as a refund as the amount of the surplus at the end of the reporting period (being the fair value of the plan assets less the present value of the defined benefit obligation) that the entity has a right to receive as a refund, less any associated costs.

**For instance**, if a refund would be subject to a tax other than income tax, an entity shall measure the amount of the refund net of the tax.

- ❖ In measuring the amount of a refund available when the plan is wound up, an entity shall include the costs to the plan of settling the plan liabilities and making the refund.

**For example**, an entity shall deduct professional fees if these are paid by the plan rather than the entity, and the costs of any insurance premiums that may be required to secure the liability on wind-up.

- ❖ If the amount of a refund is determined as the full amount or a proportion of the surplus, rather than a fixed amount, an entity shall make no adjustment for the time value of money, even if the refund is realisable only at a future date.

### 1.16.4.3 The economic benefit available as a contribution reduction

- ❖ The economic benefit available as a reduction in future contributions is the future service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity; and if there is no minimum funding requirement for contributions relating to future service. The future service cost to the entity excludes amounts that will be borne by employees.
- ❖ An entity shall determine the future service costs using assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. Therefore, an entity shall assume no change to the benefits to be provided by a plan in the future can be assumed by the entity until the plan is amended and shall assume a stable workforce in the future unless the entity makes a reduction in the number of employees covered by the plan. In the latter case, the assumption about the future workforce shall include the reduction.

### 1.16.4.4 The effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions

- ❖ An entity shall analyse any minimum funding requirement at a given date into contributions that are required to cover
  - (a) any existing shortfall for past service on the minimum funding basis; and
  - (b) future service.
    - Contributions to cover any existing shortfall on the minimum funding basis in respect of services already received do not affect future contributions for future service. They may give rise to a liability.

- ❖ If there is a minimum funding requirement for contributions relating to the future service, the economic benefit available as a reduction in future contributions is the sum of:
  - (a) any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e., paid the amount before being required to do so); and
  - (b) the estimated future service cost in each period less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in (a).
- ❖ An entity shall estimate the future minimum funding requirement contributions for future service taking into account the effect of any existing surplus determined using the minimum funding basis but excluding the prepayment. An entity shall use assumptions consistent with the minimum funding basis and, for any factors not specified by that basis, assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. The estimate shall include any changes expected as a result of the entity paying the minimum contributions when they are due. However, the estimate shall not include the effect of expected changes in the terms and conditions of the minimum funding basis that are not substantively enacted or contractually agreed at the end of the reporting period.
- ❖ When an entity determines the amount, if the future minimum funding requirement contributions for future service exceed the future service cost in any given period, that excess reduces the amount of the economic benefit available as a reduction in future contributions.

#### 1.16.4.6 When a minimum funding requirement may give rise to a liability

- ❖ If an entity has an obligation under a minimum funding requirement to pay contributions to cover an existing shortfall on the minimum funding basis in respect of services already received, the entity shall determine whether the contributions payable will be available as a refund or reduction in future contributions after they are paid into the plan.
- ❖ To the extent that the contributions payable will not be available after they are paid into the plan, the entity shall recognise a liability when the obligation arises. The liability shall reduce the defined benefit asset or increase the defined benefit liability so that no gain or loss is expected.



### 1.17 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

*Following is the extract from the financial statements of the listed entity 'Bharti Airtel Limited' for the financial year 2021-2022 with respect to 'Employee Benefits' and its accounting policy thereon.*



## 25.2 Employee benefits

The details of significant employee benefits are as follows:

|                                     | For the year ended March 31, 2022 |                      | For the year ended March 31, 2021 |                      |
|-------------------------------------|-----------------------------------|----------------------|-----------------------------------|----------------------|
|                                     | Gratuity                          | Compensated absences | Gratuity                          | Compensated absences |
| <b>Obligation:</b>                  |                                   |                      |                                   |                      |
| Balance as at beginning of the year | 1,949                             | 774                  | 1,852                             | 724                  |
| Current service cost                | 270                               | 162                  | 257                               | 167                  |
| Interest cost                       | 132                               | 53                   | 128                               | 50                   |
| Benefits paid                       | (395)                             | (170)                | (256)                             | (102)                |
| Transfers                           | (15)                              | (9)                  | (29)                              | (21)                 |
| Remeasurements                      | 33                                | (71)                 | (3)                               | (44)                 |
| <b>Present value of obligation</b>  | <b>1,974</b>                      | <b>739</b>           | <b>1,949</b>                      | <b>774</b>           |
| <b>Current portion</b>              | <b>528</b>                        | <b>739</b>           | <b>609</b>                        | <b>774</b>           |
| <b>Non-Current portion</b>          | <b>1,446</b>                      | <b>-</b>             | <b>1,340</b>                      | <b>-</b>             |

As of March 31, 2022, expected contributions for the next annual reporting period is ₹446.

### Amount recognised in Other Comprehensive Income

|                                                       | For the year ended March 31, 2022 | For the year ended March 31, 2021 |
|-------------------------------------------------------|-----------------------------------|-----------------------------------|
| Experience losses / (gains)                           | 62                                | (18)                              |
| Losses from change in demographic assumptions         | 22                                | 9                                 |
| (Gains) / losses from change in financial assumptions | (51)                              | 6                                 |
| <b>Remeasurements on defined benefit plans</b>        | <b>33</b>                         | <b>(3)</b>                        |

## ACCOUNTING POLICY

The Company's employee benefits mainly include wages, salaries, bonuses, defined contribution plans, defined benefits plans, compensated absences, deferred compensation, and share-based payments. The employee benefits are recognized in the year in which the associated services are rendered by the Company employees. Short-term employee benefits are recognized in the Statement of Profit and Loss at undiscounted amounts during the period in which the related services are rendered.

### i. Defined Contribution plans

The contributions to defined contribution plans are recognized in profit or loss as and when the services are rendered by employees. The Company has no further obligations under these plans beyond its periodic contributions.

### ii. Defined benefits plans

In accordance with the local laws and regulations, all the employees in India are entitled for the Gratuity plan. The said plan requires a lump-sum payment to eligible employees

(meeting the required vesting service condition) at retirement or termination of employment, based on a pre-defined formula.

The Company provides for the liability towards the said plans on the basis of actuarial valuation carried out quarterly as at the reporting date, by an independent qualified actuary using the projected-unit-credit method.

The obligation towards the said benefits is recognized in the Balance Sheet, at the present value of the defined benefit obligations. The present value of the said obligation is determined by discounting the estimated future cash outflows, using interest rates of government bonds.

The interest expenses are calculated by applying the above-mentioned discount rate to defined benefits obligations. The interest expenses on the defined benefits obligations are recognized in the Statement of Profit and Loss. However, the related re-measurements of the defined benefits obligations are recognized directly in the other comprehensive income in the period in which they arise. The said re-measurements comprise of actuarial gains and losses (arising from experience adjustments and changes in actuarial assumptions). Re-measurements are not re-classified to the Statement of Profit and Loss in any of the subsequent periods.

#### **a. Other long-term employee benefits**

The employees of the Company are entitled to compensated absences as well as other long-term benefits. Compensated absences benefits comprise of encashment and availment of leave balances that were earned by the employees over the period of past employment.

The Company provides for the liability towards the said benefits on the basis of actuarial valuation carried out quarterly as at the reporting date, by an independent qualified actuary using the projected-unit-credit method. The related re-measurements are recognized in the Statement of Profit and Loss in the period in which they arise.

(Source: Annual Report 2021-2022 - 'Bharti Airtel Limited')



### **1.18 SIGNIFICANT DIFFERENCES IN IND AS 19 VIS-À-VIS AS 15**

| S. No. | Particulars              | Ind AS 19                                                                                                             | AS 15                                                                            |
|--------|--------------------------|-----------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------|
| 1.     | Constructive Obligations | In Ind AS 19 (paragraph 4(c), obligations arising from informal practices are referred to as constructive obligations | In AS 15 (paragraph 3(c) such obligations are simply referred to as obligations. |

|    |                                                                                                            |                                                                                                                                                                                                                                                                                                           |                                                                                                                                                                                                                                                                                                                                                                                       |
|----|------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2. | <i>Definition of Employee</i>                                                                              | Ind AS 19 the term 'employee' includes directors whether they are whole-time or not. (Paragraph 7 of Ind AS 19)                                                                                                                                                                                           | As per AS 15, the term 'employee' includes whole-time directors                                                                                                                                                                                                                                                                                                                       |
| 3. | <i>Other Definitions</i>                                                                                   | Definitions of short-term employee benefits, other long-term employee benefits, and past service cost is different in Ind AS 19 (Paragraph 8 of Ind AS 19)                                                                                                                                                | Different definitions are given in AS 15                                                                                                                                                                                                                                                                                                                                              |
| 4. | <i>Contractual Agreement between a Multi-employer Plan and its Participants</i>                            | Ind AS 19 deals with situations where there is a contractual agreement between a multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants (or the deficit funded). (Paragraph 37 of Ind AS 19)                                        | AS 15 does not deal with it                                                                                                                                                                                                                                                                                                                                                           |
| 5. | <i>Participation in a Defined Benefit Plan Sharing Risks Between Various Entities under Common Control</i> | As per Ind AS 19, participation in a defined benefit plan sharing risks between various entities under common control is a related party transaction for each group entity and some disclosures are required in the separate or individual financial statements of an entity. (Paragraph 42 of Ind AS 19) | AS 15 does not contain similar provisions                                                                                                                                                                                                                                                                                                                                             |
| 6. | <i>Recognition of Past Service Cost</i>                                                                    | As per Ind AS 19, past service cost (including curtailments) is recognised as an expense at the earlier of when the plan amendment or Curtailment occurs; and when the entity recognizes related restructuring costs or termination benefits.                                                             | As per AS 15, past service cost is recognised as an expense on a straight-line basis over the average period until the benefits become vested. If already vested, recognised as an expense immediately. Entities recognise a curtailment when it occurs. However, when curtailment is linked with a restructuring, it is accounted for at the same time as the related restructuring. |

|     |                                                           |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                               |
|-----|-----------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 7.  | <i>Involvement of a qualified actuary</i>                 | Para 59 of Ind AS 19 encourages, but does not require, an entity to involve a qualified actuary in the measurement of all material post-employment benefit obligations. (Paragraph 59 of Ind AS 19)                                                                                                                                                                                                                                                                                | AS 15 neither requires nor specifically encourage the same.                                                                                                                                                   |
| 8.  | <i>Actuarial valuation</i>                                | Detailed actuarial valuation to determine the present value of net defined benefit liability (asset) shall be performed with sufficient regularity so that the amounts recognized in the financial statements do not differ materially from the amounts that would have been determined at the end of the reporting period. Ind AS 19 does not define sufficient regularity.                                                                                                       | Detailed actuarial valuation to determine the present value of defined benefit obligation is carried out at least once every 3 years and fair value of plan assets are determined at each balance sheet date. |
| 9.  | <i>Recognition of Actuarial Gains and Losses</i>          | Ind AS 19 requires that the same shall be recognised in other comprehensive income and not reclassified to profit or loss in a subsequent period.                                                                                                                                                                                                                                                                                                                                  | AS 15 requires recognition of actuarial gains and losses immediately in the profit and loss                                                                                                                   |
| 10. | <i>Financial Assumptions</i>                              | Ind AS 19 makes it clear that financial assumptions shall be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled. (Paragraph 80 of Ind AS 19)                                                                                                                                                                                                                                                            | AS 15 does not clarify the same                                                                                                                                                                               |
| 11. | <i>Discounting of Post-employment Benefit Obligations</i> | As per Ind AS 19, subsidiaries, associates, joint ventures and branches domiciled outside India shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries where there is no deep market in such bonds, the | As per AS 15, the rate used to discount post-employment benefit obligations should always be determined by reference to market yields at the balance sheet date on government bond.                           |

|     |                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                               |                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|-----|------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|     |                                                                                                | market yields (at the end of the reporting period) on government bonds of that country shall be used.                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| 12. | <i>Timing of Recognition of Termination Benefits</i>                                           | <p>As per Ind AS 19 para 165, an entity shall recognise a liability and expense for termination benefits at the earlier of the following dates:</p> <p>(a) when the entity can no longer withdraw the offer of those benefits; and</p> <p>(b) when the entity recognises costs for a restructuring that Employee Benefits within the scope of Ind AS 37 and involves the payment of termination benefits.</p> | <p>As per AS 15 para 134, an enterprise should recognise termination benefits as a liability and an expense when, and only when:</p> <p>(a) the enterprise has a present obligation as a result of a past event;</p> <p>(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and</p> <p>(c) a reliable estimate can be made of the amount of the obligation.</p> |
| 13. | <i>Guidance on Interaction of Ceiling of Asset Recognition and Minimum Funding Requirement</i> | Ind AS 19 gives guidance on the interaction of ceiling of asset recognition and minimum funding requirement in the case of defined benefit obligations. (Appendix B of Ind AS 19)                                                                                                                                                                                                                             | Such guidance is not available in AS 15.                                                                                                                                                                                                                                                                                                                                                                                           |



twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.

State how would you measure the benefit to be attributed for the employee service for the last 20 years, 10 and 20 years and within 10 years.

5. Cisca Pvt. Ltd. has a headcount of around 1,000 employees in the organisation in 20X0-20X1. As per the company's policy, the employees are given 35 days of privilege leaves (PL), 15 days of sick leaves (SL) and 10 days of casual leaves. Out of the total PL and sick leaves, 10 PL leaves and 5 sick leaves can be carried forward to next year. On the basis of past trends, it has been noted that 200 employees will take 5 days of PL and 2 days of SL and 800 employees will avail 10 days of PL and 5 days of SL.

Also the company has been incurring profits since 20XX. It has decided in 20X0-20X1 to distribute profits to its employees @ 4% during the year. However, due to the employee turnover in the organisation, the expected pay-out of the Cisca Pvt. Ltd. is expected to be around 3.5%. The profits earned during 20X0-20X1 is ₹ 2,000 crores.

Cisca Pvt. Ltd. has a post-employment benefit plan also available which is in the nature of defined contribution plan where contribution to the fund amounts to ₹ 100 crores which will fall due within 12 months from the end of accounting period.

The company has paid ₹ 20 crores to its employees in 20X0-20X1. State what would be the treatment of the short-term compensating absences, profit-sharing plan and the defined contribution plan in the books of Cisca Pvt. Ltd. Also state what would be the treatment, if the contribution paid from defined contribution plan exceeds the contribution due. Further, determine what would be the accounting if the payment from defined contribution plan does not fall due within 12 months from the end of accounting period.

6. OPQ Ltd is a listed company having its corporate office at Nagpur. The company has a branch office at Chennai. The company has been operating in Indian market for the last 10 years.

The company operates a pension plan that provides a pension of 2.5% of the final salary for each year of service. The benefits become vested after seven years of service.

On 1<sup>st</sup> April, 20X8, the company increased the pension to 3% of the final salary for each year of service starting from 1<sup>st</sup> April, 20X1. On the date of the improvement, the present value of the additional benefits for service from 1<sup>st</sup> April, 20X1 to 1<sup>st</sup> April 20X8 was as follows:

- Employees with more than seven years' service on 1<sup>st</sup> January 20X8 – ₹ 2,75,000
- Employees with less than 7 years of service – ₹ 2,21,000 (average 4 years to go).

Provide the accounting treatment in this case.

7. SA Pvt Ltd is engaged in the business of retail having 100 retail outlets across Northern and Southern India. The company's head office is located at Chennai.

SA Pvt Ltd is a subsidiary of SAG Ltd. SAG Ltd is listed on the National Stock Exchange in India.

Following information is available for SA Pvt Ltd:

**Plan Assets**

At 1<sup>st</sup> April, 20X1, the fair value of plan assets was ₹ 10,000.

Contribution to the plan assets done on 31<sup>st</sup> March, 20X2 – ₹ 3,000

Amount paid on 31<sup>st</sup> March, 20X2 – ₹ 300

At 31<sup>st</sup> March, 20X2, the fair value of plan assets was ₹ 14,700

Actual return on plan assets – ₹ 2,000

**Defined Benefit Obligation**

At 1<sup>st</sup> April, 20X1, present value of the defined benefit obligation was ₹ 12,000.

At 31<sup>st</sup> March, 20X2, present value of the defined benefit obligation was ₹ 15,500.

Actuarial losses on the obligation for the year ended 31<sup>st</sup> March, 20X2 were ₹ 100.

Current Service Cost – ₹ 2,500

Benefit paid – ₹ 300

Discount rate used to calculate defined benefit liability - 10%.

Suggest if there is any amount based on the above-mentioned information that would be taken to other comprehensive income (with workings). Also compute net interest on the net defined benefit liability (asset).

8. A Ltd. prepares its financial statements to 31<sup>st</sup> March each year. It operates a defined benefit retirement benefits plan on behalf of current and former employees. A Ltd. receives advice from actuaries regarding contribution levels and overall liabilities of the plan to pay benefits. On 1<sup>st</sup> April, 20X1, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,00,00,000. On the same date, the fair value of the assets of the defined benefit plan was ₹ 5,20,00,000. On 1<sup>st</sup> April, 20X1, the annual market yield on government bonds was 5%. During the year ended 31<sup>st</sup> March, 20X2, A Ltd. made contributions of ₹ 70,00,000 into the plan and the plan paid out benefits of ₹ 42,00,000 to retired members. Both these payments were made on 31<sup>st</sup> March, 20X2.

The actuaries advised that the current service cost for the year ended 31<sup>st</sup> March, 20X2 was ₹ 62,00,000. On 28<sup>th</sup> February, 20X2, the rules of the plan were amended with retrospective effect. These amendments meant that the present value of the defined benefit obligation was increased by ₹ 15,00,000 from that date.



During the year ended 31<sup>st</sup> March, 20X2, A Ltd. was in negotiation with employee representatives regarding planned redundancies. The negotiations were completed shortly before the year end and redundancy packages were agreed. The impact of these redundancies was to reduce the present value of the defined benefit obligation by ₹ 80,00,000. Before 31<sup>st</sup> March, 20X2, A Ltd. made payments of ₹ 75,00,000 to the employees affected by the redundancies in compensation for the curtailment of their benefits. These payments were made out of the assets of the retirement benefits plan.

On 31<sup>st</sup> March, 20X2, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,80,00,000. On the same date, the fair value of the assets of the defined benefit plan were ₹ 5,60,00,000.

Examine and present how the above event would be reported in the financial statements of A Ltd. for the year ended 31<sup>st</sup> March, 20X2 as per Ind AS. Finance cost is to be computed on the opening balances.

9. On 1<sup>st</sup> April 20X1, the fair value of the assets of XYZ Ltd.'s defined benefit plan were valued at ₹ 20,40,000 and the present value of the defined obligation was ₹ 21,25,000. On 31<sup>st</sup> March, 20X2 the plan received contributions from XYZ Ltd amounting to ₹ 4,25,000 and paid out benefits of ₹ 2,55,000. The current service cost for the financial year ending 31<sup>st</sup> March 20X2 is ₹ 5,10,000. An interest rate of 5% is to be applied to the plan assets and obligations. The fair value of the plan assets at 31<sup>st</sup> March 20X2 was ₹ 23,80,000, and the present value of the defined benefit obligation was ₹ 27,20,000.

Provide a reconciliation from the opening balance to the closing balance for plan assets and defined benefit obligation. Also show how much amount should be recognised in the statement of profit and loss, other comprehensive income and balance sheet?

## Answers

1. At 31<sup>st</sup> March, 20X1, the average unused entitlement is two days per employee. The entity expects, on the basis of experience that is expected to continue, that 92 employees will take no more than five days of paid sick leaves in 20X1-20X2 and that the remaining eight employees will take an average of six and a half days each.

The entity expects that it will pay an additional twelve days of sick pay as a result of the unused entitlement that has accumulated at 31<sup>st</sup> March, 20X1 (one and a half days each, for eight employees).

Therefore, the entity would recognize a liability equal to twelve days of sick pay.

2. Benefit equal to the present value, at the expected retirement date, of a monthly pension of 0.3% of the estimated final salary payable from the expected retirement date until the expected date of death is attributed to each year of service. The current service cost is the present value of that benefit.

The present value of the defined benefit obligation is the present value of monthly pension payments of 0.3% of final salary, multiplied by the number of years of service up to the end of the reporting period. The current service cost and the present value of the defined benefit obligation are discounted because pension payments begin at the age of 65.

3. No benefit is attributed to service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional). A benefit of ₹ 140 is attributed to each subsequent year.
4. As per Ind AS 19, the benefit will be attributed till the period the employee service will lead to no material amount of benefits. And service in later years will lead to a materially higher level of benefit than in earlier years. Therefore, for employees expected to leave after twenty or more years, the entity would attribute benefit on a straight-line basis. Service beyond twenty years will lead to no material amount of further benefits. Therefore, the benefit attributed to each of the first twenty years is 2.5% (i.e. 50% divided by 20) of the present value of the expected medical costs.

For employees expected to leave between ten and twenty years, the benefit attributed to each of the first ten years is 2% (20 % divided by 10) of the present value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

For employees expected to leave within ten years, no benefit is attributed.

5. (i) Cisca Pvt. Ltd. will recognise a liability in its books to the extent of 5 days of PL for 200 employees and 10 days of PL for remaining 800 employees and 2 days of SL for 200 employees and 5 days of SL for remaining 800 employees in its books as an unused entitlement that has accumulated in 20X0-20X1 as short-term compensated absences.
- (ii) Cisca Pvt. Ltd. will recognise ₹ 70 crores (2,000 x 3.5%) as a liability and expense in its books of account.
- (iii) When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service.

Under Ind AS 19, the amount of ₹ 80 crores will be recognised as a liability (accrued expense), after deducting any contribution already paid (100-20) and an expense in the statement of profit and loss. However, if the contribution already paid would have exceeded the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense).

Since the contributions are payable within 12 months from the end of the year in which the employees render the related service, they will not be discounted. However, where contributions to a defined contribution plan do not fall due wholly within twelve months after

the end of the period in which the employees render the related service, they shall be discounted using the discount rate.

6. OPQ Ltd increased the pension to 3% of the final salary for each year of service starting from 1<sup>st</sup> April, 20X1 to 1<sup>st</sup> April, 20X8.

The company would recognize the total amount of ₹ 4,96,000 (i.e. ₹ 2,75,000 + ₹ 2,21,000) immediately, as for the purpose of recognition it does not make any difference as to whether the benefits are already vested or not.

7. As per Ind AS 19, net remeasurement of ₹ 900 would be recognized in other comprehensive income.

#### Computation of Net remeasurement

= Remeasurement – Actuarial loss

= ₹ 1000 (Refer WN - 1) – ₹ 100 (Given in the question) = ₹ 900.

#### Computation of net interest expense

| Particulars                                                                            | Amount in ₹  |
|----------------------------------------------------------------------------------------|--------------|
| Defined benefit liability as at 1 <sup>st</sup> April 20X1 (A) (Given in the question) | 12,000       |
| Fair value of plan asset as at 1 <sup>st</sup> April 20X1 (B) (Given in the question)  | (10,000)     |
| Net defined benefit liability (A - B)                                                  | <u>2,000</u> |
| Net interest expense (as it is net liability) (Refer note given below)                 | 200          |

#### Note:

Net interest expense would be computed on net defined benefit liability using discount rate of 10% given in the question-

= Net defined benefit liability x Discount rate

= 2,000 x 10%

= ₹ 200.

#### Working Note:

#### Computation of amount of remeasurement

| Particulars                                                                                            | ₹            |
|--------------------------------------------------------------------------------------------------------|--------------|
| Actual return on plan asset for the year ended 31 <sup>st</sup> March 20X2 (C) (Given in the question) | 2,000        |
| Less: Interest income on ₹ 10,000 held for 12 months at 10% (D)                                        | (1,000)      |
| Remeasurement (E = C - D)                                                                              | <u>1,000</u> |

**8.** All figures are ₹ in '000.

On 31<sup>st</sup> March, 20X2, A Ltd. will report a net pension liability in the statement of financial position. The amount of the liability will be 12,000 (68,000 – 56,000).

For the year ended 31<sup>st</sup> March, 20X2, A Ltd. will report the current service cost as an operating cost in the statement of profit or loss. The amount reported will be 6,200. The same treatment applies to the past service cost of 1,500.

For the year ended 31<sup>st</sup> March, 20X2, A Ltd. will report a finance cost in profit or loss based on the net pension liability at the start of the year of 8,000 (60,000 – 52,000). The amount of the finance cost will be 400 (8,000 x 5%).

The redundancy programme represents the partial settlement of the curtailment of a defined benefit obligation. The gain on settlement of 500 (8,000 – 7,500) will be reported in the statement of profit or loss.

Other movements in the net pension liability will be reported as remeasurement gains or losses in other comprehensive income.

For the year ended 31<sup>st</sup> March, 20X2, the remeasurement loss will be 3,400 (Refer W. N.).

**Working Note:**

**Remeasurement of gain or loss**

|                                                      | ₹ in '000     |
|------------------------------------------------------|---------------|
| Liability at the start of the year (60,000 – 52,000) | 8,000         |
| Current service cost                                 | 6,200         |
| Past service cost                                    | 1,500         |
| Net finance cost                                     | 400           |
| Gain on settlement                                   | (500)         |
| Contributions to plan                                | (7,000)       |
| Remeasurement loss (balancing figure)                | <u>3,400</u>  |
| Liability at the end of the year (68,000 – 56,000)   | <u>12,000</u> |

**9. Reconciliation of Plan assets and Defined benefit obligation**

|                                                           | Plan Assets<br>₹ | Defined benefit obligation<br>₹ |
|-----------------------------------------------------------|------------------|---------------------------------|
| Fair value/present value as at 1 <sup>st</sup> April 20X1 | 20,40,000        | 21,25,000                       |
| Interest @ 5%                                             | 1,02,000         | 1,06,250                        |

|                                                          |            |            |
|----------------------------------------------------------|------------|------------|
| Current service cost                                     |            | 5,10,000   |
| Contributions received                                   | 4,25,000   | -          |
| Benefits paid                                            | (2,55,000) | (2,55,000) |
| Return on plan assets (gain) (assets) (balancing figure) | 68,000     | -          |
| Actuarial Loss (balancing figure)                        | -          | 2,33,750   |
| Closing balance as at 31 <sup>st</sup> March, 20X2       | 23,80,000  | 27,20,000  |

**In the Statement of Profit and loss, the following will be recognised:** ₹

|                                                                 |          |
|-----------------------------------------------------------------|----------|
| Current service cost                                            | 5,10,000 |
| Net interest on net defined liability (₹ 1,06,250 – ₹ 1,02,000) | 4,250    |

**Defined benefit re-measurements recognised in Other Comprehensive Income:** ₹

|                                    |                   |
|------------------------------------|-------------------|
| Loss on defined benefit obligation | (2,33,750)        |
| Gain on plan assets                | <u>68,000</u>     |
|                                    | <u>(1,65,750)</u> |

**In the Balance sheet, the following will be recognised:** ₹

|                                                           |          |
|-----------------------------------------------------------|----------|
| Net defined benefit liability (₹ 27,20,000 – ₹ 23,80,000) | 3,40,000 |
|-----------------------------------------------------------|----------|

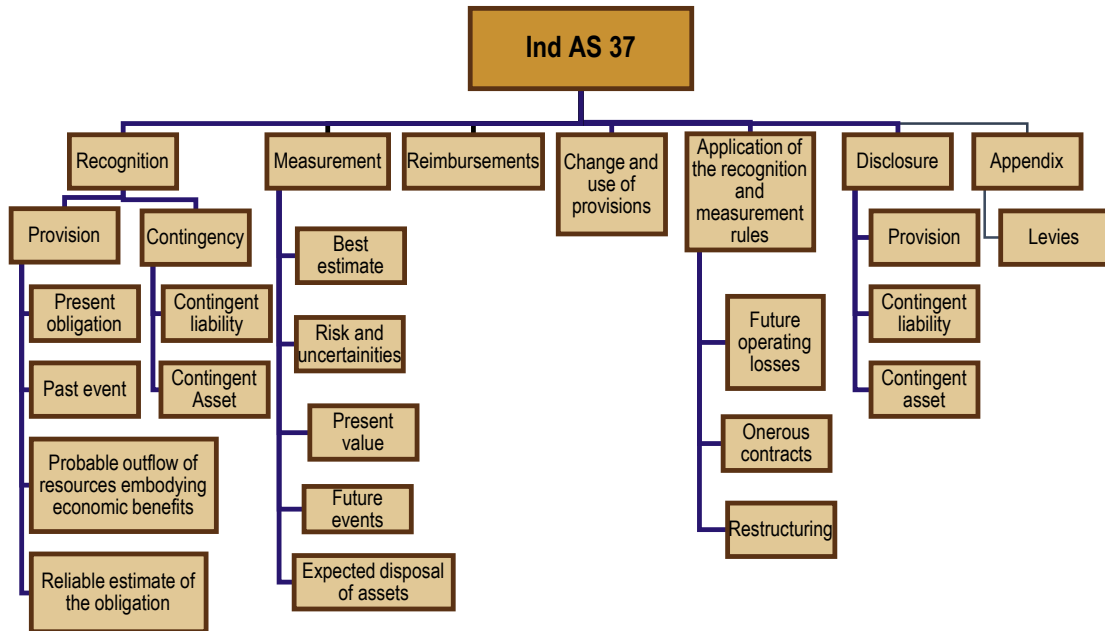
## UNIT 2: INDIAN ACCOUNTING STANDARD 37: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

### LEARNING OUTCOMES

**After studying this unit, you will be able to:**

- ☐ Define the terms like 'provision', 'contingent liability', 'contingent asset', obligating event, legal obligation, constructive obligation, onerous contracts and restructuring
- ☐ Appreciate the relationship between provision and contingent liability
- ☐ Recognise provision by examining present and past obligation, probability and estimate of the cash outflow.
- ☐ Apply the recognition principles of contingent assets and contingent liabilities
- ☐ Apply the recognition and measurement principles for future operating losses, Onerous contracts and restructuring
- ☐ Comply with the disclosure requirements with regard to disclosure of provisions, contingent liabilities and contingent assets as per Ind AS 37
- ☐ Differentiate between Ind AS 37 and AS 29

## UNIT OVERVIEW





## 2.1 OBJECTIVE

The objective of Ind AS 37 is to ensure that

- ❖ appropriate recognition criteria and measurement bases are applied to
  - provisions
  - contingent liabilities and
  - contingent assets and
- ❖ sufficient information is disclosed in the notes to enable users to understand their
  - nature
  - timing and
  - amount.



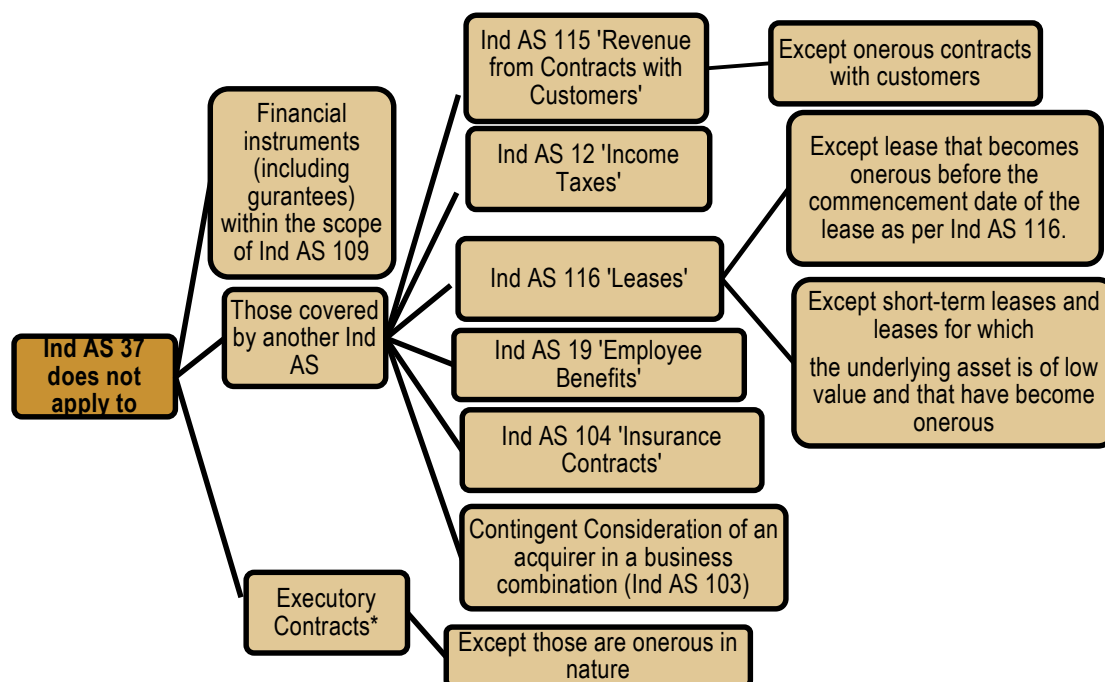
## 2.2 SCOPE

Ind AS 37 should be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, **except**:

- (a) those resulting from **executory contracts**, except where the contract is onerous; and
- (b) financial instruments (including guarantees) that are within the scope of Ind AS 109, *Financial Instruments*;
- (c) those covered by another Standard such as:
  - (i) revenue from contracts with customers covered by Ind AS 115. However, Ind AS 115 contains no specific requirement to address onerous contracts with customers. Hence, Ind AS 37 applies to such cases;
  - (ii) income taxes (Ind AS 12, *Income Taxes*);
  - (iii) leases (Ind AS 116, *Leases*). However, this Standard applies to any lease that becomes onerous before the commencement date of the lease as defined in Ind AS 116. This Standard also applies to short-term leases and leases for which the underlying asset is of low value accounted for in accordance with paragraph 6 of Ind AS 116 and that have become onerous;
  - (iv) employee benefits (Ind AS 19, *Employee Benefits*); and
  - (v) insurance contracts (Ind AS 104, *Insurance Contracts*). However, Ind AS 37 applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of Ind AS 104.



- (vi) Contingent consideration of an acquirer in a business combination (Ind AS 103, *Business Combinations*)



## 2.2.1 Executory Contracts

Executory contracts are contracts under which

- ❖ neither party has performed any of its obligations or
- ❖ both parties have partially performed their obligations to an equal extent.

For example:

- employee contracts in respect of continuing employment;
- contracts for future delivery of services such as gas and electricity;
- obligations to pay local authority charges etc are executory contracts.

**Note:** Ind AS 37 is applied to executory contracts only if they are onerous. For example, a long-term purchase contract that has a higher unit cost than unit sales price.

### Example 1 : Where both parties have performed their obligations to an equal extent

On 1<sup>st</sup> April 20X2, Company XYZ Limited enters into a contract with Company PQR Limited for the manufacture and delivery of 200 units of component A at five different dates in the future, i.e. 1,000 units are to be delivered in total. Payment is due on delivery of the units.

On 1<sup>st</sup> April 20X2, the contract between Company XYZ Limited and Company PQR Limited is executory because neither party has performed any of its obligations; Company XYZ Limited has not manufactured or delivered any of the units, nor has Company PQR Limited paid for any of them.

By 1<sup>st</sup> June 20X2, Company XYZ Limited has produced and delivered 400 of the units and Company PQR Limited has paid in full for those 400 units. At this date, the contract between Company XYZ Limited and Company PQR Limited continues to be executory because both parties have partially performed their obligations to an equal extent.

By 1<sup>st</sup> September 20X2, Company XYZ Limited has produced and delivered the full 1000 units, but Company PQR Limited has only paid for 800 units in total. The contract between Company XYZ Limited and Company PQR Limited no longer meets the definition of an executory contract because the two parties have not performed under the terms of the contract to an equal extent. Company PQR Limited is required to recognise a liability for the final 200 units of component A for which it has not yet paid.

## 2.2.2 Provisions when relate to the recognition of revenue or expense/losses

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- ❖ Some amounts treated as provisions may relate to the recognition of revenue.

**Example:** Where an entity gives guarantees in exchange for a fee.

Ind AS 37 does not address the recognition of revenue since there is a separate standard on it i.e. Ind AS 115, *Revenue from Contracts with Customers*. However, Ind AS 115 does not deal with onerous contracts with customers, so Ind AS 37 will deal with the same.

- ❖ As per Ind AS 37, provisions are liabilities of uncertain timing or amount. However, the term 'provision' is also used for certain adjustments which are made to the carrying amounts of assets.

**Example:** Depreciation, impairment of assets and doubtful debts.

The provisions which are adjustments to the carrying amounts of assets are not addressed in Ind AS 37 since other Ind AS specifies their treatment. Ind AS 37 neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

- ❖ Ind AS 37 applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*.



## 2.3 DEFINITIONS

The following definitions are relevant for the purpose of understanding the requirements of Ind AS 37.

1. A **provision** is a liability of uncertain timing or amount.
2. A **liability\*** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
3. An **obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

### Example 2

X Ltd. entered into a contract with Y Ltd. for supply of some material. As per the terms of contract in case of breach of contract, the party who breaches the contract has to pay ₹ 50,00,000 to other party. X Ltd. breached the contract with Y Ltd. Now in this case the obligating event is the breach of contract that gave rise to present obligation and X Ltd. must settle the obligation.

4. A **legal obligation** is an obligation that derives from:
  - (a) a contract (through its explicit or implicit terms);
  - (b) legislation; or
  - (c) other operation of law.

### Example

In the aforesaid example regarding breach of the contract, the obligation is a legal obligation that arises from the terms of contract.

5. A **constructive obligation** is an obligation that derives from an entity's actions where:
  - (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
  - (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

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\* The definition of a liability in this Standard is not revised following the revision of the definition of a liability in the *Conceptual Framework for Financial Reporting under Indian Accounting Standards* issued in 2021 by the Institute of Chartered Accountants of India.

**Examples 3 - 5**

3. X Ltd. is engaged in the manufacture of fertilisers. Effluents discharged in the manufacturing process have polluted the river near the manufacturing plant. The residents of the nearby locality launched a massive agitation against the pollution. X Ltd. agreed to their demands to reduce the water pollution by installing the necessary Effluent Treatment Plant. However, during the year no steps are taken to install the plant. No legislation requiring the company to reduce its pollution is in existence. In this case, though there is no law but by promising to take steps to reduce pollution, X Ltd. has created a valid expectation on the part of public that it will discharge its responsibilities. So the obligation in this case is a constructive obligation.
  4. An entity has prepared a formal plan for a re-organisation involving site closures and redundancies. The plan has been approved by the board at the year end, but the entity will not implement or announce the re-organisation until after the year end. There is no constructive obligation, even if there is an announcement after the entity's year end but before its financial statements are approved. The announcement is a non-adjusting post balance sheet event and there was no commitment to restructure at the year end. The entity could change its plans completely after the year end. A constructive obligation would exist if the entity has raised a valid expectation in those affected by beginning to implement the re-organisation by the end of the year (for example, by scrapping the plant or informing employees and suppliers of the re-organisation), despite the absence of a formal announcement.
  5. A retail store has a generally known policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. In these circumstances, the sale of its products gives rise to a constructive obligation because the entity (through its reputation for providing refunds) has created a valid expectation on the part of customers that a refund will be given if they are dissatisfied with their purchase.
6. A **contingent liability** is:
- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
  - (b) a present obligation that arises from past events but is not recognised because:
    - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    - (ii) the amount of the obligation cannot be measured with sufficient reliability.

**Example 6**

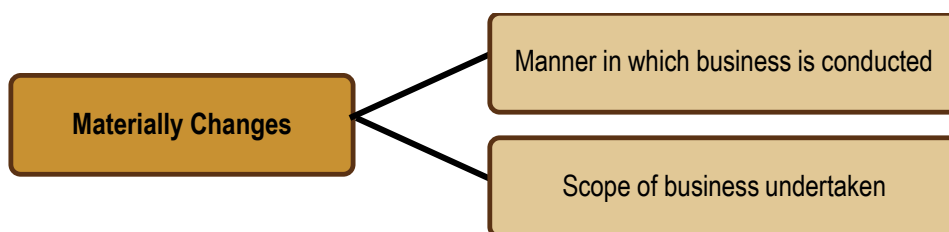
A tax case pending before the court, the liability for payment arising or not in respect of which depends on the outcome of court decision is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

7. A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

**Example 7**

X Ltd. filed a legal suit against a supplier of goods for compensation against damages on non-supply of contracted goods. This meets the definition of a contingent asset since there is a possible asset (compensation against damages) that arose from past event (contract with the supplier) and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future event not wholly within the control of the entity (i.e., the outcome of the legal suit).

8. An **onerous contract** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
9. A **restructuring** is a programme that is planned and controlled by management, and materially changes either:
- the scope of a business undertaken by an entity; or
  - the manner in which that business is conducted.



## 2.4 PROVISIONS AND OTHER LIABILITIES

Since there is uncertainty about the timing or amount of the future expenditure required in settlement of the provisions, they are different from liabilities. By contrast:

- trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

- (b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees.

**Example:** Amounts relating to accrued vacation pay.

Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

**Note:** Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

**Examples on provisions and other liabilities:**

| Nature of obligation                                                                | Recognition as provision as per Ind AS 37 (Yes/No) | Reasons                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|-------------------------------------------------------------------------------------|----------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Amount payable for utilities like electricity, gas, etc.                            | No                                                 | Amount payable for utilities represents an accrual of liability to pay for services that have been received. The amount and timing of payment can be determined with a reasonable certainty.<br><br>The timing for payment is known since the utility companies have fixed dates every month/period for the purpose of settlement of dues. A reliable estimate of the amount of payment can be made based on the quantum of consumption, prevailing rates or on the basis of earlier bills. |
| Goods or services received, but not invoiced                                        | No                                                 | Amount payable for supply of goods and services received under a formally agreed contract represents trade payables even if invoice has not been received. In such a case, amount and timing of payment would be driven by the terms agreed with the supplier.                                                                                                                                                                                                                              |
| Financial guarantee given by the parent to lenders for loan taken by its subsidiary | No                                                 | Financial guarantees are within the scope of Ind AS 109 <i>Financial Instruments</i>                                                                                                                                                                                                                                                                                                                                                                                                        |

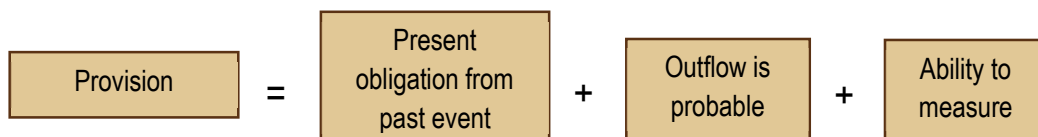
|                      |     |                                                                                                                                                                                                                                        |
|----------------------|-----|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Warranty obligations | Yes | Warranty obligation represents the additional cost that the seller may have to incur to rectify product defects. This is in the nature of provision as there is an uncertainty associated with the amount and timing of the liability. |
|----------------------|-----|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|



## 2.5 RELATIONSHIP BETWEEN PROVISIONS AND CONTINGENT LIABILITIES

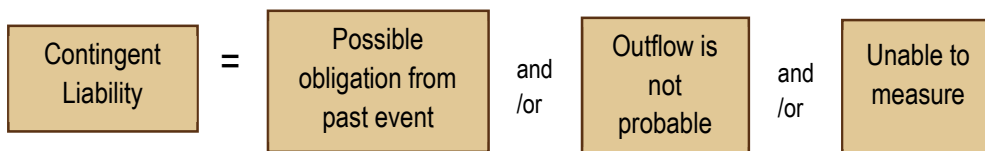
In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, Ind AS 37 distinguishes between the term 'contingent' and 'provisions'.

- (a) **Provisions** – which **are recognised as liabilities** (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and



- (b) **Contingent Liabilities** – which **are not recognised as liabilities** because they are either:

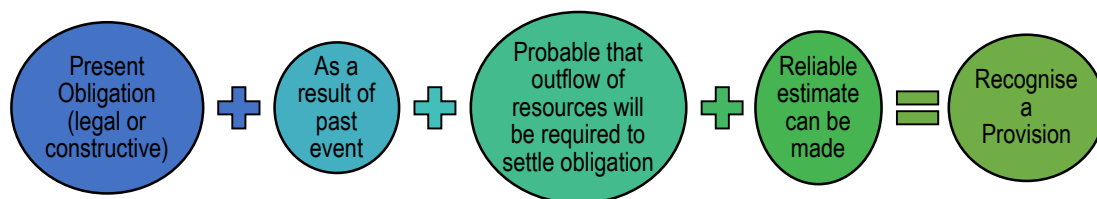
- (i) **possible obligations**, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or
- (ii) **present obligations** that do not meet the recognition criteria in Ind AS 37 (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).





## 2.6 RECOGNITION

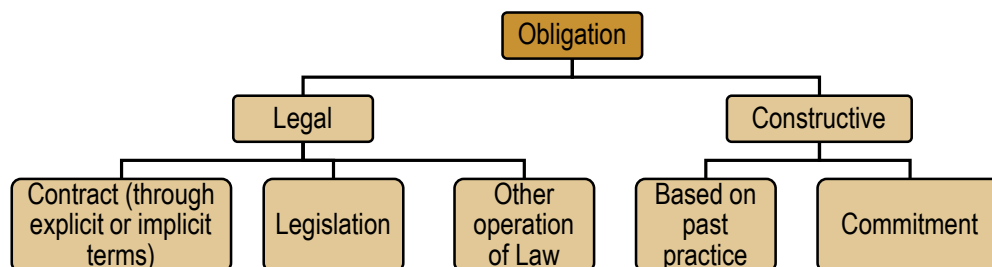
### 2.6.1 Provisions



A provision should be recognised when:

- an entity has a **present obligation** (legal or constructive) as a result of a **past event**;
- it is **probable that an outflow of resources embodying economic benefits** will be required to settle the obligation; and
- a **reliable estimate** can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.



#### 2.6.1.1 Present Obligation

- ❖ In general, it is clear that there is a present obligation. Only, in rare cases it is not clear whether there is a present obligation.
- ❖ In almost all cases it will be clear whether a past event has given rise to a present obligation.

#### Illustration 1

ABC Limited is an automobile component manufacturer. The automobile manufacturer has specified a delivery schedule, non-adherence to which will entail a penalty. As on 31<sup>st</sup> March, 20X1, the reporting date, the manufacturer has a delivery scheduled for June 20X2. However, the manufacturer is aware that he will not be able to meet the delivery schedule in June 20X2.

Determine whether the entity has a present obligation as at 31<sup>st</sup> March, 20X1, requiring recognition of provision.



### Solution

In this case, there is no present obligation arising out of a past event as the goods are scheduled for delivery in June 20X2 and there is no delay as at 31<sup>st</sup> March, 20X1. Hence, there is no present obligation to pay the penalty in the current year. Therefore, there is no present obligation to recognise the provision.

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- ❖ Where it is not clear whether there is a present obligation, past event shall be evaluated.
- ❖ In such a case, an entity should take into account all available evidence, including the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period.
- ❖ On the basis of such evidence:
  - (a) where it is **probable (i.e. more likely than not) that a present obligation exists** at the end of the reporting period,
    - ✓ the entity **recognises a provision** (if the recognition criteria are met); and
  - (b) where it is **more likely that no present obligation exists** at the end of the reporting period,
    - ✓ the entity discloses a contingent liability, if the possibility of an outflow of resources embodying economic benefits is not remote.

**Note:** It may be inferred that if the possibility of an outflow of resources embodying economic benefits is remote, then the entity need not disclose the contingent liability.

### 2.6.1.2 Past Event

- ❖ A past event that leads to a present obligation is called an obligating event. Obligating event, is the event where the entity has no realistic alternative to settling the obligation created by the event. This is the case only:
  - (a) where the settlement of the obligation can be enforced by law; or
  - (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.
- ❖ There should be a past event which lead to present obligation and give rise to a liability for which a provision is required to be made.

#### Example 8

1. In respect of contamination of land, it would be the original contamination.
2. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

- ❖ No provision is recognised for costs that need to be incurred by an entity to operate in the future.
- ❖ The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.
- ❖ It is only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) that should be recognised as provisions.

**Examples 9 & 10**

9. Penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.
  10. Similarly, an entity should recognise a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused.
- ❖ In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future.
  - ❖ The entity can avoid the future expenditure by its future actions (for example by changing its method of operation). In such a case, it has no present obligation for that future expenditure and no provision is recognised.

**Example 11 : Fitting smoke filters in a certain type of factory.**

Since, the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

**Example 12 : Staff retraining as a result of changes in the income tax system**

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff has taken place. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no obligation because no obligating event (retraining) has taken place.

Conclusion – No provision is recognised.

**Example 13: Legal requirement to fit smoke filters**

Under new legislation, an entity is required to fit smoke filters to its factories by 30<sup>th</sup> September, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31<sup>st</sup> March, 20X1, the end of the reporting period

Present obligation as a result of a past obligating event – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

**Conclusion** – No provision is recognised for the cost of fitting the smoke filters.

(b) At 31<sup>st</sup> March, 20X2, the end of the reporting period

Present obligation as a result of a past obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

**Conclusion** – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

**Example 14: Repairs and maintenance**

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. Ind AS 16, *Property, Plant and Equipment* gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

**Example 15: Refurbishment costs – no legislative requirement**

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

**Conclusion** – No provision is recognised.

The cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the company's future

actions—even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e., it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

#### **Example 16: Refurbishment costs – legislative requirement**

An airline is required by law to overhaul its aircraft once every three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

Conclusion – No provision is recognised.

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in above example on refurbishment costs. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e., an amount equivalent to the expected maintenance costs is depreciated over three years.

#### **Illustration 2**

*X Shipping Ltd. is required by law to overhaul its shipping fleet once in every 3 years. The company's finance team was of the view that recognising the costs only when paid would prevent matching of revenue earned all the time with certain costs of large amounts which are incurred occasional. Thereby, it has formulated an accounting policy of providing in its books of account for the future cost of maintenance (overhauls, annual inspection etc.) by calculating a rate per hours sailed on sea and accumulating a provision over time. The provision is adjusted when the expenditure is actually incurred.*

*Comment whether the accounting policy of X Shipping Ltd. is correct.*

#### **Solution**

A provision is made for a present obligation arising out of a past event. Even a legal requirement to overhaul does not make the cost of overhaul a liability, because no obligation exists to overhaul the ships independently of the company's future actions - the company could avoid the future expenditure by its future actions for example by selling the ships. So there is no present obligation.

As per the standard, financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only

liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.

Therefore, the accounting policy of X Shipping Ltd. is not correct. The company should adopt the component approach in Ind AS 16, *Property, Plant and Equipment*, for accounting for the refurbishment cost.

\*\*\*\*\*

- ❖ An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed.
- ❖ A management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.
- ❖ An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation.

#### Example 17

An entity may not be obliged to remedy the consequences due to causing of environmental damage by it. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

- ❖ Where details of a proposed new law have yet to be finalised, an obligation would arise only when the legislation is virtually certain to be enacted as drafted. For the purpose of Ind AS 37, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

#### Example 18: Contaminated land – legislation virtually certain to be enacted

An entity in the oil industry (having 31<sup>st</sup> March year-end) causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At 31<sup>st</sup> March, 20X1, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the costs of the clean-up.

#### **Example 19: Contaminated land and constructive obligation**

An entity in the oil industry (having 31<sup>st</sup> March year-end) causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement- Probable.

Conclusion- A provision is recognised for the best estimate of the costs of clean-up.

#### **Example 20: Offshore oilfield**

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

#### **Example 21: A Court case**

After a wedding in 20X1-20X2, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of approval of the financial statements for the year to 31<sup>st</sup> March 20X2 for issue, the entity's lawyers advise that it is probable that the entity will

not be found liable. However, when the entity prepares the financial statements for the year to 31<sup>st</sup> March 20X3, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31<sup>st</sup> March 20X2

Present obligation as a result of a past obligating event – On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion – No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31<sup>st</sup> March 20X3

Present obligation as a result of a past obligating event – On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the amount to settle the obligation.

### Illustration 3

*X Chemical Ltd. is operating in the vicinity of a river since 20 years. A community living near X Chemical Ltd. claims that its operations has caused contamination of drinking water. X Chemical Ltd. has received notice from the governmental environmental agency that official investigations will be made into claims of pollution caused by the entity. If it is found that X Chemical Ltd. has caused contamination, then penalties and fine would be levied on it.*

*X Chemical Ltd. believes that it has implemented all environmental safety measures to an extent that it is unlikely to cause pollution. Management is not sure whether it has all the information about the entire 20 years. Therefore, neither management nor external experts are able to assess X Chemical Ltd.'s responsibility until the investigation has completed.*

*In such situation, how should management of X Chemical Ltd. account for a liability?*

### Solution

As per the standard, in the present case, the available evidence does not support a conclusion that a present obligation exists. However, there is a possible obligation which exists and will be confirmed upon completion of investigations. Therefore, management should disclose the contingent liability for potential penalties and fines that may be imposed if contamination is proved.

\*\*\*\*\*

### 2.6.1.3 Probable Outflow of Resources Embodying Economic Benefits

- ❖ For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

**Note:** For the purpose of Ind AS 37<sup>1</sup>, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

- ❖ Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.
- ❖ Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision should be recognised (if the other recognition criteria are met).

#### Example 22: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e., more likely than not) that there will be some claims under the warranties. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – Probable for the warranties as a whole.

Conclusion – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period.

### 2.6.1.4 Reliable Estimate of the Obligation

- ❖ The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the balance sheet.

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<sup>1</sup> The interpretation of 'probable' in Ind AS 37 as 'more likely than not' does not necessarily apply in other Ind AS.



- ❖ Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

**Illustration 4**

*X Ltd. has entered into an agreement with its selling agent Y, in accordance with which X Ltd. has to pay a base percentage of commission on export sales and an additional commission is to be paid if the export incentives are received. As per the accounting policy of X Ltd., it recognises export incentives when actually realised, on account of the uncertainty in realising such incentives. Export incentives have not been received for the year 20X1-20X2, however X Ltd. is hopeful of receiving the export incentives in the year 20X2-20X3.*

*State whether in the financial statements for 20X1-20X2, should X Ltd. provide for both base commission and additional commission.*

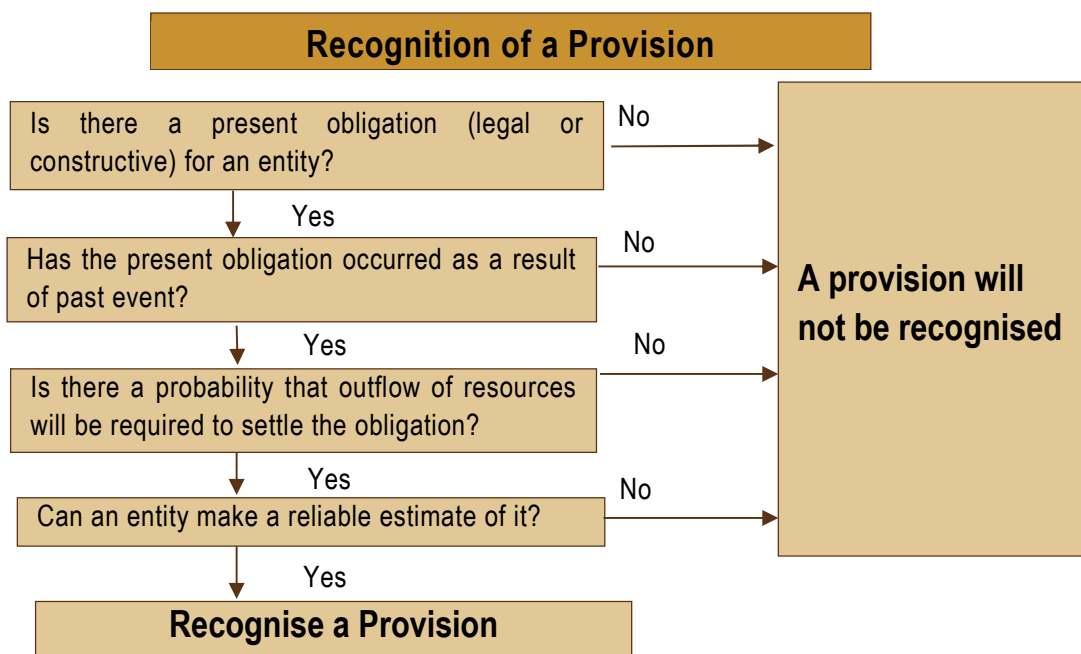
**Solution**

So far as the base percentage of sales commission is concerned, it is a present obligation arising out of past events. The obligating event takes place when the sales are made and also since commission is based on percentage of sale, reliable estimation can also be made. Therefore, the base percentage of sales commission should be provided.

However, in respect of additional commission, it is to be paid when the export incentives are recognised and export incentives are recognised only when it is received. Therefore, the obligating event will arise only when export incentives are received. Hence, no provision for additional commission is to be made in financial year 20X1-20X2. The expectation of X Ltd. to receive the export incentives in next year would not make any difference as on 31<sup>st</sup> March 20X2.

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- ❖ In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.



### 2.6.2 Contingent Liabilities

- ❖ An entity should not recognise a contingent liability.
- ❖ A contingent liability should be disclosed, if the possibility of an outflow of resources embodying economic benefits is not remote.
- ❖ Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties should be treated as a contingent liability.
- ❖ The entity should recognise a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.
- ❖ Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.
- ❖ If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision should be recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

The principles describing provisions and contingent liabilities is as follows:

|                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                 |                                                                                                                          |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------|
| Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. |                                                                                                                                 |                                                                                                                          |
| <b>There is a present obligation that probably requires an outflow of resources.</b>                                                                                                                                                                                                                                                               | <b>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.</b> | <b>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</b> |
| A provision is recognised.                                                                                                                                                                                                                                                                                                                         | No provision is recognised.                                                                                                     | No provision is recognised.                                                                                              |
| Disclosures are required for the provision.                                                                                                                                                                                                                                                                                                        | Disclosures are required for the contingent liability.                                                                          | No disclosure is required.                                                                                               |

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability.

### 2.6.3 Contingent Assets

- ❖ An entity should not recognise a contingent asset.
- ❖ Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

#### Example

A claim that an entity is pursuing through legal processes, where the outcome is uncertain.

- ❖ Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised.
- ❖ However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- ❖ A contingent asset should be disclosed, where an inflow of economic benefits is probable.
- ❖ Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements **of the period in which the change occurs.**

|                                                                                                                                                                                                                            |                                                                               |                                   |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------|-----------------------------------|
| Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity |                                                                               |                                   |
| <b>The inflow of economic benefits is virtually certain</b>                                                                                                                                                                | <b>The inflow of economic benefits is probable, but not virtually certain</b> | <b>The inflow is not probable</b> |
| The asset is not contingent and its recognition is appropriate                                                                                                                                                             | No asset is recognised                                                        | No asset is recognised            |
|                                                                                                                                                                                                                            | Disclosures are required                                                      | No disclosure is required         |

#### Tabular depiction

| <b>Likelihood of outcome</b>                        | <b>Contingent liability</b> | <b>Contingent asset</b>             |
|-----------------------------------------------------|-----------------------------|-------------------------------------|
| Virtually certain (greater than 95% probability)    | Recognise the provision     | Recognise the asset                 |
| Probable (50% - 95% of probability)                 | Recognise the provision     | Disclose about the contingent asset |
| Possible but not probable (5% - 50% of probability) | Disclose the contingency    | No disclosure permitted             |
| Remote (less than 5% probability)                   | No disclosure required      | No disclosure permitted             |



## 2.7 MEASUREMENT



### 2.7.1 Best Estimate

- ❖ The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

- ❖ The estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- ❖ The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and in some cases, reports from independent experts, for example, in legal cases, expert legal advice might be taken. The evidence considered includes any additional evidence provided by events after the reporting period.
- ❖ Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, for example, customer refunds, warranties, etc., the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60% or 90%.
- ❖ Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

#### Illustration 5

*An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of ₹ 1 million would result. If major defects were detected in all products sold, repair costs of ₹ 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects.*

*Assess the probability of an outflow for the warranty obligations as a whole.*

#### Solution

The expected value of the cost of repairs is:

$$(75\% \text{ of nil}) + (20\% \text{ of } 1\text{m}) + (5\% \text{ of } 4\text{m}) = ₹ 4,00,000$$

\*\*\*\*\*

- ❖ Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes.

#### Example 23

An entity faces a single legal claim, with a 40 per cent likelihood of success with no cost and a 60 percent likelihood of failure with a cost of ₹ 1 million. Expected value is not valid in

this case because the outcome will never be a cost of ₹ 600,000 (60 percent × ₹ 1 million); the outcome will either be nil or ₹ 1 million. Ind AS 37 indicates that the provision may be estimated at the individual most likely outcome. In this example, it is more likely that a cost of ₹ 1 million will result and, therefore, a provision for ₹ 1 million should be recognised.

- ❖ Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

#### Examples 24 & 25

24. If an entity has an environmental obligation to clean up the drinking water that got contaminated, there might be a number of different ways to carry out this work. Each of these methods would have different probabilities of success and would cost different amounts. In such case, the entity might choose the method which has the most likely possibility of success.
25. If an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of ₹ 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

- ❖ Generally, when the most likely outcome is close to the expected value, it will be appropriate to provide for the most likely outcome because expected value provides evidence of the probable outflow of benefits.

#### Example 26

An entity is required to replace a major component of an asset under warranty. Each time replacement costs ₹ 1 million. From experience, there is a 30 per cent chance of a single failure, a 50 per cent chance of two failures, and a 20 per cent chance of three failures.

The most likely outcome is two failures, costing ₹ 2 million. The expected value is ₹ 1.9 million [(30 per cent × ₹ 1 million) + (50 per cent × ₹ 2 million) + (20 per cent × ₹ 3 million)]. The expected value supports the provision for the most likely outcome of ₹ 2 million.

- ❖ The provision should be measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under Ind AS 12.

### 2.7.2 Risks and Uncertainties

- ❖ The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.
- ❖ Risk describes variability of outcome.
- ❖ A risk adjustment should be made for the amount that the entity would pay in excess of the

expected present value of outflows due to uncertainty attached with the actual outcome.

- ❖ A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities.

For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case.

- ❖ Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.
- ❖ Risk adjustment can be accounted for in number of ways such as:
  - Adding it to the expected present value of future outflows.
  - Adjusting the estimates of future outflows.
  - Adjusting the discount rate.
- ❖ Disclosure of the uncertainties surrounding the amount of the expenditure should be made.

### 2.7.3 Present Value

---

- ❖ Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.
- ❖ Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions should therefore be discounted, where the effect is material.
- ❖ Ind AS 37 does not require cash flows to be discounted unless this has a material effect.
- ❖ The expected present value of outflows are calculated as follows:
  - Each outcome is discounted to its present value.
  - The present value of outcomes are weighted by their associated probabilities.
- ❖ **The discount rate (or rates) should be a pre-tax rate (or rates)** that reflect(s) current market assessments of the time value of money and the risks specific to the liability.
- ❖ The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

#### Illustration 6

*X Solar Power Ltd., a power company, has a present obligation to dismantle its plant after 35 years of useful life. X Solar Power Ltd. cannot cancel this obligation or transfer to third*

party. X Solar Power Ltd. has estimated the total cost of dismantling at ₹ 50,00,000, the present value of which is ₹ 30,00,000. Based on the facts and circumstances, X Solar Power Ltd. considers the risk factor of 5% i.e., the risk that the actual outflows would be more from the expected present value.

State how should X Solar Power Ltd. account for the obligation.

### Solution

The obligation should be measured at the present value of outflows i.e., ₹ 30,00,000. Further a risk adjustment of 5% i.e., ₹ 1,50,000 ( $₹ 30,00,000 \times 5\%$ ) would be made.

So, the liability will be recognised at = ₹ 30,00,000 + ₹ 1,50,000 = ₹ 31,50,000.

### Illustration 7

ABC Ltd. has an obligation to restore the seabed for the damage it has caused in the past. It has to pay ₹ 10,00,000 cash on 31<sup>st</sup> March 20X3 relating to this liability. ABC Ltd.'s management considers that 5% is an appropriate discount rate.

Calculate the amount to be provided for at 31<sup>st</sup> March 20X1 for the costs of restoring the seabed.

### Solution

Discounting factor of 5% for 2<sup>nd</sup> year as on 31<sup>st</sup> March 20X1 =  $(1/1.05)^2 = 0.907$

The present value of the provision as on 31<sup>st</sup> March 20X1 is = ₹ 10,00,000 x 0.907  
= ₹ 9,07,000

The amount of increase in the provision resulting from unwinding of discounting to reflect the passage of time should be included as an element of borrowing cost in determining the profit or loss for the year.

The provision should be initially recognised at ₹ 9,07,000 which is the present value of ₹ 10,00,000 discounted at 5% for two years. At the end of year 1 i.e. 31<sup>st</sup> March 20X2, the provision increases to ₹ 9,52,350, and the difference of ₹ 45,350 is recognised as borrowing cost. Similarly, for the year ending 31<sup>st</sup> March 20X3, the provision will increase to 10,00,000 and the increase being recognised as borrowing cost. Consequently, at the end of year 2 the amount of provision will be equal to the amount due, i.e., ₹ 10,00,000.

**Note:** There may be some difference in amount due to approximation (limiting discounting factor to 3 place decimal), which can be overcome either by full scale calculation or adjustment at the end.

\*\*\*\*\*

## 2.7.4 Future Events

- ❖ Future events that may affect the amount required to settle an obligation should be



reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

- ❖ Expected future events may be particularly important in measuring provisions.

For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology.

The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence. It is fine to anticipate the use of existing method with the some refinement, adaptation and cost reduction, if there is sufficient evidence that such factors are likely to arise in future. However, it would not be acceptable to assume that there would be a completely new idea or a new method, which would be significantly cost effective.

- ❖ The effect of possible new legislation should be taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

#### Illustration 8

*X Chemicals Ltd. engaged in the chemical industry causes environmental damage by dumping waste in the river near its factory. It does not clean up because there is no environmental legislation requiring cleaning up and X Chemicals Ltd. is causing damage for last 40 years. As at 31<sup>st</sup> March, 20X2, the State Legislature has passed a path breaking legislation requiring all polluting factories to clean-up the river water already contaminated. The formal Gazette notification of the law is pending.*

*Comment on how should X Chemicals Ltd. deal with this situation.*

#### Solution

The obligating event is the contamination of water and because of the virtually certainty of legislation requiring cleaning up, an outflow of resources is certain. It is possible to arrive at best estimated cost for the cleanup activity. So, a provision should be recognised in the books of X Chemicals Ltd. for 20X1-20X2.

\*\*\*\*\*

## 2.7.5 Expected Disposal of Assets

- ❖ Gains on the expected disposal of assets should not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.
- ❖ Instead, an entity should recognise gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned.

### Example 27

At the end of 20X1, an entity is demonstrably committed to the closure of some facilities, having drawn up a detailed plan and made appropriate announcements. The expected impact of the plan is as follows:

|                            | 20X2        | 20X3       |
|----------------------------|-------------|------------|
| Committed closure costs    | ₹ 10,00,000 |            |
| Gain from sale of property |             | ₹ 2,00,000 |

The provision required at the end of 20X1 is ₹ 10,00,000 (ignoring discounting). The expected gain on the sale of the property is dealt with separately under the derecognition criteria in Ind AS 16.



## 2.8 REIMBURSEMENTS

- ❖ Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.
- ❖ In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.
- ❖ Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly.
- ❖ In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision should be recognised for the full amount of the liability, and a separate asset for the expected reimbursement should be recognised when it is virtually

certain that reimbursement will be received if the entity settles the liability.

- ❖ In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they should not be included in the provision.
- ❖ As noted earlier, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

In various situations where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the treatment would be as follows:

| Reimbursements |                                                                                                  |                                                                                                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                         |
|----------------|--------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Situation      | The entity has no obligation for the part of the expenditure to be reimbursed by the other party | Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party and it is virtually certain that reimbursement will be received if the entity settles the provision                                                                                                                                                               | Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party but the reimbursement is <u>NOT</u> virtually certain |
| Recognition    | The entity has no liability for the amount to be reimbursed. Hence no provision will be made.    | <ul style="list-style-type: none"> <li>• The reimbursement is recognised as a separate asset in the balance sheet</li> <li>• In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.</li> <li>• The amount recognised for the expected reimbursement shall not exceed the liability.</li> </ul> | The expected reimbursement is not recognised as an asset.                                                                                                               |
| Disclosure     | No disclosure is required.                                                                       | The reimbursement is disclosed together with the amount recognised for the reimbursement.                                                                                                                                                                                                                                                                                           | The expected reimbursement is disclosed.                                                                                                                                |

#### Illustration 9

*X Beauty Solutions Ltd. is selling cosmetic products under its brand name 'B', but it is getting its product manufactured from Y Ltd. It has an understanding (enforceable agreement) with Y Ltd. that if the company becomes liable for any damage claims, due to any injury or harm to the*

*customer of the cosmetic products, 30% will be reimbursed to it by Y Ltd. During the financial year 20X1-20X2, an estimate of the claim of ₹ 30,00,000 may be payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?*

### Solution

Since the understanding results in an enforceable agreement, the reimbursement of ₹ 9,00,000 (₹ 30,00,000 x 30%) shall be recognised as a reimbursement right and provision will be recognised for ₹ 30,00,000. The reimbursement right shall be treated as a separate asset and shall not be offset with the provision. In the statement of profit and loss, the expense may be presented as ₹ 21,00,000 after offsetting the reimbursement right.

\*\*\*\*\*



## 2.9 CHANGES IN PROVISIONS

- ❖ Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.
- ❖ Once the amount of the obligation is crystallised and there is no uncertainty associated with an obligation, the liability is no longer a provision. The same should be reclassified as an element within liabilities.

### Example 28

Customer X has made a claim of ₹ 2 million for liquidated damages, the entity is disputing the amount of claim. Due to the uncertainty involved in the amount payable, the entity recognises this as a provision. After negotiation with the customer, the amount is agreed at ₹ 1.5 million. As there is no uncertainty involved relating to the amount payable, it no longer meets the definition of provision and should be reclassified to an appropriate category within liabilities.

- ❖ Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

### Illustration 10

*X Telecom Ltd. has income tax litigation pending before appellate authorities. Legal advisor's opinion is that X Telecom Ltd. will lose the case and estimated that liability of ₹ 1,00,00,000 may arise in two years. The liability is recognised on a discounted basis. The discount rate at which*

*the liability has been discounted is 10% and it is assumed that discount rate does not change over the period of 2 years.*

*How should X Telecom Ltd. calculate the amount of finance cost?*

### **Solution**

The discount factor of 10% for 2 years is 0.826. X Telecom Ltd. will initially recognise provision for ₹ 82,60,000 ( $₹ 1,00,00,000 \times 0.826$ ).

The discount factor of 10% at the end of year 1 is 0.909. At the end of year 1, provision amount would be ₹ 90,90,000 ( $₹ 1,00,00,000 \times 0.909$ ).

As per the standard, the difference between the two present values i.e., ₹ 8,30,000 ( $90,90,000 - 82,60,000$ ) is recognised as a finance cost in year 1.

At the end of the Year 2, the liability would be ₹ 1,00,00,000.

The difference between the two present values i.e., ₹ 9,10,000 ( $₹ 1,00,00,000 - ₹ 90,90,000$ ) is recognised as finance cost in year 2.

\*\*\*\*\*



## **2.10 USE OF PROVISIONS**

- ❖ A provision should be used only for expenditures for which the provision was originally recognised. Repurposing of the provisions is not allowed.
- ❖ Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.



## **2.11 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES**

### **2.11.1 Future Operating Losses**

- ❖ Provisions should not be recognised for future operating losses.
- ❖ Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions as specified in the standard. Ind AS 37 does not permit recognition of provision for future operating losses this since they do not stem from a past event.
- ❖ An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity should test these assets for impairment under Ind AS 36, *Impairment of Assets*.

**Illustration 11**

*X Packaging Ltd. has two segments, packaging division and paper division. In March 20X1, the board of directors approved and announced a formal plan to sell the paper division in June 20X1. Operating losses of the paper division are estimated to be approximately ₹ 50,00,000 during the period from 1<sup>st</sup> April, 20X1 to the expected date of disposal. Management of X Packaging Ltd. wants to include the future operating loss of ₹ 50,00,000 in a provision for restructuring in the financial statements for the period ended 31<sup>st</sup> March, 20X1.*

*Recommend whether X Packaging Ltd. can include these operating losses in a provision for restructuring.*

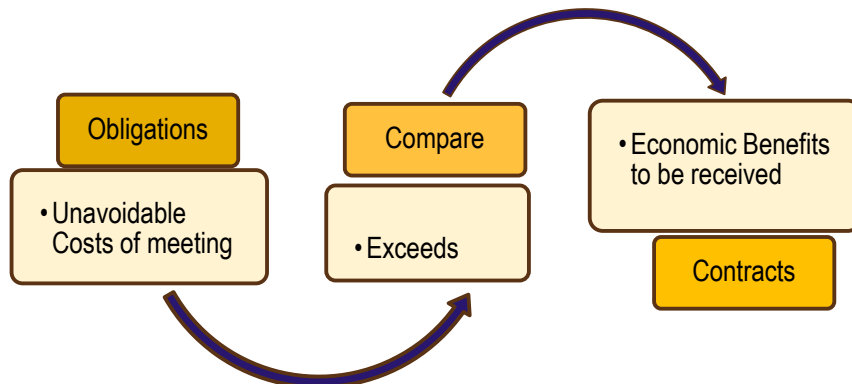
**Solution**

Standard states that provision should not be made for future operating losses. Since Ind AS 37 prohibits the recognition of future operating losses, so X Packaging Ltd. should not include these future operating losses in a provision for restructuring even though these losses relate to the disposal group.

\*\*\*\*\*

**2.11.2 Onerous contracts**

- ❖ If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision.



- ❖ Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of Ind AS 37 and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of Ind AS 37.

- ❖ Ind AS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

**Note:** Both the incremental costs to fulfil a contract and allocation of directly attributable costs will form part of the cost used for determination of onerous contract.

- ❖ Before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets used in fulfilling that contract (in accordance with Ind AS 36).

### Examples 29- 32

- 29. Contract not onerous:** An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. The gas will be used to generate electricity, which will be sold at a profit. The economic benefits from the contract include the benefits to the entity of using the gas in its business and, because the electricity will be sold at a profit, the contract is not onerous.
- 30. Impairment of assets:** The contract's terms and market prices are the same as in example 29. However, the electricity is sold at a loss, and the entity makes an overall operating loss. All of the gas purchased by the entity is used to generate electricity using dedicated assets. The electricity is sold to a wide range of customers. The entity first considers whether the assets used to generate electricity are impaired. To the extent that there is still a loss after the assets have been written down, a provision for an onerous contract should be recorded.
- 31. Sale to third party at below purchase price:** The contract terms and market price are the same as in example 29. However, in this example, the entity sells the gas under contract, which it no longer needs, to a third party for 18p per unit (5p below cost). The entity determines that it would have to pay ₹ 55,000 to exit the purchase contract. The only economic benefit from the purchase contract costing ₹ 2,30,000 are the proceeds from the sales contract, which are ₹ 1,80,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of the cost of fulfilling the contract and the penalty cost of cancellation (₹ 55,000).
- 32. Contract termination costs:** In the year ended 31<sup>st</sup> December 20X1, an entity has a contract with a third party supplier. The entity wishes to terminate this contract in 20X2 because it can enter into a cheaper contract with a new supplier, even though it will still have two years to run. It will incur a charge for terminating the contract. Does the entity have to provide in 20X1-20X2 for the contract that it will be exiting in 20X2-20X3? A provision should be recognised only if the contract is onerous. If the

goods received under the supply contract are sold at a profit, the contract is not onerous and provision should not be made in 20X1-20X2. The termination cost should be recognised as incurred in 20X2-20X3.

### Illustration 12

*X Metals Ltd. had entered into a non-cancellable contract with Y Ltd. to purchase 10,000 units of raw material at ₹ 50 per unit at a contract price of ₹ 5,00,000. As per the terms of contract, X Metals Ltd. would have to pay ₹ 60,000 to exit the said contract. X Metals Ltd. has discontinued manufacturing the product that would use the said raw material. For that X Metals Ltd. has identified a third party to whom it can sell the said raw material at ₹ 45 per unit.*

*State how should X Metals Ltd. account for this transaction in its books of account in respect of the above contract?*

### Solution

These circumstances do indicate an onerous contract. The only benefit to be derived from the purchase contract costing ₹ 5,00,000 are the proceeds from the sale contract, which are ₹ 4,50,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of cost of fulfilling the contract and the penal cost of cancellation of ₹ 60,000.

\*\*\*\*\*

## 2.11.3 Restructuring

- ❖ The following are examples of events that may fall under the definition of restructuring:
  - (a) sale or termination of a line of business;
  - (b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
  - (c) changes in management structure, for example, eliminating a layer of management; and
  - (d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.
- ❖ A provision for restructuring costs should be recognised only when the general recognition criteria for provisions set out the standard are met.
- ❖ A constructive obligation to restructure arises only when an entity:
  - (a) has a detailed formal plan for the restructuring identifying at least:
    - (i) the business or part of a business concerned;



- (ii) the principal locations affected;
  - (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
  - (iv) the expenditures that will be undertaken; and
  - (v) when the plan will be implemented; and
- (b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

**Example 33: Closure of a division – no implementation before end of the reporting period**

On 12<sup>th</sup> March, 20X1 the board of an entity decided to close down a division. Before the end of the reporting period (31<sup>st</sup> March, 20X1) the decision was not communicated to any of those affected and no other steps were taken to implement the decision. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There has been no obligating event and so there is no obligation.

Conclusion – No provision is recognised.

**Example 34: Closure of a division – communication/ implementation before end of the reporting period**

On 12<sup>th</sup> March, 20X1 (reporting date), the board of an entity decided to close down a division making a particular product. On 20<sup>th</sup> March, 20X1 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised at 31<sup>st</sup> March, 20X1 for the best estimate of the costs of closing the division.

- ❖ Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a

constructive obligation to restructure only if it is made in such a way and in sufficient detail (i.e., setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

- ❖ For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.
- ❖ A management or board decision to restructure taken before the end of the reporting period does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period:
  - (a) started to implement the restructuring plan; or
  - (b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting period, disclosure is required under, Ind AS 10, Events after the Reporting Period, if the restructuring is material and non-disclosure could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

- ❖ Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of the standard are met.
- ❖ In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (e.g., employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.
- ❖ No obligation arises for the sale of an operation until the entity is committed to the sale, i.e., there is a binding sale agreement.

- ❖ Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Ind AS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.
- ❖ A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:
  - (a) necessarily entailed by the restructuring; and
  - (b) not associated with the ongoing activities of the entity.
- ❖ A restructuring provision does not include such costs as:
  - (a) retraining or relocating continuing staff;
  - (b) marketing; or
  - (c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures should be recognised on the same basis as if they arose independently of a restructuring.

- ❖ Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract.
- ❖ Gains on the expected disposal of assets should not be taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.



Includes only the direct expenditures arising from the restructuring that are both:

- (i) Necessarily entailed by restructuring
- (ii) Not associated by the ongoing activities of the entity



Does not include such cost:

1. Retraining or Relocating continuing staff
2. Marketing or
3. Investment in new systems and distribution networks

**Illustration 13**

*X Cements Ltd. has three manufacturing units situated in three different states of India. The board of directors of X Cements Ltd., in their meeting held on 10<sup>th</sup> January, 20X1, decided to close down its operations in one particular state on account of environmental reasons. A detailed formal plan for shutting down the above unit was also formalised and agreed by the board of directors in that meeting, which specifies the approximate number of employees who will be compensated and expenditure expected to be incurred. Date of implementation of plan has also been mentioned. Meetings were also held with customers, suppliers, and workers to communicate the features of the formal plan to close down the operations in the said state, and representatives of all interested parties were present in those meetings.*

*Evaluate whether the actions of the board of directors create a constructive obligation that needs a provision for restructuring.*

**Solution**

As per Ind AS 37, the conditions prescribed are:

- (a) there should be detailed formal plan of restructuring;
- (b) which should have raised valid expectations in the minds of those affected that the entity would carry out the restructuring by announcing the main features of its plans to restructure.

The board of directors did discuss and formalise a formal plan of winding up the operation in the above said state. This plan was communicated to the parties affected and created a valid expectation in their minds that X Cements Ltd. would go ahead with its plans to close down operations in that state. Thus, there is a constructive obligation that needs to be provided at year-end.

\*\*\*\*\*

**2.12 DISCLOSURE**

- ❖ For each class of provision, an entity should disclose:
  - (a) the carrying amount at the beginning and end of the period;
  - (b) additional provisions made in the period, including increases to existing provisions;
  - (c) amounts used (i.e., incurred and charged against the provision) during the period;
  - (d) unused amounts reversed during the period; and

- (e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required to be disclosed.

- ❖ An entity should disclose the following for each class of provision:
  - (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
  - (b) an indication of the uncertainties about the amount or timing of those outflows.  
Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events; and
  - (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.
- ❖ Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:
  - (a) an estimate of its financial effect, measured in the standard;
  - (b) an indication of the uncertainties relating to the amount or timing of any outflow; and
  - (c) the possibility of any reimbursement.
- ❖ In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of the standard and
- ❖ Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.
- ❖ Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by the standard in a way that shows the link between the provision and the contingent liability.
- ❖ Where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in the standard.

- ❖ It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.
- ❖ Where any of the information required by the standard is not disclosed because it is not practicable to do so, that fact should be stated.
- ❖ In extremely rare cases, disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

**Illustration 14 : Warranties**

*A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the end of the reporting period, a provision of ₹ 60,000 has been recognised for the sale made during the year. The provision has not been discounted as the effect of discounting is not material.*

*Draft the Note.*

**Solution**

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the current financial year. It is assumed that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years from the reporting period.

\*\*\*\*\*

**2.13 LEVIES (APPENDIX C OF IND AS 37)****2.13.1 Appendix C deals with**

- the accounting for a liability to pay a levy if that liability is within the scope of Ind AS 37
- accounting for a liability to pay a levy whose timing and amount is certain.

**2.13.2 Appendix C does not deal with**

- the accounting for the costs that arise from recognising a liability to pay a levy.

**Note:** Entities should apply other Standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense.

### 2.13.3 What is a Levy?

A charge imposed by governments on entities in accordance with laws and/or regulations. It leads to outflow of resources embodying economic benefits

It excludes

- outflows of resources that are within the scope of other Ind AS
- fines or other penalties that are imposed for breaches of the legislation
- payment made to the government for acquiring assets or for rendering services as per the contractual agreement
- liabilities that arise from emissions trading schemes.

**Note:** Government' refers to government, government agencies and similar bodies whether local, national or international.

### 2.13.4 Accounting Principles

- If and activity triggers the payment of the levy, it will be considered as an obligating event that gives rise to a liability to pay a levy

#### Example 35

If the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to create a present obligation.

- Any compulsion to operate in future will not be considered as constructive obligation for an entity, to pay a levy.
- The preparation of financial statements under the going concern assumption does not imply that an entity has a present obligation to pay a levy that will be triggered by operating in a future period.

- The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (ie if the activity that triggers the payment of the levy, as identified by the legislation, occurs over a period of time).

**Example**

If the obligating event is the generation of revenue over a period of time, the corresponding liability is recognised as the entity generates that revenue.

- If an obligation to pay a levy is triggered when a minimum threshold is reached, the accounting for the liability that arises from that obligation shall be consistent with the principles established in the standard.

**Example**

If the obligating event is the reaching of a minimum activity threshold (such as a minimum amount of revenue or sales generated or outputs produced), the corresponding liability is recognised when that minimum activity threshold is reached.

- An entity shall apply the same recognition principles in the interim financial report that it applies in the annual financial statements. As a result, in the interim financial report, a liability to pay a levy:
  - (a) shall not be recognised if there is no present obligation to pay the levy at the end of the interim reporting period; and
  - (b) shall be recognised if a present obligation to pay the levy exists at the end of the interim reporting period.
- An entity shall recognise an asset if it has prepaid a levy but does not yet have a present obligation to pay that levy.





## 2.14 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'UPL Limited' for the financial year 2021 – 2022 with respect to Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets':

### 35. CONTINGENT LIABILITIES

The Company is involved in a number of appellate, judicial and arbitration proceedings (including those described below) concerning matters arising in the course of conduct of the Company's businesses. Some of these proceedings in respect of matters under litigation are in early stages, and in some other cases, the claims are indeterminate. A summary of claims asserted on the Group in respect of these cases have been summarised below.

Amounts in respect of claims asserted by various revenue authorities on the Company, in respect of taxes, which are in dispute, have been tabulated below:

|                                                                   | ₹ in Crores             |                         |
|-------------------------------------------------------------------|-------------------------|-------------------------|
|                                                                   | As at<br>March 31, 2022 | As at<br>March 31, 2021 |
| Disputed Income-Tax Liability (excluding interest)                | 26                      | 33                      |
| Disputed Excise Duty / Service Tax liability (excluding interest) | 182                     | 186                     |
| Disputed Sales Tax/ GST liability                                 | 20                      | 25                      |
| Disputed Custom Duty liability                                    | 22                      | 22                      |
| Disputed Fiscal Penalty for cancellation of licenses              | 33                      | 33                      |
| Claims against the Company not acknowledged as debts              | 1                       | 4                       |

The management believes that the claims made are untenable and is contesting them. As of the reporting date, the management is unable to determine the ultimate outcome of above matters. However, in the event the revenue authorities succeed with enforcement of their assessments, the Company may be required to pay some or all of the asserted claims and the consequential interest and penalties, which would reduce net income and could have a material adverse effect on net income in the respective reported period.

Management is generally unable to reasonably estimate a range of possible loss for proceedings or disputes other than those included in the estimate above, including where:

- plaintiffs / parties have not claimed an amount of money damages, unless management can otherwise determine an appropriate amount;
- the proceedings are in early stages;
- there is uncertainty as to the outcome of pending appeals or motions or negotiations;
- there are significant factual issues to be resolved; and/or
- there are novel legal issues presented.

However, in respect of the above matters, management does not believe, based on currently available information, that the outcomes of the litigation, will have a material adverse effect on the Company's standalone financial condition, though the outcomes could be material to the Group's operating results for any particular period, depending, in part, upon the operating results for such period.

(Source: Annual Report of financial year 2021 – 2022 of UPL Limited' )



## 2.15 SIGNIFICANT DIFFERENCES IN IND AS 37 VIS-A-VIS AS 29

| S. No. | Particulars                     | Ind AS 37                                                                                                                                                                                                                             | AS 29                                                                                                                                                                                                                                                                                       |
|--------|---------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.     | <i>Constructive obligations</i> | Ind AS 37 explicitly defines the term 'constructive obligations' and uses term in certain paragraphs.                                                                                                                                 | Paragraph 11 of AS 29 included expression similar to constructive obligations in the context of explaining when the obligations arise i.e. obligation also arises from normal business practices, custom and a desire to maintain good business relations or to act in an equitable manner. |
| 2.     | <i>Discounting</i>              | Ind AS 37 requires discounting the amounts of provisions, if effect of the time value of money is material.                                                                                                                           | AS 29 prohibits discounting the amounts of provisions except in case of decommissioning, restoration and similar liabilities that are recognised as cost of property, plant and equipment.                                                                                                  |
| 3.     | <i>Contingent asset</i>         | Ind AS 37 requires disclosure of contingent assets in the financial statements when the inflow of economic benefits is probable. The disclosure, however, should avoid misleading indications of the likelihood of income arising.    | AS 29 prohibits disclosure of a contingent asset in the financial statements and mentions that it is usually disclosed in the report of the approving authority, where an inflow of economic benefits is probable.                                                                          |
| 4.     | <i>Onerous Contracts</i>        | Ind AS 37 makes it clear that before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36. | There is no such specific provision in the existing standard.                                                                                                                                                                                                                               |

|    |                                |                                                                                                                                                                                                                                                                                                |                                                                                                                         |
|----|--------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|
| 5. | <i>Future Operating Losses</i> | Ind AS 37 gives an exception to this principle viz. such losses related to an onerous contract.                                                                                                                                                                                                | AS 29 states that identifiable future operating losses up to the date of restructuring are not included in a provision. |
| 6. | <i>Additional guidance</i>     | Ind AS 37 gives guidance on:<br>(a) Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds<br>(b) Liabilities arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment<br>(c) Levies (imposed by government). | AS 29 does not give such guidance.                                                                                      |

**FOR SHORTCUT TO IND AS WISDOM: SCAN ME!**



## **TEST YOUR KNOWLEDGE**

### **Questions**

1. X Ltd. is operating in the telecom industry. During the Financial Year 20X1-20X2, the Income Tax authorities sent a scrutiny assessment notice under Section 143(2) of the Income-tax Act, 1961, in respect to return filed under Section 139 of this Act for Previous Year 20X0-20X1 (Assessment Year 20X1-20X2) and initiated assessment proceedings on account of a deduction claimed by the company which in the view of the authorities was inadmissible.

During the financial year 20X1-20X2 itself, the assessment proceedings were completed and the assessing officer did not allow the deduction and raised a demand of ₹ 1,00,00,000 against the company. The company contested such levy and filed an appeal with the Appellate authority. At the end of the financial year 20X1-20X2, the appeal had not been heard. The company is not confident whether that the company would win the appeal. However, the company was advised by its legal counsel that on a similar matter, two appellate authorities of different jurisdictions had given conflicting judgements, one in favour of the assessee and one against the assessee. The legal counsel further stated it had 50% chance of winning the appeal.

Advise how the company should account for these transactions in the financial year 20X1-20X2.

2. An entity is a telecom operator. Laying of cables across the world is a requirement to enable the entity to run its business. Cables are also laid under the sea and contracts are entered into for the same. By virtue of laws of the countries through which the cable passes, the entity is required to restore the sea bed at the end of the contract period.

State the nature of obligation that the entity has in such a case.

3. U Ltd. is a large conglomerate with a number of subsidiaries. It is preparing consolidated financial statements as on 31<sup>st</sup> March 20X2 as per the notified Ind AS. The financial statements are due to be approved for issue on 15<sup>th</sup> May 20X2. Following are a few transactions that have taken place in some of its subsidiaries during the year:

G Ltd. is a wholly owned subsidiary of U Ltd. engaged in management consultancy services. On 31<sup>st</sup> January 20X2, the board of directors of U Ltd. decided to discontinue the business of G Ltd. from 30<sup>th</sup> April 20X2. They made a public announcement of their decision on 15<sup>th</sup> February 20X2.

G Ltd. does not have many assets or liabilities and it is estimated that the outstanding trade receivables and payables would be settled by 31<sup>st</sup> May 20X2. U Ltd. would collect any amounts still owed by G Ltd.'s customers after 31<sup>st</sup> May 20X2. They have offered the employees of G Ltd. termination payments or alternative employment opportunities.

Following are some of the details relating to G Ltd.:

- On the date of public announcement, it is estimated by G Ltd. that it would have to pay ₹ 540 lakhs as termination payments to employees and the costs for relocation of employees who would remain with the Group would be ₹ 60 lakhs. The actual termination payments totalling to ₹ 520 lakhs were made in full on 15<sup>th</sup> May 20X2. As per latest estimates made on 15<sup>th</sup> May 20X2, the total relocation cost is ₹ 63 lakhs.
- G Ltd. had taken a property on lease, which was expiring on 31<sup>st</sup> March 20X6. The present value of the future lease rentals (using an appropriate discount rate) is ₹ 430 lakhs. On 15<sup>th</sup> May 20X2, G Ltd. made a payment to the lessor of ₹ 410 lakhs in return for early termination of the lease.

The loss after tax of G Ltd. for the year ended 31<sup>st</sup> March 20X2 was ₹ 400 lakhs. G Ltd. made further operating losses totalling ₹ 60 lakhs till 30<sup>th</sup> April 20X2.

Determine the provisions that the Company is required to make as per Ind AS 37?

4. A company manufacturing and supplying process control equipment is entitled to duty draw back if it exceeds its turnover above a specified limit. To claim duty drawback, the company needs to file application within 15 days of meeting the specified turnover. If application is not filed within stipulated time, the Department has discretionary power of giving duty draw back credit. For the year 20X1-20X2 the company has exceeded the specified limit of turnover by the end of the reporting period. However, duty drawback can be claimed on filing of application within the stipulated time or on discretion of the Department if filing of application is late. The application for duty drawback is filed on 20<sup>th</sup> April, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition. Duty drawback has been credited by the Department on 28<sup>th</sup> June, 20X2 and financial statements have been approved by the Board of Directors of the company on 26<sup>th</sup> July, 20X2.

Identify the treatment of duty drawback credit as per the given information.

5. Entity XYZ entered into a contract to supply 1000 television sets for ₹ 2 million. An increase in the cost of inputs has resulted into an increase in the cost of sales to ₹ 2.5 million. The penalty for non- performance of the contract is expected to be ₹ 0.25 million.

Evaluate whether the contract is onerous and also determine the amount of provision to be made in this regard.

6. Marico has an obligation to restore environmental damage in the area surrounding its factory. Expert advice indicates that the restoration will be carried out in two distinct phases; the first phase requiring expenditure of ₹ 2 million to remove the contaminated soil from the area and the second phase, commencing three years later from the end of first phase, to replant the area with suitable trees and vegetation. The estimated cost of replanting is ₹ 3.5 million. Marico uses a cost of capital (before taxation) of 10% and the expenditure, when incurred, will attract tax relief at the company's marginal tax rate of 30%. Marico has not recognised any provision for such costs in the past and today's date is 31<sup>st</sup> March 20X2. The first phase of the clean-up will commence in a few months time and will be completed on 31<sup>st</sup> March 20X3 when the first payment of ₹ 2 million will be made. Phase 2 costs will be paid three years later from the end of first phase.

Calculate the amount to be provided at 31<sup>st</sup> March 20X2 for the restoration costs.

## Answers

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1. Ind AS 37 provides that in rare cases it not clear whether there is a present obligation, for example, in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity should determine whether a present obligation exists at the end of the reporting period by taking account of all available evidence, for example, the opinion of experts.

In the present case, the company is not confident that whether it would win the appeal. By taking into account the opinion of the legal counsel, it is not sure that whether the company would win the appeal. On the basis of such evidence, it is more likely than not that a present obligation exists at the end of the reporting period. Therefore, the entity should recognise a provision. The company should provide for a liability of ₹ 1,00,00,000.

2. Paragraph 14 of Ind AS 37 states that a provision shall be recognised when:
- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
  - (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
  - (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised.

Further, with regard to past event paragraph 17 of Ind AS 37 states that a past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

- (a) where the settlement of the obligation can be enforced by law; or
- (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation."

On the basis of the above, provision should be recognised as soon as the obligating event takes place because the entity is under legal obligation to restore the sea bed, provided the other recognition criteria stated in paragraph 14 reproduced above are met. Moreover, the amount of the provision would depend on the extent of the obligation arising from the obligating event. In the instant case, an obligating event is the laying of cables under the sea. To the extent the cables have been laid down under the sea, a legal obligation has arisen and to that extent provision for restoration of sea bed should be recognised.

3. A discontinued operation is one that is discontinued in the period or classified as held for sale at the year end. The operations of G Ltd were discontinued on 30<sup>th</sup> April 20X2 and therefore, would be treated as discontinued operation for the year ending 31<sup>st</sup> March 20X3. It does not meet the criteria for held for sale since the company is terminating its business and does not hold these for sale.

As per para 72 of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', restructuring includes sale or termination of a line of business. A constructive obligation to restructure arises when:

- (a) an entity has a detailed formal plan for the restructuring
- (b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

The Board of directors of U Ltd have decided to terminate the operations of G Ltd. from 30<sup>th</sup> April 20X2. They have made a formal announcement on 15<sup>th</sup> February 20X2, thus creating a valid expectation that the termination will be implemented. This creates a constructive obligation on the company and requires provisions for restructuring.

A restructuring provision includes only the direct expenditures arising from the restructuring that are necessarily entailed by the restructuring and are not associated with the ongoing activities of the entity.

The termination payments fulfil the above condition. As per Ind AS 10 'Events after Reporting Date', events that provide additional evidence of conditions existing at the



reporting date should be reflected in the financial statements. Therefore, the company should make a provision for ₹ 520 lakhs in this respect.

The relocation costs relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Hence, these would be recognised on the same basis as if they arose independently of a restructuring.

The lease would be regarded as an onerous contract. A provision would be made at the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Hence, a provision shall be made for ₹ 410 lakhs.

Further operating losses relate to future events and do not form a part of the closure provision.

Therefore, the total provision required = ₹ 520 lakhs + ₹ 410 lakhs = ₹ 930 lakhs

4. In the instant case, the condition of exceeding the specified turnover was met at the end of the reporting period and the company was entitled for the duty drawback. However, the application for the same has been filed after the stipulated time. Therefore, credit of duty drawback was discretionary in the hands of the Department. Since the claim was to be accrued only after filing of application, its accrual will be considered in the year 20X2-20X3 only.

Accordingly, the duty drawback credit is a contingent asset as at the end of the reporting period 20X1-20X2, which will be realised when the Department credits the same.

As per para 35 of Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset.

In accordance with the above, the duty drawback credit which was contingent asset for the financial year 20X1-20X2 should be recognised as asset and related income should be recognized in the reporting period in which the change occurs. i.e., in the period in which realisation becomes virtually certain, i.e., financial year 20X2-20X3.

5. Ind AS 37 "*Provisions, Contingent Liabilities and Contingent Assets*" defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Paragraph 68 of Ind AS 37 states that the unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and



any compensation or penalties arising from failure to fulfill it.

In the instant case, cost of fulfilling the contract is ₹ 0.5 million (₹ 2.5 million – ₹ 2 million) and cost of exiting from the contract by paying penalty is ₹ 0.25 million.

In accordance with the above reproduced paragraph, it is an onerous contract as cost of meeting the contract exceeds the economic benefits.

Therefore, the provision should be recognised at the best estimate of the unavoidable cost, which is lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it, i.e., at ₹ 0.25 million (lower of ₹ 0.25 million and ₹ 0.5 million).

6.

| Year                                              | Cash Flow | 10% Discount factor | Present Value           |
|---------------------------------------------------|-----------|---------------------|-------------------------|
| 20X2-20X3                                         | 20,00,000 | 0.909               | 18,18,000               |
| 20X5-20X6                                         | 35,00,000 | 0.683               | <u>23,90,500</u>        |
| Provision required at 31 <sup>st</sup> March 20X2 |           |                     | <u><b>42,08,500</b></u> |

The provision is calculated using the pre-tax costs and a pre-tax cost of capital. The fact that the eventual payment will attract tax relief will be reflected in the recognition of a deferred tax asset for the deductible temporary difference (assuming that the recognition criteria for deferred tax assets are met.)

[illegible]



# IND AS ON ITEMS IMPACTING THE FINANCIAL STATEMENTS



## UNIT 1: INDIAN ACCOUNTING STANDARD 12 : INCOME TAXES

### LEARNING OUTCOMES

After studying this unit, you will be able to:

- ☐ List the objective and scope of the standard
- ☐ Define the terms used in the standard like accounting profit, taxable profit (tax loss), tax expense (tax income), current tax, deferred tax liabilities, deferred tax assets, temporary differences, taxable temporary differences, deductible temporary differences and the tax base
- ☐ Recognise current tax liabilities and current tax assets
- ☐ Recognise deferred tax liabilities and deferred tax assets
- ☐ Demonstrate when Ind AS permit or require certain assets to be carried at fair value or to be revalued
- ☐ Identify the situations where temporary difference may arise on initial recognition of an asset or liability
- ☐ Recognise deferred tax asset for all deductible temporary differences
- ☐ Evaluate the cases, when a deferred tax asset arises on initial recognition of an asset

- ❑ Measure current tax liabilities (assets) for the current and prior periods
- ❑ Measure deferred tax assets and liabilities using the tax rates
- ❑ Identify the items recognised outside profit or loss
- ❑ Calculate the deferred tax arising from a business combination
- ❑ Calculate current and deferred tax arising from share-based payment transactions
- ❑ Account for tax assets and tax liabilities
- ❑ Offset tax assets with tax liabilities
- ❑ Present the tax expense in the Statement of Profit and Loss with respect to various transactions
- ❑ Disclose the major components of tax expense (income)
- ❑ Account for the income taxes on account of changes in the tax status of an entity or its shareholders.

## UNIT OVERVIEW



|                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Definition            | <ul style="list-style-type: none"> <li>• Accounting profit</li> <li>• Taxable profit (tax loss)</li> <li>• Tax expense (tax income)</li> <li>• Current tax</li> <li>• Deferred tax liabilities</li> <li>• Deferred tax assets</li> <li>• Temporary differences</li> <li>• Taxable temporary differences</li> <li>• Deductible temporary differences</li> <li>• Tax base</li> </ul>                                                                                                                                                                                                                                                             |
| Tax Expense           | <ul style="list-style-type: none"> <li>• Current Tax</li> <li>• Deferred Tax</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| Current tax           | <ul style="list-style-type: none"> <li>• Recognition</li> <li>• Measurement</li> <li>• Accounting of Current Tax Effects</li> <li>• Offsetting Current Tax Assets and Current Tax Liabilities</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| Deferred Tax          | <ul style="list-style-type: none"> <li>• Compute carrying amount</li> <li>• Compute tax base</li> <li>• Compute temporary differences</li> <li>• Classify temporary differences</li> <li>• Identify exceptions</li> <li>• Assess (also reassess) deductible temporary differences, tax losses and tax credits</li> <li>• Determine the tax rate (law)</li> <li>• Calculate and recognise deferred tax</li> <li>• Accounting of deferred tax</li> <li>• Offsetting deferred tax assets and deferred tax liabilities</li> </ul>                                                                                                                  |
| Practical Application | <ul style="list-style-type: none"> <li>• Deferred tax arising from a business combination</li> <li>• Current and deferred tax arising from share-based payment transactions</li> <li>• Change in tax status of an entity or its shareholders</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                        |
| Disclosure            | <ul style="list-style-type: none"> <li>• Disclose components of tax expenses (income)</li> <li>• Tax related to items charged directly to equity</li> <li>• Tax related to items recognised in statement of other comprehensive income</li> <li>• Explanation of the relationship between tax expense (income) and accounting profit</li> <li>• Change in tax rates</li> <li>• Unrecognised deductible temporary differences, unused tax losses and unused tax credits</li> <li>• Temporary differences associated with investments in subsidiaries etc.</li> <li>• Amount of deferred tax liabilities (assets) or income (expense)</li> </ul> |



## 1.1 OBJECTIVE

There was a time in India, few decades back when the concept of zero income tax entities was prevalent. Due to various income tax benefits, these companies had no current tax liability for any income tax that was payable based on that year's accounting profit. Thus, no provision of income tax was created. Profit after tax used to be equal to profit before tax. But from accounting perspective, this was not a correct reflection of results. Quite a few of these tax benefits were primarily accelerated benefits.

For example, depreciation was deductible in taxation on written down value method (WDV) whereas in the books of accounts, entities could claim depreciation on straight line method (SLM). As everybody knows that under WDV method, in initial years' depreciation charge is greater than depreciation under SLM. This resulted into accounting profits but no taxable profits. But over the useful life of the asset, depreciation under both methods is equal. In later years, depreciation charge under SLM would be higher than in depreciation under WDV. Therefore, in later years, in such a situation, the taxable profits will be higher than the book profits. This will require a higher tax provision in books when compared to the accounting profits of that year. Basically, this differential will be due to non-provision of tax liability in an earlier year.

### Example 1

An entity has acquired an asset for ₹ 10,000. The depreciation rate as per income tax is 40% on WDV basis. In books of account, entity claims depreciation on equivalent SLM basis of 16.21%. The entity has accounting and taxable profits of ₹ 20,000 from year 1 to year 4, inclusive, before any allowance of depreciation in either case.

The tax rate is 30%. Assuming no concept of deferred tax, the provision for current tax would be computed as under:

| Year                                | 1       | 2       | 3       | 4      |
|-------------------------------------|---------|---------|---------|--------|
| Cost of the asset                   | 10,000  | 10,000  | 10,000  | 10,000 |
| Depreciation rate – WDV             | 40%     | 40%     | 40%     | 40%    |
| Depreciation amount – WDV           | 4,000   | 2,400   | 1,440   | 864    |
| Taxable profits before depreciation | 20,000  | 20,000  | 20,000  | 20,000 |
| Less: Depreciation                  | (4,000) | (2,400) | (1,440) | (864)  |
| Taxable profits after depreciation  | 16,000  | 17,600  | 18,560  | 19,136 |
| Tax rate                            | 30%     | 30%     | 30%     | 30%    |
| Tax amount                          | 4,800   | 5,280   | 5,568   | 5,741  |

However, in the books of accounts, the situation will be as under:

| Year                                       | 1       | 2       | 3       | 4       |
|--------------------------------------------|---------|---------|---------|---------|
| (a) Cost of the asset                      | 10,000  | 10,000  | 10,000  | 10,000  |
| (b) Depreciation rate – SLM                | 16.21%  | 16.21%  | 16.21%  | 16.21%  |
| (c) Depreciation amount – SLM              | 1,621   | 1,621   | 1,621   | 1,621   |
| (d) Accounting profits before depreciation | 20,000  | 20,000  | 20,000  | 20,000  |
| (e) Less: Depreciation                     | (1,621) | (1,621) | (1,621) | (1,621) |
| (f) Accounting profits after depreciation  | 18,379  | 18,379  | 18,379  | 18,379  |
| (g) Tax amount – as above                  | 4,800   | 5,280   | 5,568   | 5,741   |
| (h) Effective tax rate=(g)/(f)             | 26.12%  | 28.73%  | 30.30%  | 31.24%  |
| (i) Tax @ 30% tax rate {30%*(f)}           | 5,514   | 5,514   | 5,514   | 5,514   |

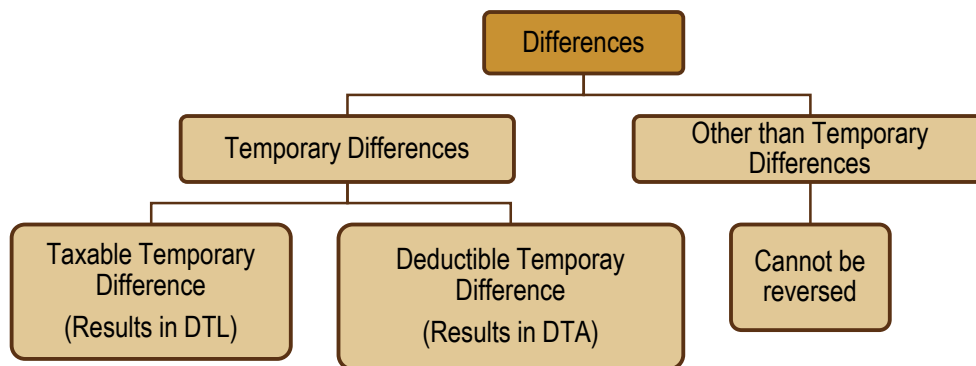
Thus, from the above two tables, for an accountant the tax should be ₹ 5,514 in all cases as per the accounting profit. The results are distorted. You will observe that in year 3, in books, the amount of tax provision is higher by ₹ 54 (5,568 – 5,514) and in year 4, it is higher by ₹ 227 (5,741 – 5,514). This is so because in year 1 & 2, these figures are lower by ₹ 714 (5,514 – 4,800) & ₹ 234 (5,514 – 5,280). Thus, the liability that was incurred in year 1 & 2 is paid year 3 onwards. However, no provision of the differential (₹ 714 in year 1 & ₹ 234 in year 2) is made.

The provision of differential should have been made by the entity following three major accounting concepts and convention of periodicity, matching and accrual. The entity has merely deferred the payment of tax to subsequent year. This understanding and appreciation of situation gave rise to the concept of deferred tax liabilities or deferred tax assets.

In earlier years, deferred tax was recognised based on concepts of timing differences and permanent differences based on differences in accounting profits and taxable profits known as income tax liability method. This concept stands revised with this Accounting Standard which recognised deferred tax based on temporary differences that arises due to difference in the carrying value of an item of asset or liability as per books of accounts with the carrying value of that item as per income tax provisions, known as tax base. This method is known as balance sheet approach.

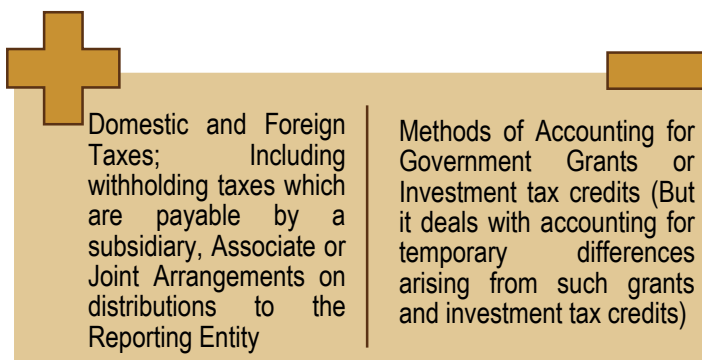
This Accounting Standard though titled as 'income taxes' primarily deals with deferred tax though guidance is provided on current tax.





## 1.2 SCOPE

- The objective of this Standard is to prescribe the accounting treatment for income taxes. Income taxes for the purpose of this Standard includes:
  - (a) all domestic and foreign taxes which are based on taxable profits;
  - (b) taxes, such as withholding taxes (Tax Deducted at Source), which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.



- Further, the income-tax for the purpose of this Standard could be classified as:
  - (a) **Current tax** being current tax consequence that arises due to transactions and other events of the current period that are recognised in an entity's financial statements.
  - (b) **Deferred tax** being future tax consequence that arises due to the future
    - (i) recovery of the carrying amount of assets or
    - (ii) settlement of carrying amount of the liabilities that are recognised in an entity's balance sheet. For example: Recovery of fixed assets means by way of depreciation or sale and for other assets by way of realization.

- Before we proceed further, it is essential to understand the fundamental principle in recognising deferred tax. This is enunciated in the Standard as under:

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset).

Let us try to understand the aforesaid principle with the help of an example:

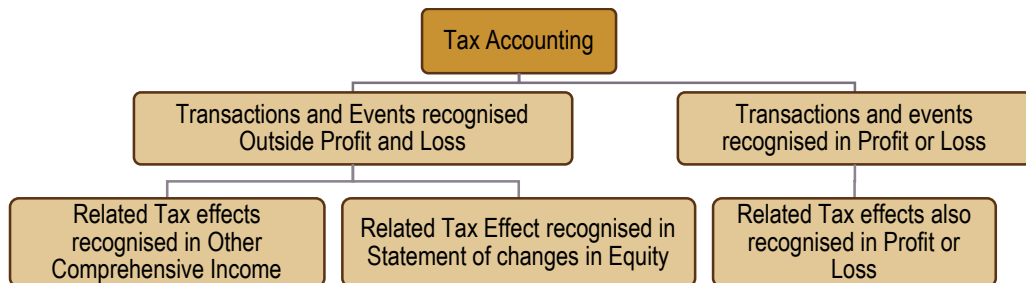
### Example 2

- (a) Whenever an entity recognises an asset, it expects that it will recover the carrying value of that asset. For example, if an entity recognises an item of land at ₹ 1,00,000, it expects that it will be able to recover at least ₹ 1,00,000 if that land is sold sometime in the future.
- (b) Assume that under the income tax provisions, if this piece of land is sold after holding it for more than one year, there will be an indexation benefit @ 10% per year. Thus, if the land is sold after one year, the cost of the land will for the purpose of taxation will be assumed at ₹ 1,10,000 (₹ 1,00,000 + 10%). If it is sold after two years, the cost of the land for the purpose of taxation will be assumed at ₹ 1,21,000 (₹ 1,10,000 + 10%).
- (c) The tax rate in all years continues to be flat 30%.
- (d) Thus, the recovery of the carrying value of land after two years will result into a tax saving of ₹ 6,300 i.e. 30% of 21,000 (1,21,000-1,00,000). For instance, if after two and half years, the land is sold for ₹ 1,50,000, the entity will pay a tax of ₹ 8,700 at 30% of ₹ 29,000 (₹ 1,50,000 – ₹ 1,21,000). If there would have been no indexation benefits, the tax liability would have been ₹ 15,000 at 30% of ₹ 50,000 (₹ 1,50,000 – ₹ 1,00,000). Saving in tax is of ₹ 6,300 (15,000-8,700).
- (e) In view of the above savings, the entity should recognise a deferred tax asset of ₹ 6,300 in this case in Year 1.
- (f) This principle has to be applied to each item of asset or liability.

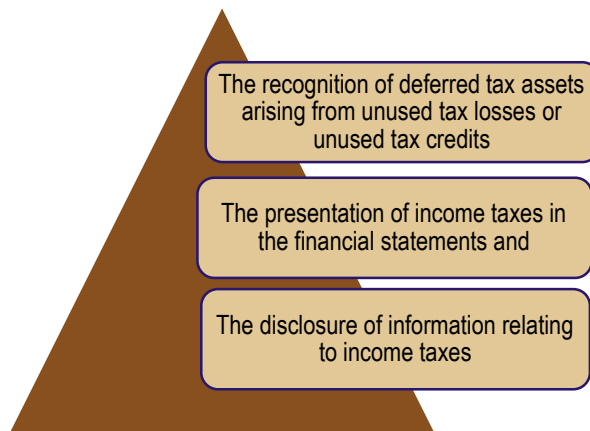
**Note:** There are controversial views in case of Indexation of land for a temporary difference because if the land is not going to be sold in a near future particularly in business then in such case it is not advisable to calculate temporary difference.

- The Standard also provides guidance as to where the current tax or deferred tax should be recognised, accounted and presented.

- An entity may incur a loss in the current period and set off against a profit in the earlier period. As the entity would recover a tax paid in the earlier year, the entity should recognize the benefit of tax recoverable as an asset.
- Items of current tax or defer tax recognized in profit and loss are subject to two exceptions:
  1. An item of current tax or defer tax pertaining to other comprehensive income should be recognized in other comprehensive income
  2. An item of current tax or defer tax pertaining to direct equity should be recognized in direct equity



- In addition, the Standard deals with the:
  - (a) recognition of deferred tax assets arising from unused tax losses or unused tax credits;
  - (b) presentation of income taxes in the financial statements; and
  - (c) disclosure of information relating to income taxes.



- The Standard however, **does not deal** with the methods of accounting for government grants (see Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*) or investment tax credits. However, it deals with the accounting for temporary differences that may arise from such grants or investment tax credits.



## 1.3 DEFINITIONS

Having understood, the basic concepts of current tax and deferred tax, the following definitions needs to be appreciated:

- (a) **Accounting profit** is profit or loss for a period before deducting tax expense.
- (b) **Taxable profit (tax loss)** is the profit (loss) for a period, computed as per the income tax act, upon which income taxes are payable (recoverable).
- (c) **Tax expense (tax income)** is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.
- (d) **Current tax** is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.
- (e) **Deferred tax liabilities** are the amounts of income taxes payable in future periods in respect of taxable temporary differences.
- (f) **Deferred tax assets** are the amounts of income taxes recoverable in future periods in respect of:
  - ◆ deductible temporary differences;
  - ◆ the carry forward of unused tax losses; and
  - ◆ the carry forward of unused tax credits.
- (g) **Temporary differences** are differences between the carrying amount of an asset or liability in the balance sheet and its tax base.
- (h) **Temporary differences** may be either:
  - ◆ **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
  - ◆ **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.

### Comparison with AS 22:

- ◆ **Timing differences** are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.
- ◆ Thus, it can be seen that while AS 22 spoke of timing differences with reference to income,

*Ind AS 12 speaks of temporary differences with reference to carrying amounts and tax bases of assets and liabilities. In other words, AS 22 adopts a P/L approach, whereas Ind AS 12 adopts a balance sheet approach towards accounting for taxes on income.*

- (i) The **tax base** of an asset or liability is the carrying amount to that asset or liability for tax purposes.

To facilitate, easy understanding, this chapter has been divided as under:

- (a) Part A : Tax Expense
- (b) Part B : Current Tax, its Recognition, Measurement and Presentation
- (c) Part C : Deferred Tax, its Recognition, Measurement and Presentation
- (d) Part D : Practical Application
- (e) Part E : Disclosures



## 1.4 PART A: TAX EXPENSE (TAX INCOME)

- Tax expense or tax income is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.
- The following needs to be appreciated:
  - (a) Tax expense could be positive or negative. Thus, there could be a tax income.
  - (b) Tax expense is the aggregate of:
    - ◆ **current tax; and**
    - ◆ **deferred tax.**



## 1.5 PART B: CURRENT TAX, ITS RECOGNITION, MEASUREMENT AND PRESENTATION

### 1.5.1 Current Tax

Current tax is the amount of *income taxes* payable (recoverable) in respect of the *taxable profit (tax loss)* for a period.

### 1.5.2 Recognition

#### (a) Current tax liability

- ◆ Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability.

- ◆ The exact liability of current tax crystallises only on preparation and finalisation of financial statements at the end of the reporting period.
- ◆ Any excess of this liability over the prepaid taxes (advance tax) and withhold taxes (TDS) is to be treated as current liability. This liability may be for the current reporting period or may relate to earlier reporting periods.

**(b) Current tax assets**

If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.

### **1.5.3 Measurement**

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- (a)** Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted.

**(b) Uncertain tax position interpretations**

- ◆ An entity computes its current income-taxes in accordance with the provisions contained in the taxation laws. Taxation laws provide certain benefits or require enhancements in accordance with the fiscal, economic and other policies of the country. These at times are prone to varying interpretations and settled by the appellate authorities after a considerable period from the reporting period. The taxability remains uncertain.
- ◆ Ind AS 12 requires that current tax liabilities or assets for the current period or the period should be computed based on the amount it expects to pay. It is suggested that statistical tools may be used in computing the current tax with respect to the uncertain tax interpretations.
- ◆ Thus, computation of current tax at best is an estimate. Any change in this estimate based on subsequent developments should be treated as a change in estimate in accordance with Ind AS 8.

**(c) Enacted or substantively enacted**

- ◆ The tax rates in computing the current tax should be based on taxation laws that have enacted or substantively enacted.
- ◆ A proposed legislation is enacted when all the formalities with respect to the legislation is completed. In India, the enactment occurs when the legislation is notified in the gazette on and from the date it comes into force as mentioned in the said gazette notification.
- ◆ Implicit in the word 'substantively enacted' is the emphasis that in the relevant situation the enactment process is not fully completed. The process of enactment of a taxation

law in India is as under:

- Finance bill is presented in Lok Sabha of Indian Parliament.
  - It is discussed and passed by the Lok Sabha.
  - It then moves to Rajya Sabha of Indian Parliament.
  - It is discussed in the Rajya Sabha.
  - It is then presented before the President for assent.
  - It is then notified in the gazette of India.
- ◆ Now, at which stage an entity should conclude that the legislation is substantively enacted becomes a key consideration. More so, the finance bill in India is normally presented on the last day of February and is enacted by the 3<sup>rd</sup> week of May. The reporting period of most of the entities ends on 31<sup>st</sup> March and listed entities attempt to issue their financial statements within 4-6 weeks of the reporting date.
  - ◆ Ind AS 12 does not provide any guidance.
  - ◆ It is therefore suggested that the entity should explicitly disclose in its financial statements the accounting policy with respect to the adoption of tax rates based on the principle of 'substantive enactment'. Needless to add, the policy should be applied consistently. If material, the variation due to adoption of rates based on 'substantive enactment' should also be disclosed.

### 1.5.4 Accounting of Current Tax Effects

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- (a) The accounting of current tax effects of a transaction of an event is consistent with the accounting for that transaction or event.
- (b) The current tax effects of a transaction shall follow its accounting treatment if the item is recognised in statement of profit or loss, its current tax effect will be recognised in statement of profit or loss.
- (c) For further discussion on this topic, refer Accounting for Deferred Tax.

### 1.5.5 Offsetting Current Tax Assets and Current Tax Liabilities

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- (a) An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:
  - ◆ has a legally enforceable right to set off the recognised amounts; and
  - ◆ intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.
- (b) Although current tax assets and liabilities are separately recognised and measured they are offset in the balance sheet subject to criteria similar to those established for financial instruments in Ind AS 32. An entity will normally have a legally enforceable right to set off a

current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation laws permit the entity to make or receive a single net payment.

- (c) In consolidated financial statements, a current tax asset of one entity in a group is offset against a current tax liability of another entity in the group if, and only if, the entities concerned have a legally enforceable right to make or receive a single net payment and the entities intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

### Illustration 1A

*H Ltd. is a manufacturing company, wanting to calculate its taxable profit or loss for the year ended 31 March 20X8. The statement of profit and loss and other comprehensive income, the balance sheet and the notes are given below.*

*Tax rate for the financial year 20X7-20X8 is 30%, but the new tax rate of 32%, for the year 20X8-20X9 and beyond, has already been enacted before the year end.*

*Calculate taxable profit for the financial year 20X7-20X8 and the related current tax expense.*

#### Balance Sheet as of 31 March 20X8

|                                   | ₹                   |
|-----------------------------------|---------------------|
| <b>ASSETS</b>                     |                     |
| <b>Non-current assets</b>         |                     |
| Property, plant and equipment     | 4,20,00,000         |
| Product development costs         | 21,00,000           |
| Investment in subsidiary – S Ltd. | 1,54,00,000         |
| <b>Current assets</b>             |                     |
| Trading investments               | 72,80,000           |
| Trade receivables                 | 2,19,10,000         |
| Inventories                       | 1,06,40,000         |
| Cash and cash equivalents         | <u>63,00,000</u>    |
| <b>TOTAL ASSETS</b>               | <u>10,56,30,000</u> |
| <b>EQUITY &amp; LIABILITIES</b>   |                     |
| <b>Equity</b>                     |                     |
| Share capital                     | 4,20,00,000         |
| Accumulated profits               | 2,86,24,330         |
| Revaluation surplus               | 30,80,000           |



|                                         |                     |
|-----------------------------------------|---------------------|
| <b>Non-current liabilities</b>          |                     |
| Deferred income - government grants     | 14,00,000           |
| Liability for product warranty costs    | 5,60,000            |
| Deferred tax liability (from 20X6-20X7) | 7,75,670            |
| <b>Current liabilities</b>              |                     |
| Trade payables                          | 2,67,40,000         |
| Medical benefits for employees          | 24,50,000           |
| <b>TOTAL EQUITY &amp; LIABILITIES</b>   | <b>10,56,30,000</b> |

**Extract of Statement of profit and loss for the year ended 31 March 20X8**

|                        |                       |
|------------------------|-----------------------|
| Revenue                | 16,81,40,000          |
| Cost of sales          | <u>(13,44,00,000)</u> |
| Gross profit           | 3,37,40,000           |
| Operating costs        | <u>(2,68,80,000)</u>  |
| Profit from operations | 68,60,000             |
| Finance costs          | <u>(9,10,000)</u>     |
| Profit before taxation | <u>59,50,000</u>      |

**Notes:**

1. Depreciation expense for the year financial year 20X7-20X8 allowable as per the Income Tax Rules is ₹ 72,10,000. Depreciation as allowed for the purposes of financial reporting included in operating costs is ₹ 59,50,000. Cost of PPE is ₹ 5,60,00,000 and H Ltd. deducted expenses of ₹ 1,45,60,000 in its tax returns prior to financial year 20X7-20X8. Further, as of 31 March 20X8, H Ltd. for the first time revalued its property, plant and equipment to market value of ₹ 4,20,00,000 (revaluation surplus = ₹ 30,80,000).
2. In 20X4-20X5, H Ltd. incurred product development costs of ₹ 35,00,000. These costs were recognized as an asset and amortized over period of 10 years. For tax purposes, H Ltd. deducted full product development costs when they were in 20X4-20X5.
3. Trading investments were acquired in the preceding year at a cost of ₹ 80,50,000. These investments are classified as at fair value through profit or loss and thus recognized in their fair value. Fair value adjustments are not allowable by the tax authorities.
4. Bad debt provision amounts to ₹ 45,50,000 and relates to 2 debtors: debtor A – ₹ 28,00,000 (receivable originates in 20X5-20X6 and 100% provision was recognized in the preceding year) and debtor B – ₹ 17,50,000 (receivable originates in 20X6-20X7 and 100% provision was recognized in F.Y. 20X7-20X8). Tax law allows deduction of 20% of provision for debtors

overdue for more than 1 year, another 30% for debtors overdue for more than 2 years and remaining 50% for debtors overdue for more than 3 years.

5. H Ltd. created a provision for inventory obsolescence in accordance with Ind AS 2 requirements. New provision created in 20X7-20X8 was ₹ 3,78,000 (total provision: ₹ 6,30,000). Being a general provision, this provision is not tax deductible.
6. Government grants are not taxable. Full government grant received in 20X7-20X8 is included in the balance sheet.
7. In 20X7-20X8, H Ltd. increased a liability for product warranty costs by ₹ 1,75,000. Product warranty costs are not tax deductible until the company pays claims. Claims paid in 20X7-20X8 amounted to ₹ 2,17,000.
8. During the year, H Ltd. introduced health care benefits for employees. The expenses are allowable for tax purposes only when benefits are paid but in line with Ind AS 19, recognized in profit or loss when employees provide service.
9. Penalties towards violation of laws included in operating expenses amount to ₹ 63,000. These are not deductible for tax purposes.
10. Tax law allows to deduct expenses for petrol only up to ₹ 1,40,000 per vehicle per year. H Ltd. had 4 vehicles in 20X7-20X8 and its total petrol expenses amounted to ₹ 7,21,000.

Note: This illustration is prepared for the purposes of understanding the computation of current tax and is in no way based on the provisions of the Income Tax Act, 1961. For the purposes of Financial Reporting, the tax treatments will be given in the question.

### Solution:

#### Calculation of current tax expense

|                                                   |     |                   |
|---------------------------------------------------|-----|-------------------|
| Accounting profit                                 | (A) | <u>59,50,000</u>  |
| Add back:                                         |     |                   |
| Accounting depreciation                           |     | 59,50,000         |
| Amortization of product development costs (W.N.1) |     | 3,50,000          |
| Revaluation of trading investments                |     | 7,70,000          |
| Bad debt provisions - 20X7-20X8                   |     | 17,50,000         |
| Inventory obsolescence provision                  |     | 3,78,000          |
| Product warranty costs provision - 20X7-20X8      |     | 1,75,000          |
| Provision for health care benefit costs           |     | 24,50,000         |
| Fines and Penalties disallowed for tax purposes   |     | 63,000            |
| Petrol over limit (W.N.3)                         |     | <u>1,61,000</u>   |
| Total                                             | (B) | <u>120,47,000</u> |

|                                                |         |                    |
|------------------------------------------------|---------|--------------------|
| Deduct:                                        |         |                    |
| Tax depreciation                               |         | (72,10,000)        |
| Tax allowance for bad debt provisions (W.N.2)  |         | (11,90,000)        |
| Product warranty costs provision - claims paid |         | <u>(2,17,000)</u>  |
| Total                                          | (C)     | <u>(86,17,000)</u> |
| Taxable profit / loss:                         | (A+B-C) | 93,80,000          |
| Tax rate is 30%                                |         |                    |
| Current income tax (93,80,000 x 30%)           |         | 28,14,000          |

### Journal Entry

|                                             |     |           |           |
|---------------------------------------------|-----|-----------|-----------|
| Profit or loss - Current income tax expense | Dr. | 28,14,000 |           |
| To Credit Current income tax liabilities    |     |           | 28,14,000 |

### Working Notes:

#### 1. Product development costs:

Annual amortization (₹ 35,00,000/ 10) 3,50,000

#### 2. Bad debt provisions:

Debtor A - ₹ 28,00,000 from 20X5-20X6

> 2 years - 30% deductible in 20X7-20X8 8,40,000

Debtor B - ₹ 17,50,000 from 20X6-20X7

> 1 year - 20% deductible in 20X7-20X8 3,50,000

Total - tax deductible in 20X7-20X8 11,90,000

#### 3. Petrol expenses

Actual expenses 7,21,000

Tax deductible (4 x 140,000) 5,60,000

Excess 1,61,000

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## 1.6 PART C: DEFERRED TAX, ITS RECOGNITION, MEASUREMENT AND PRESENTATION

The following steps should be followed in the recognition, measurement and presentation of deferred tax liabilities or assets:

- Step 1: Compute carrying amounts of assets and liabilities
- Step 2: Compute tax base
- Step 3: Compute temporary differences
- Step 4: Classify temporary differences into either:
  - ◆ Taxable temporary difference
  - ◆ Deductible temporary difference
- Step 5: Identify exceptions
- Step 6: Assess deductible temporary differences, tax losses and tax credits
- Step 7: Determine the tax rate
- Step 8: Calculate and recognise deferred tax
- Step 9: Accounting of deferred tax
- Step 10: Offsetting of deferred tax liabilities and deferred tax assets

These are now discussed in detail.

### 1.6.1 Step 1: Compute carrying amount

For the purpose of this Standard, we can define carrying amount at which an asset or liability is recognised in the balance sheet, after making necessary adjustments like depreciation, impairment, etc. In other words, carrying amount of the assets and liabilities means balance as per the ledger.

#### Example 3

Entity A had acquired an item of plant and machinery for ₹ 1,00,000 on 1<sup>st</sup> April, 20X1. It depreciated this item @ 10% per annum on SLM basis. For the year ended 31<sup>st</sup> March, 20X2, it provides depreciation of ₹ 10,000. The carrying amount of this item of plant and machinery as on 31<sup>st</sup> March, 20X2 is ₹ 90,000.

## 1.6.2 Step 2: Compute tax base

- (a) The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

### Example 4

Entity A had acquired an item of plant and machinery for ₹ 1,00,000 on 1<sup>st</sup> April, 20X1. It depreciated this item @ 10% per annum on SLM basis. For the year ended 31<sup>st</sup> March, 20X2, it provides depreciation of ₹ 10,000. The carrying amount of this item of plant and machinery as on 31<sup>st</sup> March, 20X2 is ₹ 90,000. As per taxation laws, this item of plant and machinery has to be depreciated @ 30% per annum on WDV basis. Thus, the entity, for the purposes of taxation, computes depreciation of ₹ 30,000. The tax base of this item of plant and machinery is ₹ 70,000 (₹ 1,00,000 – ₹ 30,000).

In the above scenario, if Entity A decides to revalue the item of plant and machinery and measures it at ₹ 1,50,000, the carrying value of the item of plant and machinery will be ₹ 1,50,000. For tax purposes, if the revaluation is ignored, the tax base remains ₹ 70,000 (Initial cost ₹ 1,00,000 – ₹ 30,000).

- (b) Four scenarios could be anticipated for computation of the tax base of either an asset or a liability:
- ◆ Tax base of an asset.
  - ◆ Tax base of a liability.
  - ◆ Items with a tax base but no carrying amount.
  - ◆ Items of assets and liabilities where tax base is not apparent.

Let us examine and compute tax base under each of the four scenarios:

### (i) Tax base of an asset

The principle to compute tax base of an asset is as under:

- ❖ The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset.
- ❖ The carrying amount of the asset could be recovered either through sale of the asset or through its use or partly through use and partly through sale. The method of recovery has to be determined at each reporting date.

**Examples 5-9**

5. Entity A has inventory with carrying amount of ₹ 1,00,000 as at the reporting date. It recovers the value of inventory through sale in a subsequent reporting period. The sale value is the economic benefit derived by the entity and is taxable. However, as per the matching and other concepts, against this sale the entity is entitled to deduct its cost. The cost is the carrying amount of the inventory i.e., ₹ 1,00,000. The tax base in this case is ₹ 1,00,000.
6. Entity A has acquired an item of asset for ₹ 1,00,000 for production of certain items to be sold by the entity. It is deductible equally over two years in the books of accounts. The carrying amount as the end of first reporting period is ₹ 50,000 (₹ 1,00,000 – ₹ 50,000). In the income tax, ₹ 75,000 is deductible in year 1 and balance is deductible in year 2. We have to compute its tax base as on the last day of the first reporting period. However, in income-tax, it can claim only ₹ 25,000 being 25% of the cost of the asset as 75% has already been claimed in year 1. Thus, the tax base in this case is ₹ 25,000.
7. Interest receivable has a carrying amount of 100. The related interest revenue will be taxed on a cash basis. The tax base of the interest receivable is nil.
8. An entity that follows mercantile system of accounting has trade receivables of ₹ 1,000. It creates a general bad debt allowance of ₹ 50. The carrying amount in the books of accounts of trade receivables is thus ₹ 950. However, in income-tax, general bad debt provision is not deductible. In the subsequent period, entity is able to recover only ₹ 950. The amount recovered is a taxable economic benefit. But for tax purposes, entity is entitled for a deduction of ₹ 1,000 against this recovery of trade receivable. The tax base in the current year is ₹ 1,000.
9. An entity that follows mercantile system of accounting has trade receivables of ₹ 1,000. It creates a specific bad debt of ₹ 50. The carrying amount in the books of accounts of trade receivables is thus ₹ 950. In the subsequent period, entity is able to recover only ₹ 950. Further, in income-tax, specific bad debt provision is deductible in the very year it is created. The amount recovered is a taxable economic benefit. For tax purposes, entity will be entitled for a deduction of ₹ 950 against this recovery of trade receivable. The tax base is ₹ 950.

- ❖ If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- ❖ It is quite feasible that in certain cases, the economic benefits that are derived from the recovery of an asset are not taxable. In these situations, the tax base of the asset is taken at its carrying amount.

**Examples 10 & 11**

10. An entity has an investment in listed equity shares. There is no tax on gains that arise on sale of these listed equity shares. Thus, the tax base in this case will be the carrying amount of the investments.
11. An entity has given a loan of ₹ 10,000 which is the carrying amount. The repayment of loan has no tax consequences. The tax base is ₹ 10,000.

**(ii) Tax base of a liability**

The principle to compute tax base of a liability is as under:

- ❖ The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

**Examples 12 & 13**

12. Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense will be deducted for tax purposes on a cash basis.  
*The tax base of the accrued expenses is nil.*
13. Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense has already been deducted for tax purposes.  
*The tax base of the accrued expenses is ₹ 100.*

- ❖ If those liabilities are not tax deductible, the tax base of that liability is equal to its carrying amount.

**Example 14**

Current liabilities include accrued fines and penalties with a carrying amount of ₹ 100. Fines and penalties are not deductible for tax purposes.  
*The tax base of the accrued fines and penalties is ₹ 100.*

- ❖ It is an other than temporary difference, as the expenses are not allowable as per income tax.

**Example 15**

A loan payable has a carrying amount of ₹ 100. The repayment of the loan will have no tax consequences.  
*The tax base of the loan is ₹ 100.*

- ❖ In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

**Example 16**

Current liabilities include interest revenue received in advance, with a carrying amount of ₹ 100. The related interest revenue was taxed on a cash basis.

*The tax base of the interest received in advance is nil.*

**(iii) Items with a tax base but no carrying amount**

- ❖ There are certain items that have a tax base but no carrying amount. These include items that are charged to revenue statement in the period in which they are incurred but are allowed as a deduction over a number of periods as per the taxation laws.

**Examples 17 & 18**

17. A Limited has been incorporated recently. It incurred ₹ 1,00,000 on its incorporation. It has been charged to revenue in the very first accounting period. The taxation laws allow deduction over a period of 5 years. The carrying amount at the end of year 1 is Nil.

*The tax base will be ₹ 80,000 (20,000 x 4) as ₹ 20,000 being 1/5<sup>th</sup> is allowable as a deduction in taxation laws over 4 years.*

18. Public issue expenses. The entity may have written off the public issue expenses in the very first year. But since tax laws permit deduction over 5 years, the temporary differences will exist till complete deduction is claimed in taxation laws.

**(iv) Items of assets and liabilities where tax base is not apparent**

- ❖ There could be situations where it may be difficult to compute the tax base of an item. One however, knows the carrying amount. This is because of the provisions of taxation laws. Whereas in books of accounts, all or most of the revenue and gains are included as part of one single performance statement, in the taxation laws they are charged under different head.
- ❖ The taxable amount amongst other things depends under which head an item at the time of recovery may be charged. In India, income or gains are charged either as 'Salaries', 'Income from house property', 'Profits and gains of business', 'Capital Gain' & 'Income from other sources'. Further certain specific or weighted deductions are also permissible. For example, rental income is subject to a flat deduction. So how will you compute the rental income received in advance? Moreover, there are cases depending upon the substance of the transaction, the rental income is to be charged as business income. At times, reverse may be the case. Many more similar situations could be anticipated.



**Example 19**

Entity A has an industrial undertaking that consists of land, building, plant and machinery. It is contemplating disposing the entity. It has the option to recover the carrying amount of the entity either by disposing the entire entity as a slump sale or dispose of each asset on a piecemeal basis. Depending upon the manner of recovery and period of holding, the carrying amount may be subject to indexation benefit, the recovery may be charged either as a business profit or capital gains. Again, it could be long-term gain capital gain or short-term capital gain. As at the end of the reporting period, the entity is not sure of the manner and time of recovery.

- ❖ So, how should one proceed with the determination of the tax base? It is a matter of judgment. The Standard states that one should refer the fundamental principle as enumerated in the Standard. The principle is reproduced hereunder:

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset)

- ❖ It is recommended, if material, the basis of judgment and related uncertainties should be disclosed.

- (c) Tax base is determined with reference to the tax returns of each entity. This poses no problems when computing tax base of a stand-alone entity. In some jurisdiction, taxation laws, in the case of a group permits a consolidated tax return. In such cases, tax bases should be determined based on a consolidated tax return. If this is not so, then the basis should be individual tax returns. The carrying amount in both the cases shall be determined on the basis of consolidated financial statements.

**Illustration 1B (in continuation to Illustration 1A):**

*Based on the balance sheet and notes of H Ltd. from previous example, calculate tax base of its assets and liabilities as of 31 March 20X8. Note that balance sheet has been adjusted by current tax expense and liability.*

**Balance Sheet as of 31 March 20X8**

| <b>ASSETS</b>                 | <b>₹</b>   |
|-------------------------------|------------|
| <b>Non-current assets</b>     |            |
| Property, plant and equipment | 420,00,000 |
| Product development costs     | 21,00,000  |

|                                         |                            |
|-----------------------------------------|----------------------------|
| Investment in subsidiary – S Ltd.       | 154,00,000                 |
| <b>Current assets</b>                   |                            |
| Trading investments                     | 72,80,000                  |
| Trade receivables                       | 219,10,000                 |
| Inventories                             | 106,40,000                 |
| Cash and cash equivalents               | <u>63,00,000</u>           |
| <b>Total Assets</b>                     | <b><u>10,56,30,000</u></b> |
| <b>EQUITY &amp; LIABILITIES</b>         | ₹                          |
| <b>Equity</b>                           |                            |
| Share capital                           | 420,00,000                 |
| Accumulated profits                     | 258,10,330                 |
| Revaluation surplus                     | 30,80,000                  |
| <b>Long-term liabilities</b>            |                            |
| Deferred income - government grants     | 14,00,000                  |
| Liability for product warranty costs    | 5,60,000                   |
| Deferred tax liability (from 20X6-20X7) | 7,75,670                   |
| <b>Current liabilities</b>              |                            |
| Trade payables                          | 267,40,000                 |
| Medical benefits for employees          | 24,50,000                  |
| Current Tax Liability                   | <u>28,14,000</u>           |
| <b>Total Equity &amp; Liabilities</b>   | <b><u>10,56,30,000</u></b> |

Remaining information are same as per Illustration 1A.

**Solution:**

**Determination of Tax Base**

| Item                          | Carrying amount | Tax base   |
|-------------------------------|-----------------|------------|
| Property, plant and equipment | 420,00,000      | 342,30,000 |
| Product development costs     | 21,00,000       | 0          |
| Investment in subsidiary      | 154,00,000      | 154,00,000 |
| Trading investments           | 72,80,000       | 80,50,000  |
| Trade receivables             | 219,10,000      | 247,10,000 |
| Inventories                   | 106,40,000      | 112,70,000 |

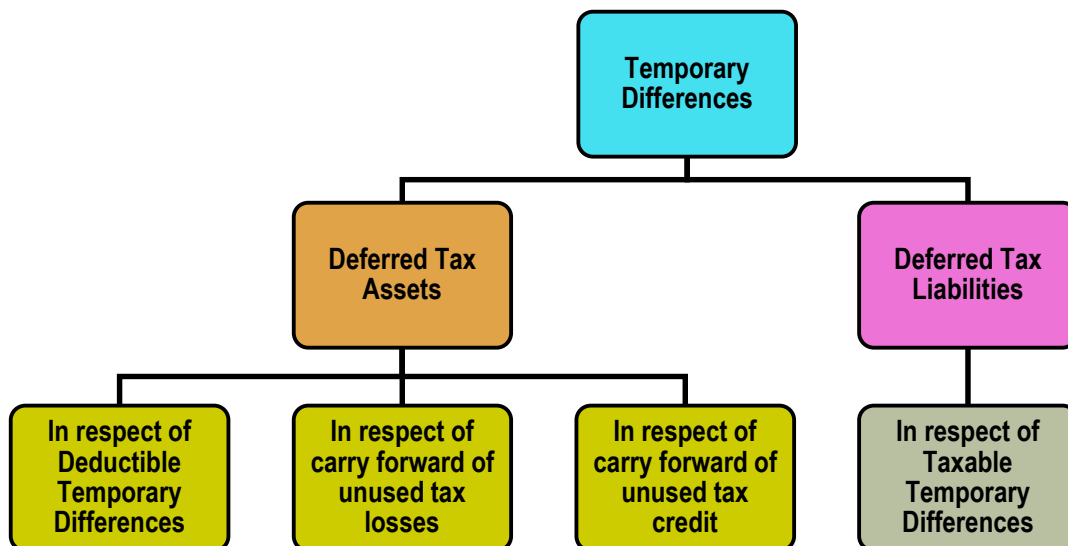
|                                      |             |             |
|--------------------------------------|-------------|-------------|
| Cash and cash equivalents            | 63,00,000   | 63,00,000   |
| Deferred income - government grants  | -14,00,000  | 0           |
| Liability for product warranty costs | -5,60,000   | 0           |
| Trade payables                       | -267,40,000 | -267,40,000 |
| Health care benefits for employees   | -24,50,000  | 0           |

**Working Notes:**

|                                                    |                           |            |  |
|----------------------------------------------------|---------------------------|------------|--|
| <b>1. Property, plant and equipment</b>            |                           |            |  |
| Cost                                               | 560,00,000                |            |  |
| Less: current tax depreciation                     | (72,10,000)               |            |  |
| Less: PY tax depreciation                          | <u>(145,60,000)</u>       |            |  |
| Tax base                                           | <b><u>3,42,30,000</u></b> |            |  |
| <b>2. Trade receivables - bad debt provisions:</b> |                           |            |  |
| <b>I Calculation of cost</b>                       |                           |            |  |
| Carrying amount                                    | 219,10,000                |            |  |
| Add back: bad debt provision                       | <u>45,50,000</u>          |            |  |
| Cost                                               | <b><u>2,64,60,000</u></b> | <b>A</b>   |  |
| <b>II Debtor A - ₹ 28,00,000 from 20X5-20X6</b>    |                           |            |  |
| > 1 year - 20% deducted in 20X6-20X7               | 5,60,000                  |            |  |
| > 2 years - 30% deducted in 20X7-20X8              | <u>8,40,000</u>           |            |  |
| Already deducted for tax:                          | <b><u>14,00,000</u></b>   |            |  |
| <b>III Debtor B - ₹ 17,50,000 from 20X6-20X7</b>   |                           |            |  |
| > 1 year - 20% deducted in 20X7-20X8               | 3,50,000                  |            |  |
| Total deducted for tax purposes                    | <u>17,50,000</u>          | <b>B</b>   |  |
| <b>Tax base of trade receivables:</b>              | <b><u>2,47,10,000</u></b> | <b>A-B</b> |  |

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### 1.6.3 Step 3: Compute temporary differences



- (a) The term temporary difference is defined as the difference between the carrying amount of an asset or liability in the balance sheet and its tax base.

#### Example 20

An entity has an item of plant and machinery acquired on the first day of the reporting period for ₹ 1,00,000. It depreciates it @ 20% p.a on SLM basis. The carrying amount in balance sheet is ₹ 80,000. The taxation laws require depreciation @ 30% on WDV basis. The tax base at the end of the reporting period is ₹ 70,000. The temporary difference is ₹ 10,000 (₹ 80,000 – ₹ 70,000).

- (b) The contention in favour of temporary difference is that at the end of the day, all differences between the carrying amount and tax base of an asset or liability will reverse. At most the entity may be able to delay the timing of reversal but the difference will ultimately have reversed, therefore the term 'temporary difference' is used. The cumulative impact is 'zero'.

#### Example 21

An entity acquires an asset on the first day of reporting period for ₹ 120 with a useful life of 6 years and no residual value. It depreciates the asset on SLM basis. The tax rate is 30%. The tax depreciation is as assumed in the computation below.

The following computations are performed.

| Financial Statements    |      |      |      |      |       |       |
|-------------------------|------|------|------|------|-------|-------|
| Year                    | 1    | 2    | 3    | 4    | 5     | 6     |
| Gross Block             | 120  | 120  | 120  | 120  | 120   | 120   |
| Cumulative Depreciation | (20) | (40) | (60) | (80) | (100) | (120) |
| Carrying Amount         | 100  | 80   | 60   | 40   | 20    | 0     |

| Tax Computation               |      |      |     |     |     |     |
|-------------------------------|------|------|-----|-----|-----|-----|
| Year                          | 1    | 2    | 3   | 4   | 5   | 6   |
| Tax base brought forward      | 120  | 30   | 20  | 13  | 8   | 3   |
| Depreciation charge (assumed) | (90) | (10) | (7) | (5) | (5) | (3) |
| Tax base carried forward      | 30   | 20   | 13  | 8   | 3   | 0   |

| Temporary Difference     |      |      |      |     |     |     |
|--------------------------|------|------|------|-----|-----|-----|
| Year                     | 1    | 2    | 3    | 4   | 5   | 6   |
| Carrying Amount          | 100  | 80   | 60   | 40  | 20  | 0   |
| Tax base carried forward | (30) | (20) | (13) | (8) | (3) | 0   |
| Temporary difference     | 70   | 60   | 47   | 32  | 17  | 0   |
| Cumulative impact        | +70  | -10  | -13  | -15 | -15 | -17 |
|                          | +70  | -70  |      |     |     |     |

| Movement in Balance Sheet |     |     |    |    |    |    |
|---------------------------|-----|-----|----|----|----|----|
| Year                      | 1   | 2   | 3  | 4  | 5  | 6  |
| Temporary difference      | 70  | 60  | 47 | 32 | 17 | 0  |
| Deferred tax liability    | 21  | 18  | 14 | 10 | 5  | 0  |
| Movement in provision     | +21 | -3  | -4 | -4 | -5 | -5 |
| Cumulative                | +21 | -21 |    |    |    |    |

- (c) To some, it may appear that temporary differences and timing differences are one and the same term. It is not so. It can however, be said that temporary difference includes timing differences. Timing differences arise when income or expense is included in accounting profit in one period but is included in taxable profit in a different period.
- (d) Examples of temporary differences in the nature of timing differences are as under.

**Example 22**

- Interest income recognized in income statement on a time proportion basis but recognized in taxable profit on cash basis as and when income is received.
- Depreciation used in determining taxable income may differ from that used in determining accounting profit.
- Development costs may be capitalized and amortize over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred.

- (e) Examples of temporary differences other than in the nature of timing differences are as under:

**Example 23: Business combinations**

The identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with Ind AS 103, *Business Combinations*, but no equivalent adjustment is made for tax purposes.

With limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently.

For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. However, it may be noted that the resulting deferred tax liability affects goodwill.

**Example 24: Revaluation: assets are revalued and no equivalent adjustment is made for tax purposes.**

Indian Accounting Standards permit or require certain assets to be carried at fair value or to be revalued (see, for example, Ind AS 16, *Property, Plant and Equipment*, Ind AS 38, *Intangible Assets*, Ind AS 109, *Financial Instruments* and Ind AS 116 *Leases*).

In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises.

In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted.

Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will

differ from the amount of those economic benefits. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

This is true even if:

- (a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or
- (b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

### 1.6.4 Step 4: Classify temporary differences

- (a) Temporary differences are to be classified into:
  - ◆ Taxable temporary differences
  - ◆ Deductible temporary differences
- (b) Taxable temporary differences are those temporary differences that results 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.

As the name 'taxable temporary difference' suggests, these are the temporary differences that will be taxed in future. These taxable temporary differences will increase tax liabilities. All taxable temporary differences, subject to limited exceptions, give rise to deferred tax liability.

Taxable temporary difference arises where the:

- carrying amount of an asset exceeds its tax base; or
- tax base of a liability exceeds its carrying amount.

#### Example 25

An asset which costs ₹ 150 has a carrying amount of ₹ 100. Cumulative depreciation for tax purposes is ₹ 90 and the tax rate is 25%.

The tax base of the asset is ₹ 60 (cost of ₹ 150 less cumulative tax depreciation of ₹ 90). To recover the carrying amount of ₹ 100, the entity must earn taxable income of ₹ 100 but will only be able to deduct tax depreciation of ₹ 60. Consequently, the entity will pay income taxes of ₹ 10 (₹ 40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of ₹ 100 and the tax base of ₹ 60 is a taxable temporary difference of ₹ 40.

- (c) Deductible temporary differences are those temporary differences that results 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.

Again, it should be noted, the name 'deductible temporary difference' suggests, these are the temporary differences that will be deducted in future when computing the tax liability. These deductible temporary differences will reduce tax liabilities. All deductible temporary differences, subject to exceptions/recognition criteria, give rise to deferred tax assets.

Deductible temporary difference arises where the:

- carrying amount of a liability exceeds its tax base; or
- tax base of an asset exceeds its carrying amount.

**Example 26**

An entity recognises a liability of ₹ 100 for gratuity and leave encashment expenses by creating a provision for gratuity and leave encashment. For tax purposes, any amount with regard to gratuity and leave encashment will not be deductible until the entity pays the same. The tax rate is 25%.

The tax base of the liability is nil (carrying amount of ₹ 100, less the amount that will be deductible for tax purposes in respect of that liability in future periods). In settling the liability for its carrying amount, the entity will reduce its future taxable profit by an amount of ₹ 100 and, consequently, reduce its future tax payments by ₹ 25 (₹ 100 at 25%). The difference between the carrying amount of ₹ 100 and the tax base of nil is a deductible temporary difference of ₹ 100.

- (d) Based on the above discussions, a matrix as under may be drawn:

|                               | For Assets                                                                                                     | For Liabilities                                                                                                                            |
|-------------------------------|----------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------|
| If carrying amount > tax base | Taxable Temporary Difference<br>↓<br>Deferred Tax Liability<br>(e.g. WDV as per books > WDV as per Income Tax) | Deductible Temporary Difference<br>↓<br>Deferred Tax Asset<br>(e.g. Provision for Bonus as per books > Provision for Bonus as per IT)      |
| If carrying amount < tax base | Deductible Temporary Difference<br>↓<br>Deferred Tax Asset<br>(e.g. WDV as per books < WDV as per Income Tax)  | Taxable Temporary Difference<br>↓<br>Deferred Tax Liability<br>(e.g. Loan carrying amount as per books < Loan carrying amounts as per tax) |
| If carrying amount = tax base | No temporary difference                                                                                        | No temporary difference                                                                                                                    |



(e) Further examples of taxable temporary differences:

- **Transactions that affect profit or loss**

**Example 27**

1. Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.
2. Revenue from the sale of goods is included in accounting profit when goods are delivered but is included in taxable profit when cash is collected.

*In this case, there is also a deductible temporary difference associated with any related inventory.*

3. Depreciation of an asset is accelerated for tax purposes.
4. Development costs have been capitalised and will be amortised to the statement of profit and loss but were deducted in determining taxable profit in the period in which they were incurred.
5. Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

- **Transactions that affect the balance sheet**

**Example 28**

1. Depreciation of an asset is not deductible for tax purposes and no deduction will be available for tax purposes when the asset is sold or scrapped.
2. A borrower records a loan at the proceeds received (which equal the amount due at maturity), less transaction costs. Subsequently, the carrying amount of the loan is increased by amortisation of the transaction costs to accounting profit using effective rate of interest. The transaction costs were deducted for tax purposes in the period when the loan was first recognised.
3. A loan payable was measured on initial recognition at the amount of the net proceeds, net of transaction costs. The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods.
4. The liability component of a compound financial instrument (for example a convertible bond) is measured at a discount to the amount repayable on maturity (see Ind AS 32, *Financial Instruments: Presentation*). The discount is not deductible in determining taxable profit (tax loss).

- **Fair value adjustments and revaluation**

**Example 29**

1. Financial assets are carried at fair value which exceeds cost, but no equivalent adjustment is made for tax purposes.
2. An entity revalues property, plant and equipment (under the revaluation model treatment in Ind AS 16, *Property, Plant and Equipment*) but no equivalent adjustment is made for tax purposes.

- **Business combinations and consolidation**

**Example 30**

1. The carrying amount of an asset is increased to fair value in a business combination and no equivalent adjustment is made for tax purposes.
2. Reductions in the carrying amount of goodwill are not deductible in determining taxable profit and the cost of the goodwill would not be deductible on disposal of the business.
3. Unrealised losses resulting from intragroup transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.
4. Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent.
5. Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.
6. The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency.

- **Hyperinflation**

**Example 31**

Non-monetary assets are restated in terms of the measuring unit current at the end of the reporting period (see Ind AS 29, *Financial Reporting in Hyperinflationary Economies*) and no equivalent adjustment is made for tax purposes.

(f) Further examples of deductible temporary differences:

- **Transactions that affect profit or loss**

**Example 32**

1. Retirement benefit costs are deducted in determining accounting profit as service

is provided by the employee, but are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. *(note: similar deductible temporary differences arise where other expenses, such as gratuity and leave encashment or interest, are deductible on a cash basis in determining taxable profit.)*

2. Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the end of the reporting period for tax purposes.
3. The cost of inventories sold before the end of the reporting period is deducted in determining accounting profit when goods or services are delivered but is deducted in determining taxable profit when cash is collected. *(it may be noted, there is also a taxable temporary difference associated with the related trade receivable.)*
4. The net realisable value of an item of inventory, or the recoverable amount of an item of property, plant or equipment, is less than the previous carrying amount and an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.
5. Preliminary expenses (or organisation or other start-up costs) are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.
6. Income is deferred in the balance sheet but has already been included in taxable profit in current or prior periods.
7. A government grant which is included in the balance sheet as deferred income will not be taxable in future periods.

- **Fair value adjustments and revaluation**

**Example 33**

Financial assets are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

- **Business combinations and consolidation**

**Example 34**

1. A liability is recognised at its fair value in a business combination, but none of the related expense is deducted in determining taxable profit until a later period.
2. Unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

3. Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.
4. The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency.

❖ Deferred tax liabilities are created for all taxable temporary differences with limited exceptions. Similarly, deferred tax assets are created for all deductible temporary differences subject to limited exceptions and recognition criteria. In Step 5 we will discuss the exceptions with respect to creation to deferred tax and in Step 6 we will discuss the recognition criteria area for deferred tax assets. However, before we proceed further, let's discuss the principle in recognising deferred tax liabilities or deferred tax asset.

❖ These are:

**(a) Deferred tax liability**

- A deferred tax liability shall be recognized 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 ventures, a deferred tax liability shall be recognised in accordance with paragraph 39 of Ind AS 12.

**(b) Deferred tax asset**

- A deferred tax asset shall be recognized 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 ventures, a deferred tax asset shall be recognised in accordance with paragraph 44 of Ind AS 12.
- ❖ From a reading of the aforesaid principles, deferred tax liabilities and deferred tax assets needs to be recognised in most of the cases. But the recognition of deferred tax liabilities or deferred tax assets are subject to exceptions with respect to the following items:
  - (a) the initial recognition of goodwill arising in a business combination (exception 1);
  - (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) (exception 2);
  - (c) temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures (exception 3).

These exceptions are discussed in Step 5.

- ❖ Also deferred tax assets should be created only to the extent of the probability of availability of taxable profits. In case, this probability of availability of taxable profits is missing, deferred tax assets should not be created. The profit probability recognition criterion is discussed in Step 6.

**Illustration 1C (in continuation to Illustration 1A):**

*Based on the data from above illustration 1A of H Ltd., calculate temporary differences and deferred tax. Note from Illustration 1A: Tax rate for 20X7-20X8 is 30%, but the new tax rate of 32% for the year 20X8-20X9 and beyond has already been enacted before the year end.*

**Solution:**

**Calculation of Temporary Differences / Deferred Tax**

| Item                            | Carrying amount | Tax base    | Temporary difference | Taxable / deductible | DTA / DTL at 32% |
|---------------------------------|-----------------|-------------|----------------------|----------------------|------------------|
| Property, plant and equipment   | 4,20,00,000     | 3,42,30,000 | 77,70,000            | taxable              | (24,86,400)      |
| Product development costs       | 21,00,000       | 0           | 21,00,000            | taxable              | (6,72,000)       |
| Investment in subsidiary S Ltd. | 1,54,00,000     | 1,54,00,000 | 0                    |                      | 0                |
| Trading investments             | 72,80,000       | 80,50,000   | (7,70,000)           | deductible           | 2,46,400         |

|                                       |               |               |             |                 |                    |
|---------------------------------------|---------------|---------------|-------------|-----------------|--------------------|
| Trade receivables                     | 2,19,10,000   | 2,47,10,000   | (28,00,000) | deductible      | 8,96,000           |
| Inventories                           | 1,06,40,000   | 1,12,70,000   | (6,30,000)  | deductible      | 2,01,600           |
| Cash and cash equivalents             | 63,00,000     | 63,00,000     | 0           |                 | 0                  |
| Deferred income - government grants   | (14,00,000)   | 0             | (14,00,000) | <b>excluded</b> | 0                  |
| Liability for product warranty costs  | (5,60,000)    | 0             | (5,60,000)  | deductible      | 1,79,200           |
| Trade payables                        | (2,67,40,000) | (2,67,40,000) | 0           |                 | 0                  |
| Medical benefits for employees        | (24,50,000)   | 0             | (24,50,000) | deductible      | 7,84,000           |
| <b>Deferred tax asset - total</b>     |               |               |             |                 | <b>23,07,200</b>   |
| <b>Deferred tax liability - total</b> |               |               |             |                 | <b>(31,58,400)</b> |
| <b>Deferred tax total</b>             |               |               |             |                 | <b>(8,51,200)</b>  |

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### 1.6.5 Step 5: Identify exceptions

**(a) Exception 1: The initial recognition of goodwill in the case of a business combination**

- In the case of a business combination, when the consideration paid exceeds the net identifiable assets, goodwill is created.
- Technically speaking, goodwill arising in a business combination is measured as the excess of (a) over (b) below:
  - (a) the aggregate of:
    - (i) the consideration transferred measured in accordance with Ind AS 103, which generally requires acquisition date fair value;
    - (ii) the amount of any non-controlling interest in the acquiree recognized in accordance with Ind AS 103; and
    - (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
  - (b) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured in accordance with Ind AS 103.
- As per principles enunciated in this Ind AS 12, the entity has to determine the tax base of this goodwill to compute the temporary difference, either taxable or deductible, at the time of recognition and subsequently when impairment takes place. The Standard provides separate guidance for taxable temporary difference (Situation A) and deductible temporary difference (Situation B).
- **Situation A:** Where the temporary difference is in the nature of taxable temporary difference. Again, in this case, the prescribed treatment is different where good will is

not tax deductible (Situation A1) and where it is tax deductible (Situation A2).

- **(Situation A1: Where it is not tax deductible)**

(a) At the time of initial recognition of goodwill:

- Quite a few tax jurisdictions do not permit this goodwill as a tax deductible expense. Also, the cost of goodwill is often not deductible when a subsidiary dispose of its underlying business. Put simply, the tax base of goodwill is Nil. But the entity has a taxable temporary difference as the goodwill (an asset) has a carrying amount leading to a deferred tax liability.
- The Standard does not permit the recognition of the resulting deferred tax liability as goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill, resulting into a circular type of computation.

Deferred tax liability is not recognised for goodwill since the recognition shall be done through goodwill itself. This is going to result in inflating the goodwill amount, and therefore is not permitted.

#### Example 35

An entity acquires a subsidiary and pays ₹ 1,00,000. The fair value of net identifiable assets is ₹ 65,000. The following entry shall be made in the books:

Entry 1:

|            |                  |        |          |
|------------|------------------|--------|----------|
| Goodwill   | Dr.              | 35,000 |          |
| Net Assets | Dr.              | 65,000 |          |
|            | To Consideration |        | 1,00,000 |

The tax base of goodwill is Nil. Hence the taxable temporary difference is ₹ 35,000. Assuming tax rate to be 30%, deferred tax liability of ₹ 10,500 needs to be created. Now because of recognition of this deferred tax liability, the following entry needs to be passed instead of the above entry:

Entry 2:

|            |                           |        |          |
|------------|---------------------------|--------|----------|
| Goodwill   | Dr.                       | 45,500 |          |
| Net assets | Dr.                       | 65,000 |          |
|            | To Consideration          |        | 1,00,000 |
|            | To Deferred tax liability |        | 10,500   |

The temporary difference now is ₹ 45,500 and not ₹ 35,000 and the resultant

deferred tax liability should be ₹ 13,650 ( $45,500 \times 30\%$ ) and not ₹ 10,500. Thus, deferred tax liability in entry 2 should be increased by ₹ 3,150 which in turn will increase goodwill by a similar amount. This is going to inflate the goodwill since the impact is taken in goodwill itself.

Therefore, no deferred tax liability is to be recognised in the case of taxable temporary difference arising on the initial recognition of goodwill in a business combination in tax jurisdiction where such goodwill is not tax deductible.

- (b) Subsequently at the time of impairment, if required, in the carrying amount:
- (i) This goodwill as per Ind AS 103 is not amortised though tested for impairment.
  - (ii) Subsequent reduction in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill is also regarded as arising from the initial recognition of goodwill and is therefore not recognised.

#### Example 36

In the aforesaid Example 35, after 2 years goodwill is tested for impairment and the entity recognises an impairment loss of ₹ 10,000, the amount of the taxable temporary difference relating to the goodwill is reduced from ₹ 35,000 to ₹ 25,000, with a resulting decrease in the value of the unrecognised deferred tax liability. That decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill and is therefore prohibited from being recognised as per this Ind AS 12.

- **Situation A2: Where it is tax deductible**

In tax jurisdiction, where goodwill is tax deductible, deferred tax liability should be recognised for the taxable temporary difference.

- **Situation B: where the difference is in the nature of deductible difference**

In all cases, deferred tax asset, subject to recognition criteria discussed in step 6 below, should be recognised.

- **Summary of Exception 1**

No deferred tax liability is to be recognised for taxable temporary difference arising on goodwill arising in a business combination in tax jurisdictions where such goodwill is not tax deductible.

In all other cases of temporary difference, either taxable or deferred, either deferred tax liability or deferred tax asset should be recognised in accordance with other provisions of this Ind AS.



**(b) Exception 2: 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)**

- The Standard prohibits recognition of deferred tax liability or deferred tax assets in cases of either taxable or deductible temporary difference arising in a transaction:
  - (a) is not a business combination; and
  - (b) does not affect neither the accounting profit nor the taxable profit.
- As per the Standard, three types of transactions of assets or liabilities could be anticipated:

**Type 1: In the nature of business combination**

In such a case, recognise deferred tax liabilities or deferred tax assets on temporary differences between the carrying amount and respective tax base of assets or liabilities except on goodwill (in certain circumstances)

**Type 2: Where the transaction impacts accounting profit (i.e. statement of profit or loss) (like sale of goods, recognition of debtors)**

In such a case, recognise any deferred tax in statement of profit or loss:

**Type 3: Where the transaction is not a business combination & does not impact accounting profit nor taxable profit, such as purchase of assets or receipt of government grants.**

This exception relates to the transaction of the third type.

**Example 37**

Entity A acquires a foreign made vehicle for ₹ 1,00,000 directly from the vehicle manufacturer. The transaction is not a part of any business combination. The tax laws do not permit any depreciation thereon. Also, any profits at the time of sale are not taxable or losses are not tax deductible. This vehicle thus has a tax base of Nil. There is a taxable temporary difference of ₹ 1,00,000. Assuming a tax rate of 30%, the entity should create a deferred tax liability of ₹ 30,000. But the Standard does not permit.

- The Standard implies that if the carrying amount of any asset or liability is not equal to its tax base at the time of its transaction where the transaction is:
  - (i) Not in the nature of business combination.
  - (ii) Not impacting either the accounting profit or the taxable profit.
  - (iii) Neither deferred tax liability nor deferred tax asset should be recognised.
- The following is a brief checklist:

- (i) Is the transaction in the nature of business combination?
  - (ii) Whether the transaction impacts accounting profit?
  - (iii) Whether the transaction impacts taxable profits?
  - (iv) Whether the carrying amount is equal to tax base?
- Depending on the answers to the checklist, deferred tax asset or liability needs to be determined in accordance with the guidance under this exception.
  - Furthermore, an entity does not recognise subsequent changes in unrecognised deferred tax liability or asset as the asset is depreciated.

**Example 38**

Entity X acquired an intangible asset (a license) for ₹ 10 Cr that has a life of five years. The asset will be solely recovered through use. No tax deductions can be claimed, as the license is amortised or as when the license expires. No tax deductions are available on disposal. Trading profits from using the license will be taxed at 30%.

The tax base of the asset is nil, because the cost of the intangible asset is not deductible for tax purposes (either in use or on disposal). A temporary difference of ₹ 10 Cr arises; prima facie a deferred tax liability of ₹ 3 Cr should be recognized on this amount. However, no deferred tax is recognised on the asset's initial recognition. This is because the temporary difference did not arise from a business combination and did not affect accounting or taxable profit at the time of the recognition.

The asset will have a carrying amount of ₹ 8 Cr at the end of year 1. The entity will pay tax of ₹ 2.40 Cr through recovery of the asset by earning taxable amounts of ₹ 8 Cr. The deferred tax liability is not recognised, because it arises from initial recognition of an asset. Similarly, no deferred tax is recognised in later periods.

**(c) Exception 3: Temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures**

- Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest.
- Such differences may arise in a number of different circumstances, for example:
  - (i) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;

- (ii) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and
- (iii) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

- Should an entity recognise a deferred tax liability in these cases? The guiding principle is:

An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

- (i) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
- (ii) it is probable that the temporary difference will not reverse in the foreseeable future.

Now let us examine where the parent, investor or venture is able to control the timing of reversal of taxable temporary difference. Generally, the taxable temporary difference will get reversed on distribution of dividends.

- **Subsidiary/branches:** As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with that investment (including the temporary differences arising not only from undistributed profits but also from any foreign exchange translation differences). Furthermore, it would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability. The same considerations apply to investments in branches.

*Relevant Extracts from Financial Statements of selected Listed Entities are presented below:*

*Annual Report of Bharti Airtel Ltd. for the year ending 31 March 2022 (Page 358)*

The Group has not recognised deferred tax liability with respect to unremitted retained earnings and associated foreign currency translation reserve with respect to certain of its subsidiaries and joint ventures where the Group is in a position to control the timing of the distribution of profits and it is probable that the subsidiaries will not distribute the profits in the foreseeable future. The taxable temporary difference associated with respect to unremitted retained earnings and associated foreign currency translation reserve is ₹98,427 and ₹79,800 as of March 31, 2022 and March 31, 2021, respectively. The distribution of the same is expected to attract tax in the range of NIL to 20% depending on the tax rates applicable as of March 31, 2022 in the jurisdiction in which the respective Group entity operates.

**(Source: Annual report for 2021-2022 of Bharti Airtel Ltd.)**

The non-monetary assets and liabilities of an entity are measured in its functional currency (see Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*) in the exchange rate which give rise to temporary differences that result in a recognised deferred tax liability or (subject to recognition criteria) asset. The resulting deferred tax is charged or credited to profit or loss.

- **Associate:** An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.
- **Joint Venture:** The arrangement between the parties to a joint venture usually deals with the sharing of the profits and identifies whether decisions on such matters require the consent of all the venturers or a specified majority of the venturers. When the venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred tax liability is not recognised.

The aforesaid discussion related to recognition of deferred tax liability on taxable temporary difference. But there could be deductible temporary differences. So what is the guiding principle for recognition of deferred tax assets on deductible temporary differences?

- The principle is:  
An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that:
  - (i) the temporary difference will reverse in the foreseeable future; and
  - (ii) taxable profit will be available against which the temporary difference can be utilised.
 Both the conditions have to be satisfied.
- In deciding whether a deferred tax asset is recognised for deductible temporary differences associated with its investments in subsidiaries, branches and associates, and its interests in joint ventures, an entity considers the guidance set out in Step 6 below.

### 1.6.6 Step 6: Assess (also reassess) deductible temporary differences, tax losses and tax credits

- (a) As we are aware that deductible temporary differences reduce the taxable profits of future periods. It signifies that future tax payments will be smaller by a particular amount. However, economic benefits will flow to the entity in the form of lower tax liability in future only in case it has future profits. If there are no future profits, it means there are no tax payments which in turn mean that deductible temporary differences are of no benefit.

#### Illustration 2

*The directors of H Ltd. wish to recognise a material deferred tax asset in relation to ₹ 250 Cr of unused trading losses which have accumulated as at 31<sup>st</sup> March 20X1. H Ltd. has budgeted profits for ₹ 80 Cr for the year ended 31<sup>st</sup> March 20X2. The directors have forecast that profits will grow by 20% each year thereafter.*

*However, the market is currently depressed and sales orders are at a lower level for the first quarter of 20X2 than they were for the same period in any of the previous five years. On extrapolating the sales order book, it is noted that the improvement in trading results may occur after the next couple of years to come at the position of breakeven and the budgeted profits shared by the directors of H Ltd. do not appear to be in line with the sales order book. H Ltd. operates under a tax jurisdiction which allows for trading losses to be only carried forward for a maximum of two years.*

*Analyse whether a deferred tax asset can be recognized in the financial statements of H Ltd. for the year ended 31<sup>st</sup> March 20X1?*

**Solution**

In relation to unused trading losses, the carrying amount is zero since the losses have not yet been recognised in the financial statements of H Ltd. A potential deferred tax asset does arise but the determination of the tax base is more problematic.

The tax base of an asset is the amount which will be deductible against taxable economic benefits from recovering the carrying amount of the asset. Where recovery of an asset will have no tax consequences, the tax base is equal to the carrying amount. H Ltd. operates under a tax jurisdiction which only allows losses to be carried forward for two years. The maximum the tax base could be is therefore equal to the amount of unused losses for years 20X0 and 20X1 since these only are available to be deducted from future profits. The tax base though needs to be restricted to the extent that there is a probability of sufficient future profits to offset the trading losses. The directors of H Ltd. should base their forecast of the future profitability on reasonable and supportable assumptions. There appears to be evidence that this is not the case.

H Ltd. has accumulated trading losses and there is little evidence that there will be an improvement in trading results within the next couple of years. The market is depressed and sales orders for the first quarter of 20X2 are below levels in any of the previous five years.

The forecast profitability for 20X2 and subsequent growth rate therefore appear to be unrealistically optimistic.

Given that losses can only be carried forward for a maximum of two years, it is unlikely that any deferred tax asset should be recognised.

Hence, the contention of directors to recognize deferred tax assets in relation to ₹ 250 crores is not correct.

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**Example 39**

Entity A has deductible temporary difference of ₹ 1,00,000 for the financial year ended 31<sup>st</sup> March, 20X1. It anticipates a future profit of ₹ 3,00,000 in next year against which the said deductible temporary differences could be set off. The tax rate is 30%. Thus, in future the entity will pay tax on ₹ 2,00,000 (₹ 3,00,000 – ₹ 1,00,000). The tax liability is ₹ 60,000 @ 30% tax rate.

Had there been no deductible temporary difference, the tax liability would be ₹ 90,000 @ 30% on ₹ 3,00,000. Thus, there is an inflow of economic benefit of ₹ 30,000 through a lower cash outflow.

However, if there is no probability of taxable profits in future, the entity is not able to derive any economic benefit (by way of lower cash outflow in future) because of the existing of deductible temporary difference.

- (b) Therefore, an entity should recognise deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised. This is based on the principle of prudence and conservatism. It should be noted that the entity has to make sufficient taxable profits in future. Not making losses will not suffice.
- (c) If tax law does not impose any restrictions on sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference, an entity assesses a deductible temporary difference in combination with all of its other deductible temporary differences.
- (d) If tax law restricts the utilisation of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences.
- (e) Probable means more likely than not. The Standard provides a three step criteria to be applied in a serial order. The criterion is applied in the case of the same taxable entity assessed by the same taxation authority.

#### Criteria No. 1 : Existence of taxable temporary differences

The entity at the balance sheet should see whether there are sufficient taxable temporary differences whose reversal pattern matches with the reversal profile of deductible temporary differences.

| Particulars                            | Year   |       |       |
|----------------------------------------|--------|-------|-------|
|                                        | 1      | 2     | 3     |
| <u>Taxable temporary difference</u>    |        |       |       |
| Opening balance                        | 10,000 | 5,000 | 2,000 |
| Recognised in taxable income           | 5,000  | 3,000 | 2,000 |
| Closing balance                        | 5,000  | 2,000 | -     |
| <u>Deductible temporary difference</u> |        |       |       |
| Opening balance                        | 8,000  | 4,000 | 1,000 |
| Recognised in taxable income           | 4,000  | 3,000 | 1,000 |
| Closing balance                        | 4,000  | 1,000 | -     |
| <u>Statement of taxable income</u>     |        |       |       |
| Taxable temporary difference           | 5,000  | 3,000 | 2,000 |
| Deductible temporary difference        | 4,000  | 3,000 | 1,000 |

The entity can recognise deferred tax assets for the entire deductible temporary differences.

**Example 40**

As at 31<sup>st</sup> March, 20X1, an entity has both taxable temporary differences and deductible temporary difference with the following reversal pattern. Deductible temporary differences cannot be carried forward.

| Particulars                            | Year   |       |       |
|----------------------------------------|--------|-------|-------|
|                                        | 1      | 2     | 3     |
| <u>Taxable temporary difference</u>    |        |       |       |
| Opening balance                        | 10,000 | 5,000 | 2,000 |
| Recognized in taxable income           | 5,000  | 3,000 | 2,000 |
| Closing balance                        | 5,000  | 2,000 | -     |
| <u>Deductible temporary difference</u> |        |       |       |
| Opening balance                        | 8,000  | 4,000 | -     |
| Recognized in taxable income           | 4,000  | 4,000 | -     |
| Closing balance                        | 4,000  | -     | -     |
| <u>Statement of taxable income</u>     |        |       |       |
| Taxable temporary difference           | 5,000  | 3,000 | 2,000 |
| Deductible temporary difference        | 4,000  | 4,000 | -     |

The entity can recognize deferred tax assets for the deductible temporary differences up to ₹ 7,000 (₹ 4,000 for year 1 & ₹ 3,000 for year 2) as a taxable temporary difference of that amount is available.

**Criteria No. 2: Probability of future profits**

The entity has to apply probability criteria on its future profitability. If it is probable that there will be sufficient taxable profits, then to the extent of available profits, deductible temporary differences should be applied for recognition of deferred tax assets.

**Examples 41- 43**

41. If in the aforesaid example 40, the entity expects a profit of ₹ 750 in year 2, then deferred tax asset should be created on ₹ 7,750 (₹ 4,000 + ₹ 3,000 + ₹ 750).

However, taxable profits arising in future from future origination of deductible temporary differences should not be considered as deductible temporary differences will require future taxable profits for utilisation.

42. An entity has unutilised deductible temporary difference of ₹ 1,000 at the end of year 1 that is going to be reversed in the year 2. In year 2, taxable profits are computed because of tax disallowances of unpaid statutory liabilities of ₹ 1,000 which can be claimed as deduction only in year 3, if paid, but cannot be carried forward. The entity expects nil taxable profit in year 3. In this case, no deferred tax asset will be created.



43. An entity has unutilised deductible temporary difference of ₹ 1,000 at the end of year 1 that is going to be reversed in the year 2. In year 2, taxable profits are computed because of tax disallowances of unpaid statutory liabilities of ₹ 1,000 which can be claimed as deduction only in year 3, if paid, but cannot be carried forward. The entity expects taxable profit of ₹ 450 in year 3. In this case, deferred tax asset will be created at appropriate rate on deductible temporary difference of ₹ 450 only.

### Criteria No. 3: Availability of tax planning opportunities

If even after applying criteria no. 2, still there are unrecognised deductible temporary differences, the entity endeavour to see whether any tax planning opportunities are available.

Tax planning opportunities are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carry forward.

For example, in some jurisdictions, taxable profit may be created or increased by:

- (i) electing to have interest income taxed on either a received or receivable basis;
- (ii) deferring the claim for certain deductions from taxable profit;
- (iii) selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation; and
- (iv) selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or tax credit carry forward still depends on the existence of future taxable profit from sources other than future originating temporary differences.

(d) Unused tax losses and unused tax credits:

- A deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.
- The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused

tax credits can be utilised by the entity. In such circumstances, paragraph 82 of Ind AS 12 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

(e) When an entity has a history of recent losses, the entity should consider the following guidance:

- The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences.
- However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.
- In such circumstances, this Ind AS requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.
- To assess the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the entity should consider the following:
  - (i) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;
  - (ii) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;
  - (iii) whether the unused tax losses result from identifiable causes which are unlikely to recur; and
  - (iv) whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.
- To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not to be recognised.

(f) Reassessment of unrecognised Deferred Tax Assets:

- At the end of each reporting period, the entity should reassess unrecognised deferred tax assets. It may need to recognise a previously unrecognised deferred tax asset to

the extent it has now become probable that future taxable profits will be available for deferred tax assets to be recovered. For example, improvement in trading conditions may make it probable for an entity to generate sufficient taxable profits in future years to enable it to meet the recognition criteria laid down above.

(g) Uncertainty over income tax treatment

- ◆ In assessing whether and how an uncertain tax treatment affects the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates, an entity shall assume that a taxation authority will examine amounts it has a right to examine and have full knowledge of all related information when making those examinations.
- ◆ If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.
- ◆ If an entity concludes it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates. An entity shall reflect the effect of uncertainty for each uncertain tax treatment by using either of the following methods, depending on which method the entity expects to better predict the resolution of the uncertainty:
  - (a) The most likely amount—the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value.
  - (b) The expected value—the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.
- ◆ If an uncertain tax treatment affects current tax and deferred tax (for example, if it affects both taxable profit used to determine current tax and tax bases used to determine deferred tax), an entity shall make consistent judgements and estimates for both current tax and deferred tax.

**Comparison to AS 22:**

**Para 15:** *Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.*

**Para 16:** *While recognising the tax effect of timing differences, consideration of prudence cannot*

be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future.

**Para 17:** Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Ind AS 12 and AS 22 both require exercise of prudence while recognizing deferred tax assets. However, AS 22 emphasizes on virtual certainty supported by convincing evidence for recognizing deferred tax asset, whereas Ind AS 12 requires only probable existence of taxable profit against which deductible temporary differences can be utilized. Thus, the requirement of recognizing deferred tax asset under AS 22 is very strict (virtual certainty moves towards more than 95% certainty through evidence such as a strong order book for the future, firm orders in hand etc.), whereas under Ind AS 12, the same is more realistic focusing only on probable existence of taxable profits. Ind AS 12 moves to exercise caution only in case of unused tax losses, where it specifies that deferred tax asset arising from unused tax losses or tax credits can be recognized only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.

### 1.6.7 Step 7: Determine the tax rate (law)

- (a) Having determined the taxable temporary differences and deductible temporary difference that needs to be considered for recognition of deferred tax liabilities or assets respectively, we now need to determine the tax for creation to deferred tax liabilities or assets. The principal is:

Deferred tax assets and liabilities shall be measured:

- (i) at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled;
  - (ii) based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.
- (b) We have already discussed above the meaning of 'enacted' or 'substantively enacted'.

The same discussion applies here also. But another key word that needs to be understood in the principle is 'expected to apply'. Since, we are dealing in the future and future is uncertain, we have to measure this uncertainty. This leads to application of judgment. The tax rates or the tax laws that will apply in future depends on various factors such as manner

of recovery of asset or settlement of liability, levels of income, distribution of profits among others. These are now discussed below.

It should however be remembered 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.

(c) Manner of recovery of asset or settlement of liability:

- In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and (b) the tax base of the asset (liability). In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

**Examples 44 & 45**

44. An asset has a carrying amount of ₹ 100 and a tax base of ₹ 60. A tax rate of 20% would apply if the asset was sold and a tax rate of 30% would apply to other income.

The entity recognises a deferred tax liability of ₹ 8 (₹ 40 at 20%) if it expects to sell the asset without further use or a deferred tax liability of ₹ 12 (₹ 40 at 30%) if it expects to retain the asset and recover its carrying amount through use.

45. An asset with a cost of ₹ 100 and a carrying amount of ₹ 80 is revalued to ₹ 150. No equivalent adjustment is made for tax purposes. Accumulated depreciation for tax purposes is ₹ 30 and the tax rate is 30%. If the asset's sale proceeds exceeds the cost (₹ 100), a gain of only ₹ 30 (being the cumulative tax depreciation of ₹ 30 claimed) will be included in taxable income but sale proceeds in excess of cost (₹ 100) will not be taxable.

The tax base of the asset is ₹ 70 and there is a taxable temporary difference of ₹ 80 (₹ 150 the revalued amount is the carrying amount).

If the entity expects to recover the carrying amount by using the asset, it must generate taxable income of ₹ 150, but will only be able to deduct depreciation of ₹ 70. On this basis, there is a deferred tax liability of ₹ 24 (₹ 80 at 30%).

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of ₹ 150, the deferred tax liability is computed as follows:

|      |                                         |   |     |
|------|-----------------------------------------|---|-----|
| (i)  | Sale proceeds                           | ₹ | 150 |
| (ii) | Sale proceeds in excess of cost (₹ 100) | ₹ | 50  |

|       |                              |   |     |
|-------|------------------------------|---|-----|
| (iii) | Taxable proceeds             | ₹ | 100 |
| (iv)  | Tax base                     | ₹ | 70  |
| (v)   | Taxable temporary difference | ₹ | 30  |
| (vi)  | Tax rate                     |   | 30% |
| (vii) | Deferred tax liability       | ₹ | 9   |

- Thus, 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.
- However, an issue may arise as to how to interpret the term 'recovery' in relation to an asset that is not depreciated (non-depreciable asset) and is revalued in accordance with paragraph 31 (revaluation model) of Ind AS 16.
- **The accounting principle in this case is as under:**
  - ◆ The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset in accordance with paragraph 31 of Ind AS 16 shall be measured on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset.
  - ◆ Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate (tax rate applicable to the taxable amount derived from the sale of an asset) is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

(d) Levels of taxable income:

When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse.

(e) Distribution of dividends:

In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. *In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.*

**Example 46**

The following example deals with the measurement of current and deferred tax assets and liabilities for an entity in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50%) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35%. At the end of the reporting period, 31<sup>st</sup> December, 20X1, the entity does not recognise a liability for dividends proposed or declared after the reporting period. As a result, no dividends are recognised in the year 20X1. Taxable income for 20X1 is ₹ 1,00,000. The net taxable temporary difference for the year 20X1 is ₹ 40,000.

The entity recognises a current tax liability and a current income tax expense of ₹ 50,000. No asset is recognised for the amount potentially recoverable as a result of future dividends. The entity also recognises a deferred tax liability and deferred tax expense of ₹ 20,000 (₹ 40,000 at 50%) representing the income taxes that the entity will pay when it recovers or settles the carrying amounts of its assets and liabilities based on the tax rate applicable to undistributed profits.

Subsequently, on 15<sup>th</sup> March, 20X2 the entity recognises dividends of ₹ 10,000 from previous operating profits as a liability.

On 15<sup>th</sup> March, 20X2, the entity recognises the recovery of income taxes of ₹ 1,500 (15% of the dividends recognised as a liability) as a current tax asset and as a reduction of current income tax expense for 20X2.

### 1.6.8 Step 8: Calculate and recognise deferred tax

- (a) This is the simplest of all steps. Having determined the taxable temporary differences and the deductible temporary differences as per Step 6 and the applicable tax rates with reference to tax laws, one has to multiply amount determined in Step 6 with the rates determined in Step 7.
  - Taxable temporary differences when multiplied with tax rates will lead to deferred tax liabilities.
  - Deductible temporary differences when multiplied with rates will lead to deferred tax assets.
- (b) The following should be kept in mind:
  - Deferred tax liabilities or assets should not be discounted.
  - The carrying amount of a deferred tax asset shall be reviewed at the end of each reporting period.
  - An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit

of part or all of that deferred tax asset to be utilised.

- Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.

### 1.6.9 Step 9: Accounting of deferred tax

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- (a) The accounting of deferred tax effects of a transaction of an event is consistent with the accounting for that transaction or event.
- (b) A transaction and the deferred tax effects of a transaction may be accounted for in:
  - Statement of profit and loss;
  - Outside profit and loss account:
    - (i) In other comprehensive income such as revaluation amount in accordance with Ind AS 16, *Property, Plant and Equipment*
    - (ii) Directly in equity such as correction of an error in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.
- (c) However, the carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences.
  - This can result, for example, from:
    - a change in tax rates or tax laws;
    - a reassessment of the recoverability of deferred tax assets; or
    - a change in the expected manner of recovery of an asset.
  - In such cases, the resulting deferred tax is recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss.
- (d) In exceptional circumstances, it may be difficult to determine the amount of current and deferred tax that relates to items recognised outside profit or loss (either in other comprehensive income or directly in equity).
  - This may be the case, for example, when a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss; or
  - In such cases, the current and deferred tax related to items that are recognised outside profit or loss are based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.
- (e) Ind AS 16 does not specify whether an entity should transfer each year from revaluation surplus to retained earnings an amount equal to the difference between the depreciation or



amortisation on a revalued asset and the depreciation or amortisation based on the cost of that asset.

- If an entity makes such a transfer, the amount transferred is net of any related deferred tax.
  - Similar considerations apply to transfers made on disposal of an item of property, plant or equipment.
- (f) When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment of the tax base are recognised in other comprehensive income in the periods in which they occur.
- (g) When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends to taxation authorities on behalf of shareholders. In many jurisdictions this amount is referred to as a withholding tax. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends.

### **1.6.10 Step 10: Offsetting deferred tax assets and deferred tax liabilities**

- (a) An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:
- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
  - the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
    - (i) the same taxable entity; or
    - (ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.
- (b) To avoid the need for detailed scheduling of the timing of the reversal of each temporary difference, this Standard requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.
- (c) In rare circumstances, an entity may have a legally enforceable right of set off, and an intention to settle net, for some periods but not for others. In such rare circumstances, detailed scheduling may be required to establish reliably whether the deferred tax liability of one taxable entity will result in increased tax payments in the same period in which a deferred

tax asset of another taxable entity will result in decreased payments by that second taxable entity.

### Illustration 3

On 1<sup>st</sup> April 20X1, S Ltd. leased a machine over a 5 year period. The present value of lease liability is ₹ 120 Cr (discount rate of 8%) and is recognized as lease liability and corresponding Right of Use (RoU) Asset on the same date. The RoU Asset is depreciated under straight line method over the 5 years. The annual lease rentals are ₹ 30 Cr payable starting 31<sup>st</sup> March 20X2. The tax law permits tax deduction on the basis of payment of rent.

Assuming tax rate of 30%, you are required to explain the deferred tax consequences for the above transaction for the year ended 31<sup>st</sup> March 20X2.

### Solution

A temporary difference effectively arises between the value of the machine for accounting purposes and the amount of lease liability, since the rent payment is eligible for tax deduction.

Tax base of the machine is nil as the amount is not eligible for deduction for tax purposes.

Tax base of the lease liability is nil as it is measured at carrying amount less any future tax deductible amount

### Recognition of deferred tax on 31<sup>st</sup> March 20X2:

Carrying amount in balance sheet

|                                           |            |
|-------------------------------------------|------------|
| RoU Asset (120 Cr – 24 Cr (Depreciation)) | ₹ 96.00 Dr |
|-------------------------------------------|------------|

|                                                          |            |
|----------------------------------------------------------|------------|
| Lease Liability (120 Cr + 9.60 Cr (120 Cr x 8%) - 30 Cr) | ₹ 99.60 Cr |
|----------------------------------------------------------|------------|

|                   |                  |
|-------------------|------------------|
| <b>Net Amount</b> | <b>₹ 3.60 Cr</b> |
|-------------------|------------------|

|          |           |
|----------|-----------|
| Tax Base | ₹ 0.00 Cr |
|----------|-----------|

|                                   |           |
|-----------------------------------|-----------|
| Temporary Difference (deductible) | ₹ 3.60 Cr |
|-----------------------------------|-----------|

|                                                       |           |
|-------------------------------------------------------|-----------|
| Deferred Tax asset to be recognized (₹ 3.60 Cr x 30%) | ₹ 1.08 Cr |
|-------------------------------------------------------|-----------|

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## 1.7 PART D: PRACTICAL APPLICATION

### 1.7.1 Deferred tax arising from a business combination

- (a) As discussed above, temporary differences may arise in a business combination. In accordance with Ind AS 103, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and deferred

tax liabilities affect the amount of goodwill or the bargain purchase gain the entity recognises. However, in accordance with this Ind AS, in certain circumstances, an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.

#### Illustration 4

On 1<sup>st</sup> April 20X1, A Ltd. acquired 12 Cr shares (representing 80% stake) in B Ltd. by means of a cash payment of ₹ 25 Cr. It is the group policy to value the non-controlling interest in subsidiaries at the date of acquisition at fair value. The market value of an equity share in B Ltd. at 1<sup>st</sup> April 20X1 can be used for this purpose. On 1<sup>st</sup> April 20X1, the market value of a B Ltd. share was ₹ 2.00

On 1<sup>st</sup> April 20X1, the individual financial statements of B Ltd. showed the net assets at ₹ 23 Cr.

The directors of A Ltd. carried out a fair value exercise to measure the identifiable assets and liabilities of B Ltd. at 1<sup>st</sup> April 20X1. The following matters emerged:

- Property having a carrying value of ₹ 15 Cr at 1<sup>st</sup> April 20X1 had an estimated market value of ₹ 18 Cr at that date.
- Plant and equipment having a carrying value of ₹ 11 Cr at 1<sup>st</sup> April 20X1 had an estimated market value of ₹ 13 Cr at that date.
- Inventory in the books of B Ltd. is shown at a cost of ₹ 2.50 Cr. The fair value of the inventory on the acquisition date is ₹ 3 Cr.

The fair value adjustments have not been reflected in the individual financial statements of B Ltd. In the consolidated financial statements, the fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

Assume that the current book value (prior to fair valuation exercise under Ind AS 103) equals the tax base.

Calculate the deferred tax impact on above and calculate the goodwill arising on acquisition of B Ltd.

#### Solution

##### Computation of Net Assets of B Ltd.

|                                                                |            |
|----------------------------------------------------------------|------------|
| As per books                                                   | ₹ 23.00 Cr |
| Add: Fair value differences not recognized in books of B Ltd.: |            |
| Property (18 Cr – 15 Cr)                                       | ₹ 3.00 Cr  |
| Plant and Equipment (13 Cr – 11 Cr)                            | ₹ 2.00 Cr  |

|                                                                       |                     |
|-----------------------------------------------------------------------|---------------------|
| Inventory (3 Cr – 2.5 Cr)                                             | <u>₹ 0.50 Cr</u>    |
|                                                                       | ₹ 28.5 Cr           |
| Less: Deferred tax liability on fair value difference @ 20%           |                     |
| [(3 Cr + 2 Cr + 0.50 Cr) x 20%]                                       | <u>(₹ 1.10 Cr)</u>  |
| Total Net Assets at Fair Value                                        | <u>₹ 27.40 Cr</u>   |
| <b>Computation of Goodwill:</b>                                       |                     |
| Purchase Consideration                                                | ₹ 25.00 Cr          |
| Add: Non-Controlling Interest [(12 Cr x (20% / 80%)) x ₹ 2 per share] | <u>₹ 6.00 Cr</u>    |
|                                                                       | ₹ 31.00 Cr          |
| Less: Net Assets at Fair Value                                        | <u>(₹ 27.40 Cr)</u> |
| Goodwill on acquisition date                                          | <u>₹ 3.60 Cr</u>    |

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- (b) As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as a result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination.
- (c) The potential benefit of the acquiree's income tax loss carry forwards or other deferred tax assets might not satisfy the criteria for separate recognition when a business combination is initially accounted for but might be realised subsequently. An entity shall recognise acquired deferred tax benefits that it realises after the business combination as follows:
- ◆ Acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in other comprehensive income and accumulated in equity as capital reserve or recognised directly in capital reserve, depending on whether paragraph 34 or paragraph 36A of Ind AS 103 would have applied had the measurement period adjustments been known on the date of acquisition itself.

- ◆ All other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).

### 1.7.2 Current and deferred tax arising from share-based payment transactions

- (a) In some tax jurisdictions, an entity receives a tax deduction (i.e., an amount that is deductible in determining taxable profit) that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for the consumption of employee services received as consideration for share options granted, in accordance with Ind AS 102, *Share-based Payment*, and not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise.
- (b) As with the preliminary expenses, the difference between the tax base of the employee services received to date (being the amount permitted as a deduction in future periods under taxation laws), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. If the amount permitted as a deduction in future periods under taxation laws is not known at the end of the period, it shall be estimated, based on information available at the end of the period. For example, if the amount permitted as a deduction in future periods under taxation laws is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period.
- (c) As noted above, in (a), the amount of the tax deduction or estimated future tax deduction, measured in accordance with paragraph (b) above may differ from the related cumulative remuneration expense. This Standard requires that current and deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from (a) a transaction or event that is recognised, in the same or a different period, outside profit or loss, or (b) a business combination. If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity.

#### Illustration 5

On 1<sup>st</sup> April 20X1, P Ltd. had granted 1 Cr share options worth ₹ 4 Cr s(fair value) subject to a two-year vesting period. The income tax law permits a tax deduction at the exercise date of the intrinsic value of the options. The intrinsic value of the options at 31<sup>st</sup> March 20X2 was ₹ 1.60 Cr and at 31<sup>st</sup> March 20X3 was ₹ 4.60 Cr. The increase in the fair value of the options on 31<sup>st</sup> March 20X3 was not foreseeable at 31<sup>st</sup> March 20X2. The options were exercised at 31<sup>st</sup> March 20X3.

*Give the accounting for the above transaction for deferred tax for period ending 31<sup>st</sup> March, 20X2 and 31<sup>st</sup> March, 20X3. Assume that there are sufficient taxable profits available in future against any deferred tax assets. Tax rate of 30% is applicable to P Ltd.*

**Solution:**

**On 31<sup>st</sup> March 20X2:**

The tax benefit is calculated as under:

|                                                                 |           |
|-----------------------------------------------------------------|-----------|
| Carrying amount of Share based payment                          | ₹ 0.00 Cr |
| Tax Base of Share based payment (₹ 1.60 Cr x ½)                 | ₹ 0.80 Cr |
| Temporary Difference (Carrying amount – tax base)               | ₹ 0.80 Cr |
| Deferred Tax Asset recognized (Temporary Difference x Tax rate) |           |
| (0.80 Cr x 30%)                                                 | ₹ 0.24 Cr |

**Journal Entry for above:**

|                    |     |           |           |
|--------------------|-----|-----------|-----------|
| Deferred Tax Asset | Dr. | ₹ 0.24 Cr |           |
| To Tax Expense     |     |           | ₹ 0.24 Cr |

(Being DTA recognized on equity option)

**On 31<sup>st</sup> March 20X3:**

The options have been exercised and a current tax benefit will be available to the entity on the basis of intrinsic value of ₹ 4.60 Cr. Initially recognized deferred tax asset will no longer be required.

The accounting entry will be done as under:

|                       |     |           |           |
|-----------------------|-----|-----------|-----------|
| Tax Expense           | Dr. | ₹ 0.24 Cr |           |
| To Deferred Tax Asset |     |           | ₹ 0.24 Cr |

(Being DTA reversed on the exercise of the option)

\*\*\*\*\*

### 1.7.3 Change in tax status of an entity or its shareholders

- (a) A change in the tax status of an entity or of its shareholders may have consequences for an entity by increasing or decreasing its tax liabilities or assets. This may, for example, occur upon the public listing of an entity's equity instruments or upon the restructuring of an entity's equity. It may also occur upon a controlling shareholder's move to a foreign country. As a result of such an event, an entity may be taxed differently; it may for example gain or lose tax incentives or become subject to a different rate of tax in the future.

- (b) A change in the tax status of an entity or its shareholders may have an immediate effect on the entity's current tax liabilities or assets. The change may also increase or decrease the deferred tax liabilities and assets recognised by the entity, depending on the effect the change in tax status has on the tax consequences that will arise from recovering or settling the carrying amount of the entity's assets and liabilities.
- (c) The issue is how an entity should account for the tax consequences of a change in its tax status or that of its shareholders.
- (d) The accounting principles that should be adopted in this situation are as under:
  - ◆ A change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognised outside profit or loss.
  - ◆ The current and deferred tax consequences of a change in tax status shall be included in profit or loss for the period,
    - unless those consequences relate to transactions and events that result,
    - in the same or a different period,
    - in a direct credit or charge to the recognised amount of equity or in amounts recognised in other comprehensive income.
  - ◆ Those tax consequences that relate to changes in the recognised amount of equity, in the same or a different period (not included in profit or loss), shall be charged or credited directly to equity.
  - ◆ Those tax consequences that relate to amounts recognised in other comprehensive income shall be recognised in other comprehensive income.



## 1.8 PART E: DISCLOSURES

This Ind AS not only deals with recognition and measurement of income-taxes but also requires quite a few disclosures with respect to these income tax. These are discussed as under.

### 1.8.1 Disclosure 1: Disclose components of tax expenses (income)

- (a) Each of the major components of tax expense (income) is to be disclosed separately.
- (b) As we know, tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax. The tax expense (income) related to profit or loss or loss from ordinary activities shall be presented in statement of profit or loss.

- (c) The components of tax expense (income) include:
- ◆ current tax expense (income);
  - ◆ any adjustments recognised in the period for current tax of prior periods;
  - ◆ the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
  - ◆ the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
  - ◆ the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
  - ◆ the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;
  - ◆ deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset; and
  - ◆ the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with Ind AS 8, because they cannot be accounted for retrospectively.

### **1.8.2 Disclosure 2: Tax related to items charged directly to equity**

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- (a) Indian Accounting Standards require or permit particular items to be credited or charged directly to equity.
- (b) Examples of such items are:
- ◆ an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*); and
  - ◆ amounts arising on initial recognition of the equity component of a compound financial instrument (see paragraph 23).
- (c) The current and deferred tax relating to these items have to be recognised and accounted for directly in equity.
- (d) This Ind AS requires disclosure of the aggregate current and deferred tax relating to items that are charged or credited directly to equity.



### 1.8.3 Disclosure 3: Tax related to items recognised in statement of other comprehensive income

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- (a) Indian Accounting Standards require or permit particular items to be recognised in other comprehensive income.
- (b) Examples of such items are:
  - ◆ a change in carrying amount arising from the revaluation of property, plant and equipment (see Ind AS 16); and
  - ◆ exchange differences arising on the translation of the financial statements of a foreign operation (see Ind AS 21).
- (c) The current and deferred tax relating to these items have to be recognised and accounted for in the statement of other comprehensive income.
- (d) This Ind AS requires disclosure of the amount of income tax relating to each component of other comprehensive income.

### 1.8.4 Disclosure 4: Explanation of the relationship between tax expense (income) and accounting profit

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- (a) In ideal situation, if accounting profit is say ₹ 100 and tax rate is 30%, the tax expense should be ₹ 30. But this is seldom the case due to differences in accounting principles and standards vis-a-vis tax laws.
- (b) Therefore, this Standard requires an explanation to be disclosed of the relationship between tax expense (income) and accounting profit in either or both of the following forms:
  - ◆ a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
  - ◆ a numerical reconciliation between the average effective tax rate (tax expense divided by the accounting profit) and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

#### Example 47

An entity has made an accounting profit of ₹ 1,00,000. The tax rate is 30%. In computing the accounting profit, a penalty of ₹ 10,000 has been considered which is not tax deductible. There are no other tax impacts. In this case, the taxable profits are ₹ 1,10,000 (₹ 1,00,000 + ₹ 10,000) and tax expense @ 30% is ₹ 33,000.

The two types of disclosures are as under:

| Particulars                                                                               | Amount (₹ )     |
|-------------------------------------------------------------------------------------------|-----------------|
| Accounting profit                                                                         | <u>1,00,000</u> |
| Tax at the applicable tax rate of 30%                                                     | 30,000          |
| Tax effect of expenses that are not deductible in determining taxable profits:            |                 |
| Penalties                                                                                 | <u>3,000</u>    |
| Tax expense                                                                               | <u>33,000</u>   |
| The effective tax rate is as per the national income-tax rate.                            |                 |
| Particulars                                                                               | %               |
| Applicable tax rate                                                                       | 30              |
| Tax effect of expenses that are not deductible in determining taxable profits - Penalties | <u>3</u>        |
| Average effective tax rate                                                                | <u>33</u>       |
| The effective tax rate is as per the national income-tax rate.                            |                 |

- (c) These disclosures enable users of financial statements to understand whether the relationship between tax expense (income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in the future. The relationship between tax expense (income) and accounting profit may be affected by such factors as revenue that is exempt from taxation, expenses that are not deductible in determining taxable profit (tax loss), the effect of tax losses and the effect of foreign tax rates.
- (d) In explaining the relationship between tax expense (income) and accounting profit, an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial statements. Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss).

Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

1. Annual Report of Reliance Industries Ltd. for the year ending 31<sup>st</sup> March 2022 (Page 335):

|                                                                | (₹ in crore)                   |                                |
|----------------------------------------------------------------|--------------------------------|--------------------------------|
|                                                                | Year ended<br>31st March, 2022 | Year ended<br>31st March, 2021 |
| <b>12. Taxation</b>                                            |                                |                                |
| <b>Tax Expenses Recognised in Statement of Profit and Loss</b> |                                |                                |
| Current tax                                                    | 787                            | -                              |
| Deferred tax                                                   | 6,915                          | (4,732)                        |
| <b>Tax expenses recognised in the current year</b>             | <b>7,702</b>                   | <b>(4,732)</b>                 |

|                                                                                                              | (₹ in crore)                   |                                |
|--------------------------------------------------------------------------------------------------------------|--------------------------------|--------------------------------|
|                                                                                                              | Year ended<br>31st March, 2022 | Year ended<br>31st March, 2021 |
| <b>Tax expenses for the year can be reconciled to the accounting profit as follows:</b>                      |                                |                                |
| Profit Before Tax and Exceptional Items                                                                      | 46,786                         | 22,908                         |
| Applicable Tax Rate                                                                                          | 34.944%                        | 34.944%                        |
| Computed Tax Expense                                                                                         | 16,349                         | 8,005                          |
| <b>Tax Effect of:</b>                                                                                        |                                |                                |
| Exempted income                                                                                              | (1,574)                        | (133)                          |
| Expenses disallowed                                                                                          | 5,716                          | 4,910                          |
| Additional allowances net of MAT Credit                                                                      | (19,704)                       | (12,782)                       |
| <b>Current Tax Provision (A)</b>                                                                             | <b>787</b>                     | <b>-</b>                       |
| Incremental Deferred tax Liability/(Asset) on account of Property, Plant and Equipment and Intangible Assets | 771                            | 2,354                          |
| Incremental Deferred tax Liability / (Asset) on account of Financial Assets and Other Items                  | 6,144                          | (7,086)                        |
| <b>Deferred Tax Provision (B)</b>                                                                            | <b>6,915</b>                   | <b>(4,732)</b>                 |
| <b>Tax Expenses Recognised in Statement of Profit and Loss (A+B)</b>                                         | <b>7,702</b>                   | <b>(4,732)</b>                 |
| <b>Effective Tax Rate</b>                                                                                    | <b>16.46%</b>                  | <b>-</b>                       |
| <b>Tax on Exceptional Item *</b>                                                                             | <b>(6,386)</b>                 | <b>(14,062)</b>                |

\* Refer Note 32.

(Source: Annual report for 2021-2022 of Reliance Industries Ltd.)

2. Annual Report of Hindustan Unilever Ltd. for the year ending 31<sup>st</sup> March 2022 (Page 160)

#### B. Reconciliation of Effective Tax Rate

The reconciliation between the statutory income tax rate applicable to the Company and the effective income tax rate of the Company is as follows:

|                                                          | Year ended<br>31st March, 2022 | Year ended<br>31st March, 2021 |
|----------------------------------------------------------|--------------------------------|--------------------------------|
| <b>Statutory income tax rate applicable for the year</b> | <b>25.2%</b>                   | <b>25.2%</b>                   |
| Differences due to:                                      |                                |                                |
| Expenses not deductible for tax purposes                 | 1.0%                           | 1.1%                           |
| Income exempt from income tax                            | -0.3%                          | -0.2%                          |
| Others*                                                  | -1.0%                          | -1.9%                          |
| <b>Effective tax rate</b>                                | <b>24.9%</b>                   | <b>24.2%</b>                   |

\* Others include prior period adjustment tax refunds and tax on exceptional items.

(Source: Annual report for 2021-2022 of Hindustan Unilever Ltd.)

3. Annual Report of Larsen & Toubro Ltd. for the year ending 31<sup>st</sup> March 2022 (Page 438)

**[NOTE 44]**

Disclosure pursuant to Ind AS 12 "Income Taxes": (contd.)

(b) Reconciliation of tax expense and the accounting profit multiplied by domestic tax rate applicable in India:

|         |                                                                                                            | ₹ crore  |          |
|---------|------------------------------------------------------------------------------------------------------------|----------|----------|
| Sr. No. | Particulars                                                                                                | 2021-22  | 2020-21  |
| (1)     | Profit before tax from:                                                                                    |          |          |
|         | Continuing Operations (including exceptional items)                                                        | 10031.47 | 5318.73  |
|         | Discontinued Operations                                                                                    | –        | 11199.23 |
|         |                                                                                                            | 10031.47 | 16517.96 |
| (2)     | Corporate tax rate as per Income Tax Act, 1961                                                             | 25.17%   | 25.17%   |
| (3)     | Tax on Accounting profit (3)=(1)*(2)                                                                       | 2524.72  | 4157.24  |
| (4)     | (i) Tax on expenses not tax deductible:                                                                    |          |          |
|         | (A) Corporate social responsibility                                                                        | 33.14    | 39.08    |
|         | (B) Tax on employee perquisites borne by the Company                                                       | 3.04     | 2.52     |
|         | (ii) Tax effect on impairment recognised on which deferred tax asset is not recognised                     | –        | 795.33   |
|         | (iii) Effect of current tax related to earlier years                                                       | 3.08     | 5.73     |
|         | (iv) Effect of lower tax rate on long term capital gains                                                   | (12.96)  | (266.65) |
|         | (v) Tax effect of losses in joint operation of current year on which no deferred tax benefit is recognised | 3.48     | 6.95     |
|         | (vi) Effect of deduction with respect to dividend income                                                   | (407.49) | (260.34) |
|         | (vii) Reversal of deferred tax on brought forward losses on utilisation as set off against gains           | –        | 103.51   |
|         | (viii) Tax effect on various other items                                                                   | 5.01     | 136.80   |
|         | Total effect of tax adjustments [(i) to (viii)]                                                            | (372.70) | 562.93   |
| (5)     | Tax expense recognised during the year (5)=(3)+(4)                                                         | 2152.02  | 4720.17  |
| (6)     | Effective tax Rate (6)=(5)/(1)                                                                             | 21.45%   | 28.58%   |

(Source: Annual report for 2021-2022 of Larsen & Toubro Ltd.)

4. Annual Report of SpiceJet Ltd. for the year ending 31<sup>st</sup> March 2022 (Page 110)

**52. Income tax expense**

Reconciliation of tax expense and the accounting profit multiplied by India's domestic tax rate for March 31, 2022 and March 31, 2021 :

| Particulars                                                                                                    | Year ended<br>March 31, 2022 | Year ended<br>March 31, 2021 |
|----------------------------------------------------------------------------------------------------------------|------------------------------|------------------------------|
| <b>Accounting loss before income tax</b>                                                                       | <b>(17,254.65)</b>           | <b>(9,983.02)</b>            |
| Loss before income tax multiplied by standard rate of corporate tax in India 25.168% (March 31, 2021: 25.168%) | (4,342.65)                   | (2,512.53)                   |
| <b>Effects of:</b>                                                                                             |                              |                              |
| Non-deductible expenses for tax purposes                                                                       | (824.72)                     | (485.40)                     |
| Set-off of brought forward losses                                                                              | 5,167.37                     | 2,997.92                     |
| <b>Net effective income tax</b>                                                                                | <b>-</b>                     | <b>-</b>                     |

(Source: Annual report for 2021-2022 of SpiceJet Ltd.)

- (e) However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. The following example illustrates how the selection of the applicable tax rate affects the presentation of the numerical reconciliation.

**Example 48**

In 20X2, an entity has accounting profit in its own jurisdiction (country A) of ₹ 1,500 (20X1:

₹ 2,000) and in country B of ₹ 1,500 (20X1: ₹ 500). The tax rate is 30% in country A and 20% in country B. In country A, expenses of ₹ 100 (20X1: ₹ 200) are not deductible for tax purposes.

The following reconciliation will be prepared:

| Particulars                                                     | Amount (₹ ) |       |
|-----------------------------------------------------------------|-------------|-------|
|                                                                 | 20X2        | 20X1  |
| Accounting profit                                               | 3,000       | 2,500 |
| Tax at the domestic rate of 30%                                 | 900         | 750   |
| Tax effect of expenses that are not deductible for tax purposes | 30          | 60    |
| Effect of lower tax rates in country B                          | (150)       | (50)  |
| Tax expense                                                     | 780         | 760   |

Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

Annual Report of Bharti Airtel Ltd. for the year ending 31<sup>st</sup> March 2022 (Page 357):

The impact of different tax rates is disclosed separately in Consolidated Financial Statements whose extract is given below [10th line item with amounts of ₹ 2,594 and ₹ (13,887)]:

The reconciliation between the amount computed by applying the statutory income tax rate to the loss before tax and the income tax charge is summarised below:

|                                                                          | For the year ended<br>March 31, 2022 | For the year ended<br>March 31, 2021 |
|--------------------------------------------------------------------------|--------------------------------------|--------------------------------------|
| Profit / (loss) before tax (from continuing and discontinued operations) | 124,831                              | (31,184)                             |
| Enacted tax rates in India                                               | 25.168%                              | 25.168%                              |
| Tax expense @ Company's domestic tax rate 25.168%                        | 31,418                               | (7,849)                              |
| Effect of:                                                               |                                      |                                      |
| Share of profits in associates and joint ventures                        | (6,093)                              | (1,728)                              |
| Tax holiday                                                              | 1,913                                | 542                                  |
| Adjustments in respect of previous years                                 | (420)                                | (481)                                |
| Effect of changes in tax rate including MAT                              | -                                    | 85,369                               |
| Additional taxes / taxes for which no credit is allowed                  | 158                                  | 690                                  |
| Difference in tax rate applicable to group companies                     | 2,594                                | (13,887)                             |
| Adjustment in respect of tax amnesty scheme                              | -                                    | (20,280)                             |
| Losses against which no deferred tax asset recognised                    | -                                    | 36,690                               |
| Expense / (Income) not deductible / (taxable) (net)                      | 6,823                                | (8,262)                              |
| Tax on undistributed retained earnings of subsidiaries / joint venture   | 8,745                                | 2,908                                |
| Items for which no deferred tax has been recognised                      | (2,866)                              | 16,746                               |
| Settlement of various disputes                                           | 385                                  | 766                                  |
| Tax on common control transactions                                       | -                                    | (9)                                  |
| Others                                                                   | (878)                                | 1,241                                |
| <b>Income tax expense</b>                                                | <b>41,779</b>                        | <b>92,456</b>                        |

(Source: Annual report for 2021-2022 of Bharti Airtel Ltd.)

**Illustration 6**

A Ltd.'s profit before tax according to Ind AS for Year 20X1-20X2 is ₹ 100 thousand and taxable profit for year 20X1-20X2 is ₹ 104 thousand. The difference between these amounts arose as follows:

1. On 1<sup>st</sup> February, 20X2, it acquired a machine for ₹ 120 thousand. Depreciation is charged on the machine on a monthly basis for accounting purpose. Under the tax law, the machine will be depreciated for 6 months. The machine's useful life is 10 years according to Ind AS as well as for tax purposes.
2. In the year 20X1-20X2, expenses of ₹ 8 thousand were incurred for charitable donations. These are not deductible for tax purposes.

Prepare necessary entries as at 31<sup>st</sup> March 20X2, taking current and deferred tax into account. The tax rate is 25%. Also prepare the tax reconciliation in absolute numbers as well as the tax rate reconciliation.

**Solution**

Current tax = Taxable profit x Tax rate = ₹ 104 thousand x 25% = ₹ 26 thousand.

**Computation of Taxable Profit:**

|                                 | ₹ in thousand |
|---------------------------------|---------------|
| Accounting profit               | 100           |
| Add: Donation not deductible    | 8             |
| Less: Excess Depreciation (6-2) | (4)           |
| Total Taxable profit            | <u>104</u>    |

|                       | ₹ in thousand | ₹ in thousand |
|-----------------------|---------------|---------------|
| Profit & loss A/c Dr. | 26            |               |
| To Current Tax        |               | 26            |

**Deferred tax:**

Machine's carrying amount according to Ind AS is ₹ 118 thousand (₹ 120 thousand – ₹ 2 thousand)

Machine's carrying amount for taxation purpose = ₹ 114 thousand (₹ 120 thousand – ₹ 6 thousand)

**Deferred Tax Liability** = ₹ 4 thousand x 25%

|                   |                           | ₹ in thousand |   |
|-------------------|---------------------------|---------------|---|
| Profit & loss A/c | Dr.                       | 1             |   |
|                   | To Deferred Tax Liability |               | 1 |

**Tax reconciliation in absolute numbers:**

|                                                               | ₹ in thousand |
|---------------------------------------------------------------|---------------|
| Profit before tax according to Ind AS                         | 100           |
| Applicable tax rate @ 25%                                     |               |
| Tax                                                           | 25            |
| Expenses not deductible for tax purposes (₹ 8 thousand x 25%) | <u>2</u>      |
| Tax expense (Current and deferred)                            | <u>27</u>     |

**Tax rate reconciliation**

|                                          |            |
|------------------------------------------|------------|
| Applicable tax rate                      | 25%        |
| Expenses not deductible for tax purposes | <u>2%</u>  |
| Average effective tax rate               | <u>27%</u> |

\*\*\*\*\*

### 1.8.5 Disclosure 5: Change in tax rates

- The applicable tax rates may change due to variety of reasons. There could be a change in the manner of recovery of the asset. The tax laws may have changed. There could be a change in the structure of the entity.
- In case there are changes in the applicable tax rate(s) compared to the previous accounting period, an explanation has to be provided.

### 1.8.6 Disclosure 6: Unrecognised deductible temporary differences, unused tax losses and unused tax credits

- The Standard lays down criteria for recognising deferred tax assets on deductible temporary differences, unused tax losses and unused tax credits. For example, whether a sufficient taxable temporary difference is available, is there a probability of future profits and are there any tax planning opportunities.
- If the laid down recognition criteria could not be met, no deferred tax asset is recognised on these deductible temporary differences, unused tax losses and unused tax credits.



- (c) The Standard requires the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the balance sheet, to be disclosed.

Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

A. Annual Report of SpiceJet Ltd. for the year ending 31<sup>st</sup> March 2022 (Page 111):

Brought forward losses and unabsorbed depreciation for which no deferred tax assets have been recognized are attributable to the following:

| Particulars                                  | As at<br>March 31, 2022 | As at<br>March 31, 2021 |
|----------------------------------------------|-------------------------|-------------------------|
| Unused tax losses *                          | 19,886.84               | 10,551.73               |
| Unabsorbed tax depreciation #                | 17,632.43               | 16,587.47               |
| <b>Net deferred tax asset/ (liabilities)</b> | <b>37,519.27</b>        | <b>27,139.20</b>        |

# Unabsorbed depreciation does not have any expiry period under the Income-tax Act, 1961

\*The following table details the expiry of the brought forward tax losses

|              |                  |                  |
|--------------|------------------|------------------|
| 0-4 years    | 9,022.44         | 1,823.32         |
| 4-8 years    | 10,864.40        | 8,728.41         |
| <b>Total</b> | <b>19,886.84</b> | <b>10,551.73</b> |

The brought forward losses and unabsorbed depreciation considered above includes information from tax records and returns of the Company filed upto Assessment Year 2021-22 and does not consider the potential effect of matters under dispute/litigation with the tax authorities which are currently sub-judice at various levels. Also refer note 48.

(Source: Annual report for 2021-2022 of SpiceJet Ltd.)

Annual Report of Larsen and Toubro Ltd. for the year ending 31<sup>st</sup> March 2020 (Page 416):

[NOTE 44]

Disclosure pursuant to Ind AS 12 "Income Taxes" (contd.)

(c) (i) Unused tax losses for which no deferred tax asset (DTA) is recognised in Balance Sheet

| Sr. No. | Particulars                               | As at 31-3-2020          |                           |             | As at 31-3-2019          |                           |             |
|---------|-------------------------------------------|--------------------------|---------------------------|-------------|--------------------------|---------------------------|-------------|
|         |                                           | Base Amount<br>(₹ crore) | Deferred Tax<br>(₹ crore) | Expiry date | Base Amount<br>(₹ crore) | Deferred Tax<br>(₹ crore) | Expiry date |
|         | Business loss and unabsorbed depreciation |                          |                           |             |                          |                           |             |
|         | - Amount of losses having expiry          | 2028.43                  | 510.52                    | FY 2021-28  | 2033.64                  | 710.63                    | FY 2020-28  |
|         | - Amount of losses having no expiry       | 981.38                   | 246.99                    |             | 981.38                   | 342.93                    |             |
|         | Capital loss                              | —                        | —                         |             | 3355.81                  | 614.38                    | FY 2025-27  |
|         | <b>Total</b>                              | <b>3009.81</b>           | <b>757.51</b>             |             | <b>6370.83</b>           | <b>1667.94</b>            |             |

(ii) Unrecognised deductible temporary differences for which no deferred tax asset (DTA) is recognised in Balance Sheet

₹ crore

| Sr. No. | Particulars                                                                                                        | As at 31-3-2020 |                | As at 31-3-2019 |                |
|---------|--------------------------------------------------------------------------------------------------------------------|-----------------|----------------|-----------------|----------------|
|         |                                                                                                                    | Base Amount     | Deferred Tax   | Base Amount     | Deferred Tax   |
| 1.      | Deductible temporary differences towards provision for diminution in value of investments on which DTA not created | 2966.98         | 686.82         | 3017.55         | 705.59         |
| 2.      | Temporary differences arising out of revaluation of tax base of assets (on account of indexation benefit)          | 6541.94         | 1496.80        | 5813.32         | 1354.27        |
| 3.      | Other items giving rise to temporary differences                                                                   | 78.08           | 19.65          | 78.08           | 27.29          |
|         | <b>Total</b>                                                                                                       | <b>9587.00</b>  | <b>2203.27</b> | <b>8908.95</b>  | <b>2087.15</b> |

(Source: Annual report for 2021-2022 of Larsen and Toubro Ltd.)



### 1.8.7 Disclosure 7: Temporary differences associated with investments in subsidiaries etc.

- (a) The aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised should be disclosed.
- (b) It would often be impracticable to compute the amount of unrecognised deferred tax liabilities arising from investments in subsidiaries, branches and associates and interests in joint ventures. Therefore, this Standard requires an entity to disclose the aggregate amount of the underlying temporary differences but does not require disclosure of the deferred tax liabilities.
- (c) Nevertheless, where practicable, entities are encouraged to disclose the amounts of the unrecognised deferred tax liabilities because financial statement users may find such information useful.

*Relevant Extracts from Financial Statements of selected Listed Entities are presented below:*

**A Annual Report of SpiceJet Ltd. for the year ending 31 March 2022 (Page 111):**

Brought forward losses and unabsorbed depreciation for which no deferred tax assets have been recognized are attributable to the following:

| Particulars                                  | As at<br>March 31, 2022 | As at<br>March 31, 2021 |
|----------------------------------------------|-------------------------|-------------------------|
| Unused tax losses *                          | 19,886.84               | 10,551.73               |
| Unabsorbed tax depreciation #                | 17,632.43               | 16,587.47               |
| <b>Net deferred tax asset/ (liabilities)</b> | <b>37,519.27</b>        | <b>27,139.20</b>        |

**# Unabsorbed depreciation does not have any expiry period under the Income-tax Act, 1961**

\*The following table details the expiry of the brought forward tax losses

|              |                  |                  |
|--------------|------------------|------------------|
| 0-4 years    | 9,022.44         | 1,823.32         |
| 4-8 years    | 10,864.40        | 8,728.41         |
| <b>Total</b> | <b>19,886.84</b> | <b>10,551.73</b> |

The brought forward losses and unabsorbed depreciation considered above includes information from tax records and returns of the Company filed upto Assessment Year 2021-22 and does not consider the potential effect of matters under dispute/ litigation with the tax authorities which are currently sub-judice at various levels. Also refer note 48.

*(Source: Annual report for 2021-2022 of SpiceJet Ltd.)*

B. Annual Report of Larsen and Toubro Ltd. for the year ending 31 March 2020 (Page 416):

**[NOTE 44]**

Disclosure pursuant to Ind AS 12 "Income Taxes" (contd.)

(c) (i) Unused tax losses for which no deferred tax asset (DTA) is recognised in Balance Sheet

| Sr. No. | Particulars                               | As at 31-3-2020          |                           |             | As at 31-3-2019          |                           |             |
|---------|-------------------------------------------|--------------------------|---------------------------|-------------|--------------------------|---------------------------|-------------|
|         |                                           | Base Amount<br>(₹ crore) | Deferred Tax<br>(₹ crore) | Expiry date | Base Amount<br>(₹ crore) | Deferred Tax<br>(₹ crore) | Expiry date |
|         | Business loss and unabsorbed depreciation |                          |                           |             |                          |                           |             |
|         | - Amount of losses having expiry          | 2028.43                  | 510.52                    | FY 2021-28  | 2033.64                  | 710.63                    | FY 2020-28  |
|         | - Amount of losses having no expiry       | 981.38                   | 246.99                    |             | 981.38                   | 342.93                    |             |
|         | Capital loss                              | -                        | -                         |             | 3355.81                  | 614.38                    | FY 2025-27  |
|         | Total                                     | 3009.81                  | 757.51                    |             | 6370.83                  | 1667.94                   |             |

(ii) Unrecognised deductible temporary differences for which no deferred tax asset (DTA) is recognised in Balance Sheet

₹ crore

| Sr. No. | Particulars                                                                                                        | As at 31-3-2020 |              | As at 31-3-2019 |              |
|---------|--------------------------------------------------------------------------------------------------------------------|-----------------|--------------|-----------------|--------------|
|         |                                                                                                                    | Base Amount     | Deferred Tax | Base Amount     | Deferred Tax |
| 1.      | Deductible temporary differences towards provision for diminution in value of investments on which DTA not created | 2966.98         | 686.82       | 3017.55         | 705.59       |
| 2.      | Temporary differences arising out of revaluation of tax base of assets (on account of indexation benefit)          | 6541.94         | 1496.80      | 5813.32         | 1354.27      |
| 3.      | Other items giving rise to temporary differences                                                                   | 78.08           | 19.65        | 78.08           | 27.29        |
|         | Total                                                                                                              | 9587.00         | 2203.27      | 8908.95         | 2087.15      |

(Source: Annual report for 2021-2022 of Larsen and Toubro Ltd.)

### 1.8.8 Disclosure 8: Amount of deferred tax liabilities (assets) or income (expenses)

- (a) As per the criteria laid down in the Standard, deferred tax liabilities have to be recognised for taxable temporary differences and deferred tax assets have to be recognised for deductible temporary differences, unused tax losses and unused tax credits.
- (b) Where deferred taxes have been recognised, the following should be disclosed in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:
- the amount of the deferred tax assets and liabilities recognised in the balance sheet for each period presented;
  - the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the balance sheet.

### **1.8.9 Disclosure 9: Discontinued operations**

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The following should be disclosed in respect of discontinued operations, the tax expense relating to:

- (i) the gain or loss on discontinuance; and
- (ii) the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

### **1.8.10 Disclosure 10: Dividend tax**

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- (a) At times dividends relating to the reporting period are proposed or declared after the reporting date but before the financial statements are approved for issue. These are disclosed but not recognised in financial statements.
- (b) In such a situation, an entity should disclose the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were approved for issue, but are not recognised as a liability in the financial statements.

### **1.8.11 Disclosures 11: In case of business combination**

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The following should be disclosed:

- if a business combination in which the entity is the acquirer causes a change in the amount recognised for its pre-acquisition deferred tax asset, the amount of that change; and
- if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date, a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.

### **1.8.12 Disclosure 12: Deferred tax asset and evidence thereto where based on future taxable profits**

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An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

- the utilization of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
- the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

### **1.8.13 Disclosure 13: Tax consequences of distribution of dividends**

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- (a) As discussed above, in some tax jurisdiction tax rates depend on the fact whether dividend is distributed or not.
- (b) In these circumstances, an entity shall disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable.
- (c) The aforesaid disclosure requirement requires an entity to disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. An entity also discloses the important features of the income tax systems and the factors that will affect the amount of the potential income tax consequences of dividends.
- (d) However, it would sometimes not be practicable to compute the total amount of the of the total amount may be easily determinable. For example, in a consolidated group, a parent and some of its subsidiaries may have paid income taxes at a higher rate on undistributed profits and be aware of the amount that would be refunded on the payment of future dividends to shareholders from consolidated retained earnings. In this case, that refundable amount is disclosed.
- (e) If applicable, the entity also discloses that there are additional potential income tax consequences not practicably determinable. In the parent's separate financial statements, if any, the disclosure of the potential income tax consequences relates to the parent's retained earnings.
- (f) An entity required to provide the disclosures referred above is also required to provide disclosures related to temporary differences associated with investments in subsidiaries, branches and associates or interests in joint ventures. In such cases, an entity considers this in determining the information to be disclosed under this requirement. For example, an entity may be required to disclose the aggregate amount of temporary differences associated with investments in subsidiaries for which no deferred tax liabilities have been recognised. If it is impracticable to compute the amounts of unrecognised deferred tax liabilities, there may be amounts of potential income tax consequences of dividends not practicably determinable related to these subsidiaries.

### **1.8.14 Disclosure 14: Tax related contingencies**

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An entity discloses any tax-related contingent liabilities and contingent assets in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities.

### 1.8.15 Disclosure 15: Change in tax rates or tax laws

Where changes in tax rates or tax laws are enacted or announced after the reporting period, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities (see Ind AS 10, *Events after the Reporting Period*).

*Relevant Extracts from Financial Statements of selected Listed Entities are presented below:*

*Annual Report of SpiceJet Ltd. for the year ending 31<sup>st</sup> March 2020 (Page 415):*

**[NOTE 44]**  
Disclosure pursuant to Ind AS 12 "Income Taxes" (contd.)  
(b) Reconciliation of tax expense and the accounting profit multiplied by domestic tax rate applicable in India:

|         |                                                                                                                 | ₹ crore  |          |
|---------|-----------------------------------------------------------------------------------------------------------------|----------|----------|
| Sr. No. | Particulars                                                                                                     | 2019-20  | 2018-19  |
| (1)     | Profit before tax from:                                                                                         |          |          |
|         | Continuing Operations                                                                                           | 6985.91  | 9219.46  |
|         | Discontinued Operations                                                                                         | 865.38   | 812.40   |
|         |                                                                                                                 | 7851.29  | 10031.86 |
| (2)     | Corporate tax rate as per Income tax Act, 1961                                                                  | 25.17%   | 34.94%   |
| (3)     | Tax on accounting profit (3)=(1)*(2)                                                                            | 1976.01  | 3505.53  |
| (4)     | (i) Tax on Income exempt from tax :                                                                             |          |          |
|         | (A) Dividend income                                                                                             | (347.18) | (523.73) |
|         | (B) Long-term capital gains exempt from tax                                                                     | (121.27) | (978.42) |
|         | (C) Interest on tax free bonds                                                                                  | (1.04)   | (2.50)   |
|         | (ii) Tax on expenses not tax deductible:                                                                        |          |          |
|         | (A) CSR expenses                                                                                                | 36.57    | 42.52    |
|         | (B) Expenses in relation to exempt income                                                                       | 36.42    | 28.35    |
|         | (C) Tax on employee perquisites borne by the Company                                                            | 2.08     | 1.52     |
|         | (iii) Weighted deductions on R&D expenditure and deduction u/s 80IA                                             | –        | (147.05) |
|         | (iv) Effect of previously unrecognised tax losses used to reduce deferred tax expense                           | (787.94) | (0.27)   |
|         | (v) Tax effect on impairment and fair valuation losses recognised on which deferred tax asset is not recognised | –        | 685.62   |
|         | (vi) Effect on deferred tax balances due to the change in income tax rate                                       | 179.67   | –        |
|         | (vii) Effect of current year net capital/business loss on which no deferred tax asset is recognised             | –        | (123.61) |
|         | (viii) Effect of current tax related to earlier years                                                           | (60.68)  | 227.14   |
|         | (ix) Effect of previously unrecognised tax losses used to reduce current tax expense                            | –        | (477.86) |
|         | (x) Tax effect of losses in joint operation of current year on which no deferred tax asset is recognised        | 3.87     | 37.68    |
|         | (xi) Tax effect on various other items                                                                          | 25.34    | 18.33    |
|         | (xii) Reversal of MAT credit entitlement                                                                        | 230.23   | –        |
|         | Total effect of tax adjustments [(i) to (xii)]                                                                  | (803.93) | (965.08) |
| (5)     | Tax expense recognised during the year (5)=(3)+(4)                                                              | 1172.08  | 2540.47  |
| (6)     | Effective tax Rate (6)=(5)/(1)                                                                                  | 14.93%   | 25.32%   |

The Company has opted to pay the tax under section 115BAA of the Income Tax Act, 1961. Accordingly;

- the provision for current and deferred tax has been determined at the rate of 25.17%,
- the deferred tax assets and deferred tax liabilities as at April 1, 2019 have been restated at the rate of 25.17% and
- the unutilised credit for minimum alternate tax as at April 1, 2019 has been written-off.

(Source : Annual report of 2019-2020 of SpiceJet Ltd.)



**Illustration 7**

*An entity has a deductible temporary difference of ₹ 50,000. It has no taxable temporary differences against which it can be offset. The entity is also not anticipating any future profits. However, it can implement a tax planning strategy which can generate profits up to ₹ 60,000. The cost of implementing this tax planning strategy is ₹ 12,000. The tax rate is 30%. Compute the deferred tax asset that should be recognised.*

**Solution**

The entity should recognise a deferred tax asset of ₹ 14,400 @ 30% of ₹ 48,000 (₹ 60,000 – ₹ 12,000).

The balance deferred tax asset of ₹ 600 @ 30% on ₹ 2,000 (₹ 50,000 – ₹ 48,000) shall remain unrecognised.

\*\*\*\*\*

**Illustration 8**

*A Limited recognises interest income in its books on accrual basis. However, for income tax purposes the method is 'cash basis'. On 31<sup>st</sup> December, 20X1, it has interest receivable of ₹ 10,000 and the tax rate was 25%. On 28<sup>th</sup> February, 20X2, the finance bill is introduced in the legislation that changes the tax rate to 30%. The finance bill is enacted as Act on 21<sup>st</sup> May, 20X2.*

*Discuss the treatment of deferred tax in case the reporting date of A Limited's financial statement is 31<sup>st</sup> December, 20X1 and these are approved for issued on 31<sup>st</sup> May, 20X2.*

**Solution**

The difference of ₹ 10,000 between the carrying value of interest receivable of ₹ 10,000 and its tax base of NIL is a taxable temporary difference.

A Limited has to recognise a deferred tax liability of ₹ 2,500 (₹ 10,000 x 25%) in its financial statements for the reporting period ended on 31<sup>st</sup> December, 20X1.

It will not recognise the deferred tax liability @ 30% because as on 31<sup>st</sup> December, 20X1, this tax rate was neither substantively enacted or enacted on the reporting date. However, if the effect of this change is material, A Limited should disclose this difference in its financial statements.

\*\*\*\*\*

**Illustration 9**

*A Ltd prepares financial statements to 31<sup>st</sup> March each year. The rate of income tax applicable to A Ltd is 20%. The following information relates to transactions, assets and liabilities of A Ltd during the year ended 31<sup>st</sup> March 20X2:*

- (i) *A Ltd has a 40% shareholding in L Ltd. A Ltd purchased this shareholding for ₹ 45 Cr. The shareholding gives A Ltd significant influence over L Ltd but not control and therefore A Ltd.*

accounts for its interest in L Ltd using the equity method. The equity method carrying value of A Ltd's investment in L Ltd was ₹ 70 Cr on 31<sup>st</sup> March 20X1 and ₹ 75 Cr on 31<sup>st</sup> March 20X2. In the tax jurisdiction in which A Ltd operates, profits recognised under the equity method are taxed if and when they are distributed as a dividend or the relevant investment is disposed of.

- (ii) A Ltd. measures its head office building using the revaluation model. The building is revalued every year on 31<sup>st</sup> March. On 31<sup>st</sup> March 20X1, carrying value of the building (after revaluation) was ₹ 40 Cr and its tax base was ₹ 22 Cr. During the year ended 31<sup>st</sup> March 20X2, A Ltd charged depreciation in its statement of profit or loss of ₹ 2 Cr and claimed a tax deduction for tax depreciation of ₹ 1.25 Cr. On 31<sup>st</sup> March 20X2, the building was revalued to ₹ 45 Cr. In the tax jurisdiction in which A Ltd operates, revaluation of property, plant and equipment does not affect taxable income at the time of revaluation.

Basis the above information, you are required to compute:

- (a) The deferred tax liability of A Ltd at 31<sup>st</sup> March 20X2  
 (b) The charge or credit to both profit or loss and other comprehensive income relating to deferred tax for the year ended 31<sup>st</sup> March 20X2

### Solution:

#### (A) Deferred Tax Liability as at 31<sup>st</sup> March 20X2

##### Investment in L Ltd:

|                      |   |                         |
|----------------------|---|-------------------------|
| Carrying Amount      | = | ₹ 75 Cr                 |
| Tax base             | = | ₹ 45 Cr (Purchase cost) |
| Temporary Difference | = | ₹ 30 Cr                 |

Since carrying amount is higher than the tax base, the temporary difference is recognized as a taxable temporary difference. Using the tax rate of 20%, a deferred tax liability of ₹ 6 Cr is recognized:

##### Head office building

|                      |   |                                                          |
|----------------------|---|----------------------------------------------------------|
| Carrying Amount      | = | ₹ 45 Cr (Revalued amount on 31 <sup>st</sup> March 20X2) |
| Tax base             | = | ₹ 20.75 Cr (22 Cr – 1.25 Cr)                             |
| Temporary Difference | = | ₹ 24.25 Cr                                               |

Since carrying amount is higher than the tax base, the temporary difference is recognized as a taxable temporary difference. Using the tax rate of 20%, a deferred tax liability of ₹ 4.85 Cr is created.

Total Deferred Tax Liability                      ₹ 6 Cr + ₹ 4.85 Cr = ₹ 10.85 Cr

**(B) Charge to Statement of Profit or Loss for the year ended 31<sup>st</sup> March 20X2:**

**Investment in L Ltd.**

| Particulars                                       | Carrying amount | Tax Base | Temporary Difference |
|---------------------------------------------------|-----------------|----------|----------------------|
| Opening Balance (1 <sup>st</sup> April 20X1)      | ₹ 70 Cr         | ₹ 45 Cr  | ₹ 25 Cr              |
| Closing Balance (31 <sup>st</sup> March 20X2)     | ₹ 75 Cr         | ₹ 45 Cr  | ₹ 30 Cr              |
| Net Change                                        |                 |          | ₹ 5 Cr               |
| Increase in Deferred Tax Liability (20% tax rate) |                 |          | ₹ 1 Cr               |

Considering the increase in the value of investment arising through Statement of Profit or Loss, the accounting for the increase in deferred tax liability is made as under:

|                                        |    |        |
|----------------------------------------|----|--------|
| Tax expense (Profit or Loss Statement) | Dr | ₹ 1 Cr |
| To Deferred Tax Liability              |    | ₹ 1 Cr |

(Being increase in deferred tax liability recognized)

**Head Office Building:**

The deferred tax liability at 31<sup>st</sup> March 20X1 is ₹ 3.6 Cr (20% x {₹ 40 Cr – ₹ 22 Cr}).

At 31<sup>st</sup> March 20X2, prior to revaluation, the carrying amount of the property is ₹ 38 Cr and its tax base is ₹ 20.75 Cr (₹ 22 Cr – ₹ 1.25 Cr). The deferred tax liability at this point is ₹ 3.45 Cr (20% x {₹ 38 Cr – ₹ 20.75 Cr}).

The reduction in this liability is ₹ 0.15 Cr (₹ 3.6 Cr – ₹ 3.45 Cr). This would be credited to income tax expense in arriving at profit or loss.

Post revaluation, the carrying value of the building becomes ₹ 45 Cr and the tax base stays the same. Therefore, the new deferred tax liability is ₹ 4.85 Cr (20% x {₹ 45 Cr – ₹ 20.75 Cr}). The increase in the deferred tax liability of ₹ 1.4 Cr (₹ 4.85 Cr – ₹ 3.45 Cr) is charged to other comprehensive income.

\*\*\*\*\*

**Illustration 10**

*K Ltd prepares consolidated financial statements to 31<sup>st</sup> March each year. During the year ended 31<sup>st</sup> March 20X2, K Ltd entered into the following transactions:*

- (a) *On 1<sup>st</sup> April 20X1, K Ltd purchased an equity investment for ₹ 2,00,000. The investment was designated as fair value through other comprehensive income. On 31<sup>st</sup> March 20X2, the fair value of the investment was ₹ 2,40,000. In the tax jurisdiction in which K Ltd operates, unrealised gains and losses arising on the revaluation of investments of this nature are not*



taxable unless the investment is sold. K Ltd has no intention of selling the investment in the foreseeable future.

- (b) On 1<sup>st</sup> August 20X1, K Ltd sold products to A Ltd, a wholly owned subsidiary operating in the same tax jurisdiction as K Ltd, for ₹ 80,000. The goods had cost to K Ltd for ₹ 64,000. By 31<sup>st</sup> March 20X2, A Ltd had sold 40% of these goods, selling the remaining during next year.
- (c) On 31<sup>st</sup> October 20X1, K Ltd received ₹ 2,00,000 from a customer. This payment was in respect of services to be provided by K Ltd from 1<sup>st</sup> November 20X1 to 31<sup>st</sup> July 20X2. K Ltd recognised revenue of ₹ 1,20,000 in respect of this transaction in the year ended 31<sup>st</sup> March 20X2 and will recognise the remainder in the year ended 31<sup>st</sup> March 20X3. Under the tax jurisdiction in which K Ltd operates, ₹ 2,00,000 received on 31<sup>st</sup> October 20X1 was included in the taxable profits of K Ltd for the year ended 31<sup>st</sup> March 20X2.

Explain and show how the tax consequences (current and deferred) of the three transactions would be reported in its statement of profit or loss and other comprehensive income for the year ended 31<sup>st</sup> March 20X2. Assume tax rate to be 25%.

**Solution:**

- (a) Because the unrealised gain on revaluation of the equity investment is not taxable until sold, there are no current tax consequences. The tax base of the investment is ₹ 2,00,000. The revaluation creates a taxable temporary difference of ₹ 40,000 (₹ 2,40,000 – ₹ 2,00,000).

This creates a deferred tax liability of ₹ 10,000 (₹ 40,000 x 25%). The liability would be non-current. The fact that there is no intention to dispose of the investment does not affect the accounting treatment. Because the unrealised gain is reported in other comprehensive income, the related deferred tax expense is also reported in other comprehensive income.

- (b) When K Ltd sold the products to A Ltd, K Ltd would have generated a taxable profit of ₹ 16,000 (₹ 80,000 – ₹ 64,000). This would have created a current tax liability for K Ltd and the group of ₹ 4,000 (₹ 16,000 x 25%). This liability would be shown as a current liability and charged as an expense in arriving at profit or loss for the period.

In the consolidated financial statements the carrying value of the unsold inventory would be ₹ 38,400 (₹ 64,000 x 60%). The tax base of the unsold inventory would be ₹ 48,000 (₹ 80,000 x 60%). In the consolidated financial statements there would be a deductible temporary difference of ₹ 9,600 (₹ 38,400 – ₹ 48,000) and a potential deferred tax asset of ₹ 2,400 (₹ 9,600 x 25%). This would be recognised as a deferred tax asset since A Ltd is expected to generate sufficient taxable profits against which to utilise the deductible temporary difference. The resulting credit would reduce consolidated deferred tax expense in arriving at profit or loss.

- (c) The receipt of revenue in advance on 1<sup>st</sup> October 20X1 would create a current tax liability of ₹ 50,000 (₹ 200,000 x 25%) as at 31<sup>st</sup> March 20X2. The carrying value of the revenue received in advance at 31<sup>st</sup> March 20X2 is ₹ 80,000 (₹ 200,000 – ₹ 120,000). Its tax base is

nil. The deductible temporary difference of ₹ 80,000 would create a deferred tax asset of ₹ 20,000 (₹ 80,000 x 25%). The asset can be recognised because K Ltd has sufficient taxable profits against which to utilise the deductible temporary difference.

\*\*\*\*\*



## 1.9 SIGNIFICANT CHANGES IN IND AS 12 VIS-À-VIS AS 22

| S. No. | Particulars                                                     | Ind AS 12                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | AS 22                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|--------|-----------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.     | <i>Approach for creating Deferred Tax</i>                       | Ind AS 12 is based on balance sheet approach.<br>It requires recognition of tax consequences of differences between the carrying amounts of assets and liabilities and their tax base.                                                                                                                                                                                                                                                                                                                                                                                     | AS 22 is based on income statement approach.<br><br>It requires recognition of tax consequences of differences between taxable income and accounting income. For this purpose, differences between taxable income and accounting income are classified into permanent and timing differences.                                                                                                                                                                                                                               |
| 2.     | <i>Limited Exceptions for Recognition of Deferred Tax Asset</i> | As per Ind AS 12, subject to limited exceptions, deferred tax asset is 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. The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same that for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future | As per AS 22, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised. Where deferred tax asset is recognised against unabsorbed depreciation or carry forward of losses under tax laws, it is recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available |

|    |                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                      |
|----|--------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|
|    |                                                                                      | taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. | against which such deferred tax assets can be realised. AS 22 explains what may be considered as virtual certainty supported by convincing evidence. |
| 3. | <i>Recognition of Current and Deferred Tax</i>                                       | As per Ind AS 12, current and deferred tax are recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from a transaction or event which is recognised outside profit or loss, either in other comprehensive income or directly in equity, in those cases tax is also recognised in other comprehensive income or in equity, as appropriate.                                         | AS 22 does not specifically deal with this aspect.                                                                                                   |
| 4. | <i>Investments in subsidiaries, associates and joint ventures</i>                    | As per Ind AS 12, deferred tax liability is recognised for all taxable temporary differences associated with investments in subsidiaries, associates and joint ventures, if certain conditions are satisfied.                                                                                                                                                                                                                                           | AS 22 does not deal with this aspect.                                                                                                                |
| 5. | <i>Elimination of profit and losses resulting from the intra- group transactions</i> | As per Ind AS 12, deferred tax should be recognised on temporary differences that arise from the elimination of                                                                                                                                                                                                                                                                                                                                         | As per AS 22, deferred tax in consolidated financials are a simple aggregation of the                                                                |

|     |                                                                         |                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                                                                                                  |
|-----|-------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|     |                                                                         | profit and losses resulting from the intra- group transactions.                                                                                                                                            | deferred tax recognised by the group entities.                                                                                                                                                                                                                                                                                                   |
| 6.  | <i>DTA/DTL arising out of Revaluation of Assets</i>                     | Ind AS 12 requires that deferred tax asset/liability arising from revaluation of non-depreciable assets shall be measured on the basis of tax consequences from the sale of asset rather than through use. | AS 22 does not deal with this aspect.                                                                                                                                                                                                                                                                                                            |
| 7.  | <i>Changes in Entities Tax Status or that of its Shareholders</i>       | Ind AS 12 provides guidance as to how an entity should account for the tax consequences of a change in its tax status or that of its shareholders.                                                         | AS 22 does not deal with this aspect.                                                                                                                                                                                                                                                                                                            |
| 8.  | <i>Guidance for Recognition of Deferred Tax in a Tax Holiday Period</i> | Ind AS 12 does not specifically deal with these situations.                                                                                                                                                | AS 22 specifically provides guidance regarding recognition of deferred tax in the situations of Tax Holiday under Sections 80-IA and 80-IB and Tax Holiday under Sections 10A and 10B of the Income Tax Act, 1961. Similarly, AS 22 provides guidance regarding recognition of deferred tax asset in case of loss under the head 'capital gains' |
| 9.  | <i>In case of a company paying tax under section 115JB.</i>             | Ind AS 12 does not specifically deal with this aspect.                                                                                                                                                     | AS 22 specifically provides guidance regarding tax rates to be applied in measuring deferred tax assets/liabilities in a situation where a company pays tax under section 115JB.                                                                                                                                                                 |
| 10. | <i>Guidance on Uncertainty Over Income Tax Treatment</i>                | Ind AS 12 gives special guidance on it.                                                                                                                                                                    | AS 11 gives no such guidance.                                                                                                                                                                                                                                                                                                                    |

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## TEST YOUR KNOWLEDGE

### Questions

1. An asset which cost ₹ 150 has a carrying amount of ₹ 100. Cumulative depreciation for tax purposes is ₹ 90 and the tax rate is 25%. Calculate the tax base and the corresponding deferred tax or liability, if any.
2. On 1<sup>st</sup> April 20X1, ABC Ltd acquired 100% shares of XYZ Ltd for ₹ 4,373 crore. By 31<sup>st</sup> March, 20X5, XYZ Ltd had made profits of ₹ 5 crore, which remain undistributed. Based on the tax legislation in India, the tax base investment in XYZ Ltd is its original cost. Show deferred tax treatment.
3. ABC Ltd. acquired 30% of the shares in PQR Ltd. on 1<sup>st</sup> January, 20X1 for ₹ 1,000 crore. By 31<sup>st</sup> March, 20X5, PQR Ltd. had made profits of ₹ 50 crore (ABC Ltd.'s share), which remained undistributed. Based on the tax legislation in India, the tax base of the investment in PQR Ltd. is its original cost. Show deferred tax treatment.
4. A company had purchased an asset at ₹ 1,00,000. Estimated useful life of the asset is 5 years and depreciation rate is 20% SLM. Depreciation rate for tax purposes is 25% SLM. The operating profit is ₹ 1,00,000 for all the 5 years. Tax rate is 30% for the next 5 years. Calculate the Book Value as per financial and tax purposes and then DTL.
5. A Ltd. acquired B Ltd. The following assets and liabilities are acquired in a business combination:

₹ 000's

|                     | Fair Value | Carrying amount | Temporary Difference |
|---------------------|------------|-----------------|----------------------|
| Plant and Equipment | 250        | 260             | (10)                 |
| Inventory           | 120        | 125             | (5)                  |

|                    |              |              |             |
|--------------------|--------------|--------------|-------------|
| Debtors            | <u>200</u>   | <u>210</u>   | <u>(10)</u> |
|                    | 570          | 595          | (25)        |
| 9% Debentures      | <u>(100)</u> | <u>(100)</u> |             |
|                    | 470          | 495          |             |
| Consideration paid | <u>500</u>   | <u>500</u>   | <u>—</u>    |
| Goodwill           | <u>30</u>    | <u>5</u>     | <u>(25)</u> |

Assume tax rate as 30%.

Calculate deferred tax asset assuming that the carrying amount is the tax base and prepare the journal entries.

6. B Limited is a newly incorporated entity. Its first financial period ends on 31<sup>st</sup> March, 20X1. As on the said date, the following temporary differences exist:
  - (a) Taxable temporary differences relating to accelerated depreciation of ₹ 9,000. These are expected to reverse equally over next 3 years.
  - (b) Deductible temporary differences relating to preliminary expenses of ₹ 4,000 expected to reverse equally over next 4 years.

It is expected that B Limited will continue to make losses for next 5 years. Tax rate is 30%. Losses can be carried forward but not backwards.

Discuss the treatment of deferred tax as on 31<sup>st</sup> March, 20X1.

7. X Ltd. prepares consolidated financial statements to 31<sup>st</sup> March each year. During the year ended 31<sup>st</sup> March 20X2, the following events affected the tax position of the group:
  - (i) Y Ltd., a wholly owned subsidiary of X Ltd., made a loss adjusted for tax purposes of ₹ 30,00,000. Y Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow Y Ltd. to transfer the tax loss to other group companies. However, it allows Y Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of X Ltd. do not consider that Y Ltd. will make taxable profits in the foreseeable future.
  - (ii) Just before 31<sup>st</sup> March, 20X2, X Ltd. committed itself to closing a division after the year end, making a number of employees redundant. Therefore, X Ltd. recognised a provision for closure costs of ₹ 20,00,000 in its statement of financial position as at 31<sup>st</sup> March, 20X2. Income-tax Act allows tax deductions for closure costs only when the closure actually takes place. In the year ended 31<sup>st</sup> March 20X3, X Ltd. expects to make taxable profits which are well in excess of ₹ 20,00,000. On 31<sup>st</sup> March, 20X2, X Ltd. had taxable temporary differences from other sources which were greater than ₹ 20,00,000.

- (iii) During the year ended 31<sup>st</sup> March, 20X1, X Ltd. capitalised development costs which satisfied the criteria in paragraph 57 of Ind AS 38 'Intangible Assets'. The total amount capitalised was ₹ 16,00,000. The development project began to generate economic benefits for X Ltd. from 1<sup>st</sup> January, 20X2. The directors of X Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31<sup>st</sup> March, 20X2.
- (iv) On 1<sup>st</sup> April, 20X1, X Ltd. borrowed ₹ 1,00,00,000. The cost to X Ltd. of arranging the borrowing was ₹ 2,00,000 and this cost qualified for a tax deduction on 1<sup>st</sup> April, 20X1. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31<sup>st</sup> March, 20X4 will be ₹ 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of ₹ 30,43,800 will be claimable when the loan is repaid on 31<sup>st</sup> March, 20X4.

Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of X Ltd. group at 31<sup>st</sup> March, 20X2 as per Ind AS. Assume the rate of corporate income tax is 20%.

8. PQR Ltd., a manufacturing company, prepares consolidated financial statements to 31<sup>st</sup> March each year. During the year ended 31<sup>st</sup> March, 20X2, the following events affected the tax position of the group:
  - QPR Ltd., a wholly owned subsidiary of PQR Ltd., incurred a loss adjusted for tax purposes of ₹ 30,00,000. QPR Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow QPR Ltd. to transfer the tax loss to other group companies. However, it allows QPR Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of PQR Ltd. do not consider that QPR Ltd. will make taxable profits in the foreseeable future.
  - During the year ended 31<sup>st</sup> March, 20X2, PQR Ltd. capitalised development costs which satisfied the criteria as per Ind AS 38 'Intangible Assets'. The total amount capitalised was ₹ 16,00,000. The development project began to generate economic benefits for PQR Ltd. from 1<sup>st</sup> January, 20X2. The directors of PQR Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31<sup>st</sup> March, 20X2.
  - On 1<sup>st</sup> April, 20X1, PQR Ltd. borrowed ₹ 1,00,00,000. The cost to PQR Ltd. of arranging the borrowing was ₹ 2,00,000 and this cost qualified for a tax deduction on 1<sup>st</sup> April 20X1. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31<sup>st</sup> March 20X4 will be ₹ 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of ₹ 30,43,800 will be claimable when the loan is repaid on 31<sup>st</sup> March, 20X4.

Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of PQR Ltd. group at 31<sup>st</sup> March, 20X2 as per Ind AS. The rate of corporate income tax is 30%.

9. An entity is finalising its financial statements for the year ended 31<sup>st</sup> March, 20X2. Before 31<sup>st</sup> March, 20X2, the government announced that the tax rate was to be amended from 40 per cent to 45 per cent of taxable profit from 30<sup>th</sup> June, 20X2.

The legislation to amend the tax rate has not yet been approved by the legislature. However, the government has a significant majority and it is usual, in the tax jurisdiction concerned, to regard an announcement of a change in the tax rate as having the substantive effect of actual enactment (i.e. it is substantively enacted).

After performing the income tax calculations at the rate of 40 per cent, the entity has the following deferred tax asset and deferred tax liability balances:

|                        |          |
|------------------------|----------|
| Deferred tax asset     | ₹ 80,000 |
| Deferred tax liability | ₹ 60,000 |

Of the deferred tax asset balance, ₹ 28,000 related to a temporary difference. This deferred tax asset had previously been recognised in OCI and accumulated in equity as a revaluation surplus.

The entity reviewed the carrying amount of the asset in accordance with para 56 of Ind AS 12 and determined that it was probable that sufficient taxable profit to allow utilisation of the deferred tax asset would be available in the future.

Show the revised amount of Deferred tax asset & Deferred tax liability and present the necessary journal entries.

10. On 1<sup>st</sup> January 20X2, entity H acquired 100% share capital of entity S for ₹ 15,00,000. The book values and the fair values of the identifiable assets and liabilities of entity S at the date of acquisition are set out below, together with their tax bases in entity S's tax jurisdictions. Any goodwill arising on the acquisition is not deductible for tax purposes. The tax rates in entity H's and entity S's jurisdictions are 30% and 40% respectively.

| Acquisitions                  | Book values<br>₹'000 | Tax base<br>₹'000 | Fair values<br>₹'000 |
|-------------------------------|----------------------|-------------------|----------------------|
| Land and buildings            | 600                  | 500               | 700                  |
| Property, plant and equipment | 250                  | 200               | 270                  |
| Inventory                     | 100                  | 100               | 80                   |
| Accounts receivable           | 150                  | 150               | 150                  |
| Cash and cash equivalents     | 130                  | 130               | 130                  |



|                                |       |       |       |
|--------------------------------|-------|-------|-------|
| Accounts payable               | (160) | (160) | (160) |
| Retirement benefit obligations | (100) | -     | (100) |

You are required to calculate the deferred tax arising on acquisition of Entity S. Also calculate the Goodwill arising on acquisition.

## Answers

1. The tax base of the asset is ₹ 60 (cost of ₹ 150 less cumulative tax depreciation of ₹ 90). To recover the carrying amount of ₹ 100, the entity must earn taxable income of ₹ 100, but will only be able to deduct tax depreciation of ₹ 60. Consequently, the entity will pay income taxes of ₹ 10 (₹ 40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of ₹ 100 and the tax base of ₹ 60 is a taxable temporary difference of ₹ 40. Therefore, the entity recognises a deferred tax liability of ₹ 10 (₹ 40 at 25%) representing the income taxes that it will pay when it recovers the carrying amount of the asset.
2. A taxable temporary difference of ₹ 5 crore exists between the carrying value of the investment in XYZ at the reporting date of ₹ 4,378 crore (₹ 4,373 crore + ₹ 5 crore) and its tax base of ₹ 4,373 crore. Since a parent, by definition, controls a subsidiary, it will be able to control the reversal of this temporary difference, for example - through control of the dividend policy of the subsidiary. Therefore, deferred tax on such temporary difference is generally not provided unless it is probable that the temporary will reverse in the foreseeable future.
3. A taxable temporary difference of ₹ 50 crore therefore exists between the carrying value of the investment in PQR at the reporting date of ₹ 1,050 crore (₹ 1,000 crore + ₹ 50 crore) and its tax base of ₹ 1,000 crore. As ABC Ltd. does not completely control PQR Ltd. it is not in a position to control the dividend policy of PQR Ltd. As a result, it cannot control the reversal of this temporary difference and deferred tax is provided on temporary differences arising on investments in PQR Ltd. i.e. ₹ 50 crore.
4. Calculation of the Book Value as per financial and tax purposes.

### Financial Accounting:

₹ 000's

| Year                     | 1   | 2   | 3   | 4   | 5   |
|--------------------------|-----|-----|-----|-----|-----|
| Gross Block              | 100 | 100 | 100 | 100 | 100 |
| Accumulated Depreciation | 20  | 40  | 60  | 80  | 100 |
| Carrying Amount          | 80  | 60  | 40  | 20  | 0   |

**Tax Accounting:**

₹ 000's

| Year                     | 1   | 2   | 3   | 4   | 5   |
|--------------------------|-----|-----|-----|-----|-----|
| Gross Block              | 100 | 100 | 100 | 100 | 100 |
| Accumulated Depreciation | 25  | 50  | 75  | 100 | 100 |
| Carrying Amount          | 75  | 50  | 25  | 0   | 0   |

**Calculation of DTL:**

₹ 000's

| Year                                      | 1   | 2  | 3   | 4  | 5 |
|-------------------------------------------|-----|----|-----|----|---|
| Carrying Amount                           | 80  | 60 | 40  | 20 | 0 |
| Tax Base                                  | 75  | 50 | 25  | 0  | 0 |
| Difference                                | 5   | 10 | 15  | 20 | 0 |
| Deferred Tax Liability (Difference x 30%) | 1.5 | 3  | 4.5 | 6  | 0 |

5. In this case there is a Deferred Tax Asset as the Tax base of assets acquired is higher by 25,000. DTA would be ₹ 7,500 (25,000 x 30%)

**Journal entry:**

|                     |    |                |     |
|---------------------|----|----------------|-----|
| Plant and equipment | Dr | 250            |     |
| Inventory           | Dr | 120            |     |
| Debtors             | Dr | 200            |     |
| Goodwill            | Dr | 22.5 (30- 7.5) |     |
| DTA                 | Dr | 7.5            |     |
| To 9% Debentures    |    |                | 100 |
| To Bank             |    |                | 500 |

6. The year-wise anticipated reversal of temporary differences is as under:

| Particulars                                                                                                 | Year ending on 31 <sup>st</sup> March, 20X2 | Year ending on 31 <sup>st</sup> March, 20X3 | Year ending on 31 <sup>st</sup> March, 20X4 | Year ending on 31 <sup>st</sup> March, 20X5 |
|-------------------------------------------------------------------------------------------------------------|---------------------------------------------|---------------------------------------------|---------------------------------------------|---------------------------------------------|
| Reversal of taxable temporary difference relating to accelerated depreciation over next 3 years (₹ 9,000/3) | 3,000                                       | 3,000                                       | 3,000                                       | Nil                                         |
| Reversal of deductible temporary                                                                            |                                             |                                             |                                             |                                             |

|                                                                           |       |       |       |       |
|---------------------------------------------------------------------------|-------|-------|-------|-------|
| difference relating to preliminary expenses over next 4 years (₹ 4,000/4) | 1,000 | 1,000 | 1,000 | 1,000 |
|---------------------------------------------------------------------------|-------|-------|-------|-------|

B Limited will recognise a deferred tax liability of ₹ 2,700 on taxable temporary difference relating to accelerated depreciation of ₹ 9,000 @ 30%.

However, it will limit and recognise a deferred tax asset on reversal of deductible temporary difference relating to preliminary expenses reversing up to year ending 31<sup>st</sup> March, 20X4 amounting to ₹ 900 (₹ 3,000 @ 30%). No deferred tax asset shall be recognized for the reversal of deductible temporary difference for the year ending on 31<sup>st</sup> March, 20X5 as there are no taxable temporary differences. Further, the outlook is also a loss. However, if there are tax planning opportunities that could be identified for the year ending on 31<sup>st</sup> March, 20X5 deferred tax asset on the remainder of ₹ 1,000 (₹ 4,000 – ₹ 3,000) of deductible temporary difference could be recognised at the 30% tax rate.

7. (i) The tax loss creates a potential deferred tax asset for the group since its carrying value is nil and its tax base is ₹ 30,00,000.

However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.

- (ii) The provision creates a potential deferred tax asset for the group since its carrying value is ₹ 20,00,000 and its tax base is nil.

This deferred tax asset can be recognised because X Ltd. is expected to generate taxable profits in excess of ₹ 20,00,000 in the year to 31<sup>st</sup> March, 20X3.

The amount of the deferred tax asset will be ₹ 4,00,000 (₹ 20,00,000 x 20%).

This asset will be presented as a deduction from the deferred tax liabilities caused by the (larger) taxable temporary differences.

- (iii) The development costs have a carrying value of ₹ 15,20,000 (₹ 16,00,000 – (₹ 16,00,000 x 1/5 x 3/12)).

The tax base of the development costs is nil since the relevant tax deduction has already been claimed.

The deferred tax liability will be ₹ 3,04,000 (₹ 15,20,000 x 20%). All deferred tax liabilities are shown as non-current.

- (iv) The carrying value of the loan at 31<sup>st</sup> March, 20X2 is ₹ 1,07,80,000 (₹ 1,00,00,000 – ₹ 2,00,000 + (₹ 98,00,000 x 10%)).

The tax base of the loan is ₹ 1,00,00,000.

This creates a deductible temporary difference of ₹ 7,80,000 (₹ 1,07,80,000 – ₹ 1,00,00,000) and a potential deferred tax asset of ₹ 1,56,000 (₹ 7,80,000 x 20%).

Due to the availability of taxable profits next year (see part (ii) above), this asset can be recognised as a deduction from deferred tax liabilities.

#### 8. Impact on consolidated balance sheet of PQR Ltd. group at 31<sup>st</sup> March, 20X2

- The tax loss creates a potential deferred tax asset for the PQR Ltd. group since its carrying value is nil and its tax base is ₹ 30,00,000. However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.
- The development costs have a carrying value of ₹ 15,20,000 (₹ 16,00,000 – (₹ 16,00,000 x 1/5 x 3/12)). The tax base of the development costs is nil since the relevant tax deduction has already been claimed. The deferred tax liability will be ₹ 4,56,000 (₹ 15,20,000 x 30%). All deferred tax liabilities are shown as non-current.
- The carrying value of the loan at 31<sup>st</sup> March, 20X2 is ₹ 1,07,80,000 (₹ 1,00,00,000 – ₹ 200,000 + (₹ 98,00,000 x 10%)). The tax base of the loan is 1,00,00,000. This creates a deductible temporary difference of ₹ 7,80,000 and a potential deferred tax asset of ₹ 2,34,000 (₹ 7,80,000 x 30%).

#### 9. Calculation of Deductible temporary differences:

|                                  |   |            |
|----------------------------------|---|------------|
| Deferred tax asset               | = | ₹ 80,000   |
| Existing tax rate                | = | 40%        |
| Deductible temporary differences | = | 80,000/40% |
|                                  | = | ₹ 2,00,000 |

#### Calculation of Taxable temporary differences:

|                                  |   |              |
|----------------------------------|---|--------------|
| Deferred tax liability           | = | ₹ 60,000     |
| Existing tax rate                | = | 40%          |
| Deductible temporary differences | = | 60,000 / 40% |
|                                  | = | ₹ 1,50,000   |

Of the total deferred tax asset balance of ₹ 80,000, ₹ 28,000 is recognized in OCI

Hence, Deferred tax asset balance of Profit & Loss is ₹ 80,000 - ₹ 28,000 = ₹ 52,000

Deductible temporary difference recognized in Profit & Loss is ₹ 1,30,000 (52,000 / 40%)

Deductible temporary difference recognized in OCI is ₹ 70,000 (28,000 / 40%)

The adjusted balances of the deferred tax accounts under the new tax rate are:

| Deferred tax asset                |                   | ₹             |
|-----------------------------------|-------------------|---------------|
| Previously credited to OCI-equity | ₹ 70,000 x 0.45   | 31,500        |
| Previously recognised as Income   | ₹ 1,30,000 x 0.45 | <u>58,500</u> |
|                                   |                   | <u>90,000</u> |
| Deferred tax liability            |                   |               |
| Previously recognized as expense  | ₹ 1,50,000 x 0.45 | 67,500        |

The net adjustment to deferred tax expense is a reduction of ₹ 2,500. Of this amount, ₹ 3,500 is recognised in OCI and ₹ 1,000 is charged to P&L.

The amounts are calculated as follows:

|                                   | Carrying amount at 45% | Carrying amount at 40% | Increase (decrease) in deferred tax expense |
|-----------------------------------|------------------------|------------------------|---------------------------------------------|
| <b>Deferred tax assets</b>        |                        |                        |                                             |
| Previously credited to OCI-equity | 31,500                 | 28,000                 | (3,500)                                     |
| Previously recognised as Income   | <u>58,500</u>          | <u>52,000</u>          | <u>(6,500)</u>                              |
|                                   | 90,000                 | 80,000                 | (10,000)                                    |
| <b>Deferred tax liability</b>     |                        |                        |                                             |
| Previously recognized as expense  | 67,500                 | 60,000                 | <u>7,500</u>                                |
| Net adjustment                    |                        |                        | <u>(2,500)</u>                              |

| An alternative method of calculation is: |                           | ₹     |
|------------------------------------------|---------------------------|-------|
| DTA shown in OCI                         | ₹ 70,000 x (0.45 - 0.40)  | 3,500 |
| DTA shown in Profit or Loss              | ₹ 1,30,000 x (0.45-0.40)  | 6,500 |
| DTL shown in Profit or Loss              | ₹ 1,50,000 x (0.45 -0.40) | 7,500 |

### Journal Entries

|                          |     | ₹     | ₹     |
|--------------------------|-----|-------|-------|
| Deferred tax asset       | Dr. | 3,500 |       |
| OCI –revaluation surplus |     |       | 3,500 |
| Deferred tax asset       | Dr. | 6,500 |       |
| Deferred tax expense     |     |       | 6,500 |

|                        |     |       |       |
|------------------------|-----|-------|-------|
| Deferred tax expense   | Dr. | 7,500 |       |
| Deferred tax liability |     |       | 7,500 |

Alternatively, a combined journal entry may be passed as follows:

|                             |     | ₹      | ₹     |
|-----------------------------|-----|--------|-------|
| Deferred tax asset          | Dr. | 10,000 |       |
| Deferred tax expense        | Dr. | 1,000  |       |
| To OCI –revaluation surplus |     |        | 3,500 |
| To Deferred tax liability   |     |        | 7,500 |

**10. Calculation of Net assets acquired (excluding the effect of deferred tax liability):**

| Net assets acquired                      | Tax base<br>₹'000 | Fair values<br>₹'000 |
|------------------------------------------|-------------------|----------------------|
| Land and buildings                       | 500               | 700                  |
| Property, plant and equipment            | 200               | 270                  |
| Inventory                                | 100               | 80                   |
| Accounts receivable                      | 150               | 150                  |
| Cash and cash equivalents                | 130               | 130                  |
| Total assets                             | 1,080             | 1,330                |
| Accounts payable                         | (160)             | (160)                |
| Retirement benefit obligations           | -                 | (100)                |
| Net assets before deferred tax liability | 920               | 1,070                |

**Calculation of deferred tax arising on acquisition of entity S and goodwill**

|                                                                                     | ₹ '000 | ₹ '000 |
|-------------------------------------------------------------------------------------|--------|--------|
| Fair values of S's identifiable assets and liabilities (excluding deferred tax)     |        | 1,070  |
| Less: Tax base                                                                      |        | (920)  |
| Temporary difference arising on acquisition                                         |        | 150    |
| Net deferred tax liability arising on acquisition of entity S<br>(₹ 1,50,000 @ 40%) |        | 60     |
| Purchase consideration                                                              |        | 1,500  |

|                                                                                              |       |         |
|----------------------------------------------------------------------------------------------|-------|---------|
| Less: Fair values of entity S's identifiable assets and liabilities (excluding deferred tax) | 1,070 |         |
| Deferred tax liability                                                                       | (60)  | (1,010) |
| Goodwill arising on acquisition                                                              |       | 490     |

**Note:** Since, the tax base of the goodwill is nil, taxable temporary difference of ₹ 4,90,000 arises on goodwill. However, no deferred tax is recognised on the goodwill. The deferred tax on other temporary differences arising on acquisition is provided at 40% and not 30%, because taxes will be payable or recoverable in entity S's tax jurisdictions when the temporary differences will be reversed.

## UNIT 2 : INDIAN ACCOUNTING STANDARD 21 : THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

### LEARNING OUTCOMES

After studying this unit, you will be able to:

- ☐ Describe the objective and scope of the standard
- ☐ Define the terms used in the standard like closing rate, exchange difference, exchange rate, fair value, foreign currency, foreign operation, functional currency, monetary items, group, net investment in a foreign operation, presentation currency and spot exchange rate
- ☐ Report foreign currency transactions in the functional currency
- ☐ Report at the end of subsequent reporting periods foreign currency monetary and non-monetary items
- ☐ Recognise and account for the exchange differences
- ☐ Apply the translation procedures in case of change in functional currency
- ☐ Recognise the presentation currency and translate the items into it from the functional currency
- ☐ Incorporate the results and financial position of a foreign operation on translation
- ☐ Apply the provisions of translation in case of consolidation
- ☐ Deal with the disposal or partial disposal of a foreign operation
- ☐ Compute tax effects of all exchange differences
- ☐ Comply with the disclosure requirements given in the standard



UNIT OVERVIEW 

# Accounting for Foreign Currency Transactions

Initial  
Recognition  
at the  
Transaction  
Date

Subsequent  
Recognition  
at the end of  
each  
Reporting  
Period

## Recognition of Foreign Exchange Gains and Losses

Monetary

Non-  
Monetary  
Items

Net  
Investment  
in a Foreign  
Operation

Change in  
Functional  
Currency

## Presentation and Disclosure

Tax  
effect

Other  
items



## 2.1 OBJECTIVE

The objective of the Standard is to address the accounting for foreign activities which include:

- transactions in foreign currencies; or
- foreign operations.

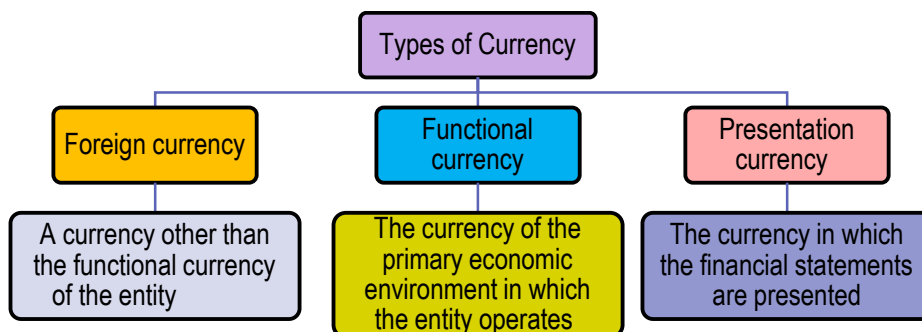
Considering that an entity may present its financial statements in a foreign currency, the Standard also seeks to prescribe how to translate financial statements into a presentation currency.

In this context, the Standard defines **foreign currency** as a currency other than the functional currency of the entity.

1. **Functional currency** is the currency of the primary economic environment in which the entity operates.

In this regard, the primary economic environment will normally be the one in which it primarily generates and expends cash i.e. it operates. The functional currency is normally the currency of the country in which the entity is located. It might, however, be a different currency.

2. **Foreign operation** has been defined as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.
3. **Presentation currency** is the currency in which the financial statements are presented, the presentation currency may be different from the entity's functional currency.
4. **Spot exchange rate** is the exchange rate for immediate delivery.
5. **Closing rate** is the spot exchange rate at the end of the reporting period.
6. **Exchange difference** is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates is the exchange rate for immediate delivery.





## 2.2 SCOPE

- Ind AS 21 shall be applied:
  - (a) in accounting for transactions and balances in foreign currencies, except for derivative transactions and balances covered by Ind AS 109.

Foreign currency derivatives not covered by Ind AS 109 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard.

The Standard also applies for translation of amounts relating to derivatives from functional currency to presentation currency.
  - (b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and
  - (c) in translating an entity's results and financial position into a presentation currency.
- Ind AS 21 **does not apply** to:
  - (a) hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation; Ind AS 109 should be applied for hedge accounting;
  - (b) presentation of cash flows from transactions in a foreign currency or to translation of cash flows of a foreign operation in the statement of cash flows (Refer Ind AS 7, Statement of Cash Flows); and
  - (c) long term foreign currency monetary items for which an entity has opted for the exemption as per Ind AS 101. Such an entity may continue to apply the accounting policy as opted for such long term foreign currency monetary items.



## 2.3 FUNCTIONAL CURRENCY

- An entity measures its assets, liabilities, equity, income and expenses in its functional currency.
- All transactions in currencies other than the functional currency are foreign currency transactions.

Ind AS 21 requires each entity to determine its functional currency.

- In determining its functional currency, an entity emphasises the currency that determines the pricing of the transactions that it undertakes, rather than focusing on the currency in which those transactions are denominated.
- The following are the factors that may be considered in determining an appropriate functional currency (**Primary indicators**):

- (a) the currency:
  - i. that mainly influences sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and
  - ii. of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
- (b) the currency that mainly influences labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.
- Other factors that may provide supporting evidence to determine an entity's functional currency are (**Secondary indicators**):
  - (a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
  - (b) the currency in which receipts from operating activities are usually retained.
- **If an entity is a foreign operation**, additional factors are set out in this Standard which should be considered to determine whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint venture:
  - (a) Whether the activities of foreign operations are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;

**An example of the former is when** the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it.

**An example of the latter** is when the foreign operations accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.
  - (b) Whether the transactions with the reporting entity are a high or a low proportion of the foreign operation's activities;
  - (c) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.
  - (d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity.

These factors also demonstrate whether the entity is integral to the reporting entity or not. In practice, the functional currency of a foreign operation that is integral to the parent / reporting entity will usually be the same as that of the parent / reporting entity.

- Determining an entity's functional currency depends on the facts and circumstances.

- When the above indicators are mixed and the functional currency is not obvious, the management will be required to use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, management has to give priority to the primary indicators before considering the other indicators, which are designed to provide additional supporting evidence to determine an entity's functional currency.

### Illustration 1

*Future Ltd. sells a revitalising energy drink that is sold throughout the world. Sales of the energy drink comprise over 90% of the revenue of Future Ltd. For convenience and consistency in pricing, sales of the energy drink are denominated in USD. All financing activities of Future Ltd. are in its local currency (L\$), although the company holds some USD cash reserves. Almost all of the costs incurred by Future Ltd. are denominated in L\$.*

*Determine the functional currency of Future Ltd.*

### Solution

The functional currency of Future Ltd. is L\$ looking at the primary indicators. The facts presented indicate that the currency that mainly influence the cost of producing the energy drink is the L\$. As stated in the fact pattern, pricing of the product in USD is done for convenience and consistency purposes; there is no indication that the sales price is influenced by the USD.

\*\*\*\*\*

### Illustration 2

*Small India Private Limited (Small), a subsidiary of Big Inc., takes orders from Indian customers for Big Inc's merchandise and then bills and collects for the sale of the merchandise in Rupees. Small also has a local warehouse in India to facilitate timely delivery and ensures that it remits to its parent all cash flows that it generates as the operations of Small are primarily financed by Big Inc. Big Inc is based out of US and has its functional currency as USD.*

*Determine the functional currency of Small India Private Limited.*

### Solution

Small, although based in India with its cash flows generated in India, is essentially a "pass through company" established by its parent. Small is totally reliant on Big Inc. for financing and goods to be sold, despite the fact that goods are sold within India and in Rupees (₹). Therefore, Small is not a self-contained entity in India, rather an entity that is dependent on its parent.

Due to this dependence of Small on its parent company, it can be said that the primary economic environment for Small is that of US and thus, its functional currency should also be USD.

Hence all the transactions of Small which are denominated in any currency other than USD should be recorded in USD at the spot rate and any changes in the exchange rate would result in an exchange gain or loss to be taken to the statement of profit or loss.

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### Illustration 3

*A is an Oman based company having a foreign operation, B, in India. The foreign operation was primarily set up to execute a construction project in India. The functional currency of A is OMR.*

*78% of entity B's finances have been raised in USD by way of contribution from A. B's bank accounts are maintained in USD as well as Rupees (₹). Cash flows generated by B are transferred to A on a monthly basis in USD in respect of repayment of finance received from A.*

*Revenues of B are in USD. Its competitors are globally based. Tendering for the construction project happened in USD.*

*B incurs 70% of the cost in Rupees (₹) and remaining 30% costs in USD.*

*Comment since B is located in India, can it presume its functional currency to be Rupees (₹).*

### Solution

No, B cannot presume Rupees (₹) to be its functional currency on the basis of its location. It needs to consider various factors listed in Ind AS for determination of functional currency.

#### Primary indicators:

1. the currency that mainly influences
  - (a) sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
  - (b) labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.
2. Other factors that may provide supporting evidence to determine an entity's functional currency are **(Secondary indicators)**:
  - (a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
  - (b) the currency in which receipts from operating activities are usually retained.
3. **If an entity is a foreign operation**, additional factors set out in Ind AS 21 should be considered to determine whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint venture:
  - (a) Whether the activities of foreign operations are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;

- (b) Whether the transactions with the reporting entity are a high or a low proportion of the foreign operation's activities;
- (c) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.
- (d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity.

**On the basis of** additional factors mentioned in point 3 above, B cannot be said to have functional currency same as that of A Ltd.

Hence primary and secondary indicators should be used for the determination of functional currency of B giving priority to primary indicators. The analysis is given below:

- Its significant revenues and competitive forces are in USD.
- Its significant portion of cost is incurred in Rupees (₹). Only 30% costs are in USD.
- 78% of its finances have been raised in USD.
- It retains its operating cash flows partially in USD and partially in Rupees (₹).

Keeping these factors in view, USD should be considered as the functional currency of B.

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#### Illustration 4

*S Ltd is a company based out of India which got listed on Bombay Stock Exchange in the financial year ended 31<sup>st</sup> March, 20X1. Since then, the company's operations have increased considerably. The company was engaged in the business of trading of motorcycles. The company only deals in imported motorcycles. These motorcycles are imported from US.*

*After importing the motorcycles, these are sold across India through its various distribution channels. The company had only private customers earlier, but the company also started corporate tie-up and increased its customer base to corporates also. The purchase of the motorcycles are in USD because the vendor(s) from whom these motorcycles are purchased those are all located in US.*

*All other operating expenses of the company are incurred in India only because of its location and they generally happen to be in Rupees (₹).*

*Currently, its customers are both corporate and private in the ratio of 70:30 approximately. The USD denominated prices of motorcycles in India are different from those in other countries.*

*The company is also expecting that in the coming years, its customers base will increase significantly in India and the current proportion may also change.*

*Currently, the invoices are raised to the corporate customers in USD for the purpose of hedging. However, private customers don't accept the same arrangement and hence invoices are raised to them in Rupees (₹).*

*Determine the functional currency of the company.*

### **Solution**

The functional currency of S Ltd is Rupees (₹).

Following factors need to be considered for determination of functional currency:

#### **Primary indicators**

1. the currency that mainly influences
  - (a) sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
  - (b) labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.
2. Other factors that may provide supporting evidence to determine an entity's functional currency are **(Secondary indicators)**:
  - (a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
  - (b) the currency in which receipts from operating activities are usually retained.

Primary and secondary indicators should be used for the determination of functional currency of S Ltd. giving priority to primary indicators.

The analysis is given below:

Ind AS 21 gives greater emphasis to the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated.

Sales prices for motorcycles are mainly influenced by the competitive forces and regulations in India. The market for motorcycles depends on the economic situation in India and the company is in competition with importers of other motor cycle brands.

Even though 70% of the revenue of the company is denominated in USD, Indian economic conditions are the main factors affecting the prices. This is evidenced by the fact that USD denominated sales prices in India are different from USD denominated sales prices for the same motorcycles in other countries.

Management is able to determine the functional currency because the revenue is clearly influenced by the Indian economic environment and expenses are mixed.



On the basis of above analysis, Rupees (₹) should be considered as the functional currency of the company.

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## 2.4 ACCOUNTING FOR FOREIGN CURRENCY TRANSACTIONS

### 2.4.1 Initial recognition at the transaction date

- A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency (i.e., a currency other than the functional currency of the entity), including transactions arising when an entity:
  - (a) buys or sells goods or services whose price is denominated in a foreign currency;
  - (b) borrows or lends funds with amounts denominated in a foreign currency; or
  - (c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.
- A foreign currency transaction is initially recorded by translation in the entity's functional currency at the exchange rate on the transaction date.

For practical reasons, a rate that approximates the actual exchange rate is often used.

#### Example

An average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period.

However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

### 2.4.2 Monetary vs non-monetary items

| S. No. | Particulars       | Monetary items                                                                                                                       | Non-monetary item                                             |
|--------|-------------------|--------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------|
| 1.     | Units of currency | Units of currency held and assets and liabilities to be received or paid are in a fixed or determinable number of units of currency. | There is no fixed or determinable number of units of currency |

- **Examples of monetary items** include:
  - ♦ pensions and other employee benefits to be paid in cash;
  - ♦ provisions that are to be settled in cash;
  - ♦ lease liabilities;

- ◆ cash dividends that are recognised as a liability;
- ◆ contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value\* to be received (or delivered) equals a fixed or determinable number of units of currency.
- ◆ Most debt securities are considered as monetary items because their contractual cash flows are fixed or determinable.

**Note:** Fair value is the price that would be recovered to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- **Examples of non-monetary items** include:
  - ◆ amounts prepaid for goods and services and income received in advance, on the basis that no money will be paid or received in the future;
  - ◆ goodwill;
  - ◆ intangible assets;
  - ◆ inventories;
  - ◆ property, plant and equipment;
  - ◆ right-of-use assets;
  - ◆ provisions that are to be settled by the delivery of a non-monetary asset.

### 2.4.3 Subsequent recognition at the end of each reporting period

- At the reporting date, assets and liabilities denominated in a foreign currency are translated as follows:
  - (a) **monetary items** are translated at the exchange rate at the reporting date i.e., closing rate;
  - (b) **non-monetary items measured at historical cost** are translated at the exchange rate at the date of the transaction; and
  - (c) **non-monetary items measured at fair value in a foreign currency** are translated at the exchange rate on the date the fair value was determined.
- The carrying amount of the item is determined applying the relevant Accounting Standard.

#### Example

Property, plant and equipment may be measured at fair value or historical cost as per Ind AS 16, *Property, Plant and Equipment*.

The carrying amount so determined, be it on the basis of historical cost or fair value, if in foreign currency, is translated into the functional currency in accordance with this Standard.

- In some cases, the carrying amount of items is determined by comparing two or more amounts e.g.:
  - ◆ Inventories - measured at lower of cost and net realisable value.
  - ◆ Asset subject to impairment loss - lower of an asset's carrying amount and its recoverable amount.

If such an asset is non-monetary and measured in a foreign currency, the carrying amount is determined by comparing:

- (a) the cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e. the rate at the date of the transaction for an item measured in terms of historical cost); and
- (b) the net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (eg. the closing rate at the end of the reporting period).

The above may result in an impairment loss being recognised in the functional currency but not in the foreign currency, or vice versa.

#### **Example 1**

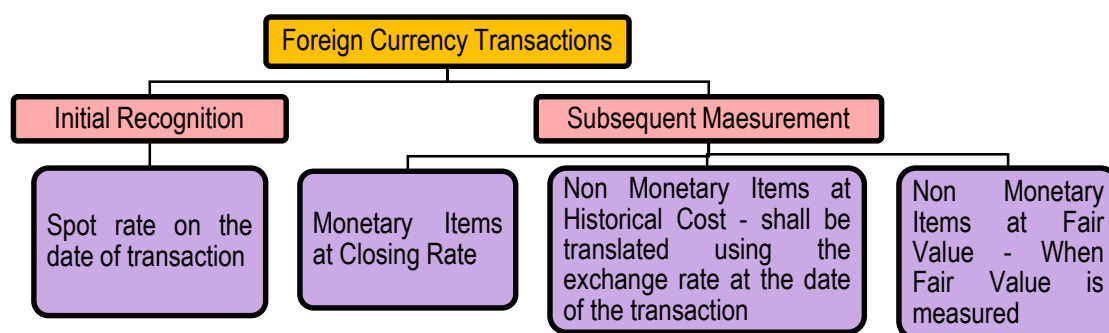
A foreign currency asset amounting to Euro 2,00,000 is recorded at the date of purchase when the exchange rate was ₹ 52 at ₹ 104 lacs.

The recoverable amount of the asset on the reporting date is calculated as Euro 1,75,000. The exchange rate on the date of valuation was ₹ 60 to a Euro.

The carrying value of the foreign currency asset will be determined based on the recoverable amount of the asset converted into functional currency at the exchange rate on valuation date which is ₹ 105 lacs.

The impairment loss of Euro 25,000 in foreign currency is not recognised.

- Where a country has multiple exchange rates, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.



## 2.4.4 Recognition of foreign exchange gains and losses

- Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.
- When the transaction occurs and settles within the same accounting period, all the exchange difference is recognized in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference is recognised in each period till settlement date based on change in exchange rates during each period.

### 2.4.4.1 Monetary items

Exchange differences arising on the settlement of monetary items or on translating monetary items are recognised in profit or loss, except:

- for accounting of exchange difference as required by application of hedge accounting under Ind AS 109. For example - Ind AS 109 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge should be recognised initially in other comprehensive income to the extent that the hedge is effective;
- for monetary items that in substance form part of the reporting entity's net investment in a foreign operation (discussed below);
- for long-term foreign currency monetary items in case the entity has exercised the option for recognising exchange differences on such items in equity (discussed below).

### 2.4.4.2 Non-monetary items

- Ind AS requires certain gains and losses to be recognised in other comprehensive income.

**For example**, revaluation gain or loss on property, plant and equipment is recognised in other comprehensive income as per Ind AS 16. When such an asset is measured in a foreign currency and its revalued amount is translated as per this Standard using the rate at the date the fair value was determined, the resulting exchange gain or loss is also recognised in other comprehensive income.

- If the gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss is also recognized in profit or loss.

#### 2.4.4.3 Net investment in a foreign operation

- **Net investment in a foreign operation** is the amount of the reporting entity's interest in the net assets of that operation.
- A monetary item receivable from or payable to a foreign operation may form part of the net investment in a foreign operation if the settlement of the monetary item is neither planned nor likely to occur in the foreseeable future.

A loan to a foreign entity which is repayable on demand might seem to be a short-term item, rather than part of capital. However, if there is demonstrably no intent or expectation to demand repayment (e.g., the short-term loan is getting rolled over continuously, whether or not the foreign subsidiary is able to repay it), the loan has the same economic effect as that of a capital contribution.

On the other hand, when there is a long-term loan with a fixed maturity period (say, 10 to 15 years) it does not automatically qualify to be treated as being part of the net investment simply because it is of a long duration, unless management has expressed its intention to renew the loan at maturity and accordingly, the period of repayment is not foreseeable.

It lies on the management to document its intention to renew by auditable evidence, such as board minutes. Otherwise, in the absence of management's intention to renew, the loan's maturity date implies that its settlement is planned in the foreseeable future.

- Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.
- Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation (i.e. a subsidiary, associate or joint venture) should be treated as follows:
  - ◆ Such exchange differences are recognised in profit or loss in the separate financial statements of the reporting entity and/or the individual financial statements of the foreign operation, as appropriate:
    - ❖ If such an item is denominated in the functional currency of the reporting entity, an exchange difference arises in the foreign operation's individual financial statements.
    - ❖ If such an item is denominated in the functional currency of the foreign operation, an exchange difference arises in the reporting entity's separate financial statements.
    - ❖ If such an item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, an exchange difference arises

in the reporting entity's separate financial statements and in the foreign operation's individual financial statements.

- ◆ In the financial statements that include the foreign operation and the reporting entity (e.g., consolidated financial statements when the foreign operation is a subsidiary, associate or joint venture), such exchange differences are recognised initially in other comprehensive income and then reclassified from equity to profit or loss on disposal of the net investment.

### Illustration 5

*Functional currency of parent P is EURO while the functional currency of its subsidiary S is USD. P sells inventory to S and a transaction for the same was made for USD 300 during the year. At the year end, a balance of the same amount is outstanding as receivable from S. It has been observed that such balance amount has been continuing as receivable from S year on year and even though the payments in respect of these balances are expected to be received in the foreseeable future but if we look at the year-end then we see this balance as outstanding every year.*

*In addition to the trading balances between P and S, P has lent an amount of USD 500 to S that is not expected to be repaid in the foreseeable future.*

*Analyse whether the exchange difference, if any, should be recognised in the profit and loss.*

### Solution

The exchange gain or loss will arise in the books of accounts of P in respect of its trading balance with S and the same should be recognised in profit or loss. This being a balance for in the nature of trade receivable for P, it would not be considered as its net investment in a foreign operation (i.e. S).

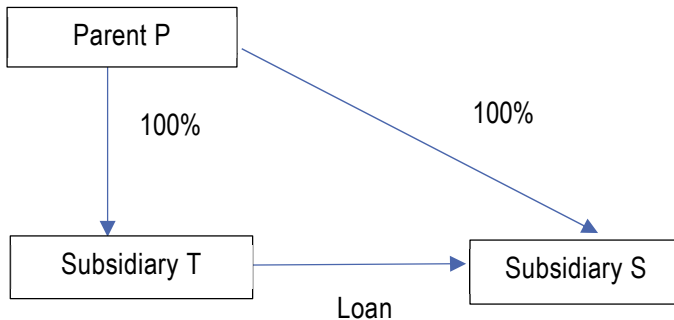
The amount lent by P should be regarded as its net investment in S (i.e. foreign operation). Thus, the exchange gain or loss incurred by P on the USD 500 loan should be recognised in profit or loss in P's separate financial statements and in other comprehensive income in its consolidated financial statements.

\*\*\*\*\*

### Illustration 6

*In the above illustration, suppose that for tax reasons, the 'permanent' funding (i.e. loan amount) extended to S is made via another entity in the group, T, rather than from P directly. That is, on the directions of P, T gives the loan to S. T is also a subsidiary of P.*

*Demonstrate where should the exchange difference, if any, be recognised.*

**Solution**

Any exchange difference in respect of the loan is recognised in other comprehensive income in the consolidated financial statements because from the group's point of view the funding relates to an investment in a foreign operation. This is the case irrespective of the currency in which the loan is denominated. So, if the loan is denominated in T's functional currency, and this is different from that of S, then exchange differences still should be recognised in other comprehensive income in the consolidated financial statements.

\*\*\*\*\*

## 2.4.5 Change in functional currency

- Once an entity has determined its functional currency, it is not changed unless there is a change in the relevant underlying transactions, events and conditions.
- If circumstances change and a change in functional currency is appropriate, then the change is accounted for prospectively from the date of the change.

**For example,** a change in the currency that mainly influences the sales price of goods and services may lead to a change in an entity's functional currency.

- For accounting the effect of a change in functional currency prospectively:
  - ◆ All items are translated into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost.
  - ◆ Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation.
  - ◆ Exchange gain or loss from long-term monetary items accumulated in equity (where such option is exercised) are not transferred to profit or loss immediately on change of the entity's functional currency; the balance would be transferred to profit or loss as per the manner provided by the option.

- Since entities prefer to present financial statements in their functional currency, a change in functional currency may be accompanied by a change in presentation currency. The choice of presentation currency represents an accounting policy, and any change should be applied retrospectively in accordance with Ind AS 8, unless impracticable. This means that the change should be treated as if the new presentation currency had always been the entity's presentation currency, with comparative amounts being restated into the new presentation currency.



## 2.5 USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

### 2.5.1 Translation to the presentation currency

- An entity measures items in its financial statements; but it may decide to present its financial statements in a currency or currencies other than its functional currency.

**For example,** an entity with Rupees (₹) functional currency may choose to present its financial statements in US Dollar because of its reporting requirement in US.

- There can be situations wherein a group comprises operations with a number of functional currencies. Under Ind AS 21, there is no concept of a “group” functional currency. Rather the group has a presentation currency only. Each entity in the group prepares financial statements in its own functional currency and translates these financial statements into the group's presentation currency (if different) for consolidation purposes.
- The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency as follows:
  - (a) **assets and liabilities** for each balance sheet presented (i.e., including comparatives) are translated **at the closing rate** at the date of that balance sheet;
  - (b) **income and expenses** are translated at exchange rates at the dates of relevant transactions; **average rates** for the period if often used if they are a reasonable approximation;
  - (c) all **resulting exchange differences** should be **recognised in other comprehensive income** as they have little or no direct effect on the present and future cash flows from operations and are presented in a separate component of equity (generally referred to as the foreign currency translation reserve or currency translation adjustment) until disposal of the foreign operation;
  - (d) cash flows are translated at exchange rates at the dates of the relevant transactions, although an appropriate average rate may be used.



- When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognized as a part of, non-controlling interest in the consolidated balance sheet.
- The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy shall be translated into a different presentation currency as follows:
  - (a) all amounts (i.e. assets, liabilities, equity items, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent balance sheet, except that
  - (b) when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (ie not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).
    - When an entity's functional currency is the currency of a hyperinflationary economy, the entity shall restate its financial statements in accordance with Ind AS 29 before applying the translation method set out above, except for comparative amounts that are translated into a currency of a non-hyperinflationary economy.



## 2.6 TRANSLATION OF FOREIGN OPERATIONS

- The guidance provided on determining an entity's functional currency equally applies to determine the functional currency of a foreign operation of the entity.
- Effectively, the translation procedures those for translating foreign operations are the same as those followed when an entity presents its financial statements in a presentation currency that is different from its functional currency:
  - (a) assets and liabilities are translated at the exchange rate at the reporting date;
  - (b) items of income and expense are translated at exchange rates at the dates of the relevant transactions, although appropriate average rates may be used;
  - (c) the resulting exchange differences are recognised in other comprehensive income and are presented in a separate component of equity (generally referred to as the foreign currency translation reserve or currency translation adjustment) until disposal of the foreign operation; and
  - (d) cash flows are translated at exchange rates at the dates of the relevant transactions, although an appropriate average rate may be used.

- In addition to the exchange difference as stated above, the foreign currency translation reserve may include exchange differences arising from loans that form part of the parent's net investment in the foreign operation and gains and losses related to hedges of a net investment in a foreign operation.

## 2.7 DIFFERENCE IN THE REPORTING DATES

- When there is difference in the year end of foreign operation and that of the reporting entity, the foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements.
- When such financial statements are not prepared, Ind AS 110 allows the use of a different date provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates.
- In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the end of the reporting period of the foreign operation.
- Adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity in accordance with Ind AS 110.
- A similar approach is used in applying the equity method to associates and joint ventures in accordance with Ind AS 28, *Investment in Associates and Joint Ventures*.

## 2.8 INTRA-GROUP TRANSACTIONS

- Although intra-group balances are eliminated on consolidation, any related foreign exchange gains or losses will not be eliminated. This is because the group has a real exposure to a foreign currency since one of the entities will need to obtain or sell foreign currency in order to settle the obligation or realise the proceeds received.
- Accordingly, in the consolidated financial statements of the reporting entity, the exchange difference arising on such intra group transactions is recognised in the statement of profit or loss account, unless it arises from a monetary item that forms part of a reporting entity's net investment in a foreign operation in which case it is taken to other comprehensive income.
- A Group may have intra-group transactions like sale and purchase of various assets such as property, plant and equipment, intangible assets or inventory. These transactions could result in intra-group profits or losses. At the time of consolidation, these profits / losses are eliminated until the profit or loss is realized i.e. when the asset is sold outside the group, depreciated, amortised or written off as per the requirements of Ind AS 110. The elimination of intra-group profits / losses arising from such transactions, like sales between entities that are consolidated,

should be based on the spot rate i.e. the exchange rate of the date of the sale.

### Example 2

Parent P has USD as its functional currency and Subsidiary S has Euro as its functional currency. P, whose reporting date is 31<sup>st</sup> March, lends USD 100 to S on 30<sup>th</sup> September, 20X1. S converted the loan amount received into Euro on receipt.

|                                                   |                                                         | USD |               | EURO          |
|---------------------------------------------------|---------------------------------------------------------|-----|---------------|---------------|
| Exchange rate at 30 <sup>th</sup> September, 20X1 |                                                         | 1   | =             | 1.5           |
| Exchange rate at 31 <sup>st</sup> March, 20X2     |                                                         | 1   | =             | 2.0           |
| <b>Entries in the books of account of S</b>       |                                                         |     | <b>Debit</b>  | <b>Credit</b> |
|                                                   |                                                         |     | <b>(EURO)</b> | <b>(EURO)</b> |
| Date                                              | Particulars                                             |     |               |               |
| 30 <sup>th</sup> September, 20X1                  | Bank A/c                                                | Dr. | 150           |               |
|                                                   | To Intra-group payable                                  |     |               | 150           |
|                                                   | <i>(To recognize intra-group loan)</i>                  |     |               |               |
| 31 <sup>st</sup> March, 20X2                      | Exchange loss A/c                                       | Dr. | 50            |               |
|                                                   | To Intra-group payable                                  |     |               | 50            |
|                                                   | <i>(To recognize exchange loss on intra-group loan)</i> |     |               |               |

In S's second entry, the liability is remeasured at 31<sup>st</sup> March, 20X2 and a translation loss is recorded.

### Entries in the books of account of P

|                                  |                                                 |     | Debit (USD) | Credit (USD) |
|----------------------------------|-------------------------------------------------|-----|-------------|--------------|
| 30 <sup>th</sup> September, 20X1 | Intra group receivable                          | Dr. | 100         |              |
|                                  | To Cash                                         |     |             | 100          |
|                                  | <i>(To recognize intra-group loan on issue)</i> |     |             |              |

On consolidation at 31<sup>st</sup> March, 20X2, the receivable and payable (in respect of Intra-group receivable and payable) will be eliminated. However, an exchange loss equivalent to EURO 50 for the year ended 31<sup>st</sup> March, 20X2 will remain on consolidation. This is appropriate because S will need to obtain USD in order to repay the liability. Therefore, the group has a foreign currency exposure. The exchange loss will be taken to consolidated profit or loss, unless the loan forms part of P's net investment in S in which case it will be transferred to other comprehensive income at the time of consolidation.

**Illustration 7**

*The functional and presentation currency of parent P is USD while the functional currency of its subsidiary S is EURO. P sold goods having a value of USD 100 to S when the exchange rate was USD 1 = Euro 2. At year-end, the amount is still due, and the exchange rate is USD 1 = Euro 2.2.*

*Advise how should the exchange difference, if any, be accounted for in the consolidated financial statements.*

**Solution**

At year-end, S should restate its accounts payable to EURO 220, recognising a loss of Euro 20 in its profit or loss. Thus, in the books of S, the balance payable to P will appear at EURO 220 while in the books of P the balance receivable from S will be USD 100.

For consolidation purposes, the assets and liabilities of S will be translated to USD at the closing rate.

At the time of consolidation, USD 100 which will get eliminated against the receivable in the books of P but the exchange loss of EURO 20 recorded in the subsidiary's statement of profit or loss has no equivalent gain in the parent's financial statements. Therefore, exchange loss of EURO 20 will remain in the consolidated statement of profit or loss.

The reason for this is that the intra-group balance represents a commitment to translate Euro into USD and this is similar to holding a foreign currency asset in the books of the parent company. i.e. the subsidiary would be required to buy USD to settle the obligation to the parent, so the Group has an exposure to foreign currency risk.

\*\*\*\*\*

**Illustration 8**

*M Ltd is engaged in the business of manufacturing of bottles for pharmaceutical companies and non-pharmaceutical companies. It has a wholly owned subsidiary, G Ltd, which is engaged in the business of pharmaceuticals. G Ltd purchases the pharmaceutical bottles from its parent company. The demand of G Ltd is very high and hence to cater to its shortfall, G Ltd also purchases the bottles from other companies. Purchases are made at the competitive prices.*

*M Ltd sold pharmaceuticals bottles to G Ltd for Euro 12 lacs on 1<sup>st</sup> February, 20X1. The cost of these bottles was ₹ 830 lacs in the books of M Ltd at the time of sale. At the year-end i.e. 31<sup>st</sup> March, 20X1, all these bottles were lying as closing stock and payable with G Ltd.*

*Euro is the functional currency of G Ltd. while Indian Rupee is the functional currency of M Ltd.*

*Following additional information is available:*

*Exchange rate on 1<sup>st</sup> February, 20X1*

*1 Euro = ₹ 83*

*Exchange rate on 31<sup>st</sup> March, 20X1*

*1 Euro = ₹ 85*

*Provide the accounting treatment for the above in books of M Ltd. and G Ltd. Also show its impact on consolidated financial statements. Support your answer by Journal entries, wherever necessary, in the books of M Ltd.*

### Solution

#### Accounting treatment in the books of M Ltd (Functional Currency Rupees (₹))

M Ltd will recognize sales of ₹ 996 lacs (12 lacs Euro x 83)

Profit on sale of inventory = 996 lacs – 830 lacs = ₹ 166 lacs.

On balance sheet date receivable from G Ltd. will be translated at closing rate i.e. 1 Euro = ₹ 85. Therefore, unrealised forex gain will be recorded in standalone profit and loss of ₹ 24 lacs. (i.e. (85 - 83) x 12 Lacs)

#### Journal Entries

|                                                                                                                           | ₹ (in Lacs) | ₹ (in Lacs) |
|---------------------------------------------------------------------------------------------------------------------------|-------------|-------------|
| G Ltd. A/c Dr.<br>To Sales<br>(Being revenue recorded on initial recognition)                                             | 996         | 996         |
| G Ltd. A/c Dr.<br>To Foreign exchange difference (unrealised)<br>(Being foreign exchange difference recorded at year end) | 24          | 24          |

#### Accounting treatment in the books of G Ltd (Functional currency EURO)

G Ltd will recognize purchases on 1<sup>st</sup> February, 20X1 of Euro 12 lacs which will also be its closing stock at year end.

#### Journal Entry

|                            | (in Euros) | (in Euros) |
|----------------------------|------------|------------|
| Purchases Dr.<br>To M Ltd. | 12 lakhs   | 12 lakhs   |

#### Accounting treatment in the consolidated financial statements

Receivable and payable in respect of above-mentioned sale / purchase between M Ltd and G Ltd will get eliminated.

The closing stock of G Ltd will be recorded at lower of cost or NRV.

|                    | Euro (in lacs) | Rate | ₹ (in lacs) |
|--------------------|----------------|------|-------------|
| Cost               | 12             | 83   | 996         |
| NRV (Assumed Same) | 12             | 85   | 1020        |

Therefore, no write off is required.

The amount of closing stock of ₹ 996 lacs includes two components–

- Cost of inventory for ₹ 830 lacs; and
- Profit element of ₹ 166 lacs; and

At the time of consolidation, the second element amounting to ₹ 166 lacs will be eliminated from the closing stock.

### Journal Entry

|                                                             | ₹ (in Lacs) | ₹ (in Lacs) |
|-------------------------------------------------------------|-------------|-------------|
| Consolidated P&L A/c Dr.                                    | 166         |             |
| To Inventory                                                |             | 166         |
| (Being profit element of intragroup transaction eliminated) |             |             |

\*\*\*\*\*

## 2.8.1 Dividends

If a subsidiary pays a dividend to the parent during the year the parent should record the dividend at the rate ruling when the dividend was declared. An exchange difference will arise in the parent's own financial statements if the exchange rate moves between the declaration date and the date the dividend is actually received. This exchange difference is required to be recognised in profit or loss and will remain there on consolidation.

The same will apply if the subsidiary declares a dividend to its parent on the last day of its financial year and this is recorded at the year-end in both entities' financial statements. There is no problem in that year as both the intragroup balances and the dividends will eliminate on consolidation with no exchange differences arising. However, as the dividend will not be received until the following year an exchange difference will arise in the parent's financial statements in that year if exchange rates have moved in the meantime. Again, this exchange difference should remain in consolidated profit or loss as it is no different from any other exchange difference arising on intragroup balances resulting from other types of intragroup transactions. It should not be recognised in other comprehensive income.

It may seem odd that the consolidated results can be affected by exchange differences on inter-company dividends. However, once the dividend has been declared, the parent now effectively has a functional currency exposure to assets that were previously regarded as part of the net investment. In order to minimise the effect of exchange rate movements entities should, therefore, arrange for inter-company dividends to be paid on the same day the dividend is declared, or as soon after the dividend is declared as possible.

## **2.9 GOODWILL AND FAIR VALUE ADJUSTMENTS ARISING FROM A BUSINESS COMBINATION**

- Any goodwill and any fair value adjustments to the carrying amounts of assets and liabilities arising on a foreign operation's acquisition are treated as assets and liabilities of the foreign operation.
- Hence, they are expressed in the functional currency of the foreign operation and should be translated at the closing exchange rate as is the case for other assets and liabilities.

## **2.10 DISPOSAL OR PARTIAL DISPOSAL OF FOREIGN OPERATIONS**

### **2.10.1 Full disposal**

- A disposal may arise, for example, through sale, liquidation or repayment of share capital. On disposal of the foreign operation, the cumulative exchange differences relating to that foreign operation recognised in other comprehensive income and accumulated in equity are reclassified from equity to profit or loss (reclassification adjustment) when the gain or loss on disposal is recognised.
- On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences related to that foreign operation that have been attributed to the non-controlling interests is derecognised, but it is not reclassified to profit or loss.
- In addition to the disposal of an entity's entire interest in a foreign operation, the following partial disposals are accounted for as disposals:
  - ◆ when the partial disposal involves the loss of control of a subsidiary that includes a foreign operation, regardless of whether the entity retains a non-controlling interest (NCI) in its former subsidiary after the partial disposal; and
  - ◆ when the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes a foreign operation.

**Example 3**

Parent P owns 100 percent of foreign subsidiary S. P sells 70 percent of its investment and loses control of S. The entire balance in the foreign currency translation reserve in respect of S is reclassified to profit or loss.

**2.10.2 Partial disposal**

A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except for those reductions that are accounted for as disposals.

In the case of the partial disposal of a subsidiary that includes a foreign operation, the entity re-attributes the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the NCI in that foreign operation.

In any other partial disposal of a foreign operation, the entity reclassifies to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.

**Examples 4 & 5**

4. Parent P owns 100 percent of foreign subsidiary S. P sells 10 percent of its investment and retains control over S. Therefore, 10 percent of the balance in the foreign currency translation reserve is reclassified to NCI.
5. Parent P owns 35 percent of foreign associate B. P sells a 5 percent stake and retains significant influence over B. Therefore, one-seventh ( $5/35$ ) of the balance in the foreign currency translation reserve is reclassified to profit or loss.

A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

**2.11 TAX EFFECT OF ALL EXCHANGE DIFFERENCES**

Ind AS 12, Income Taxes, applies to tax effects of gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency.





## 2.12 DISCLOSURES

Ind AS 21 requires following disclosures:

- (a) amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with Ind AS 109;
- (b) net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, along with the reconciliation of the amount at the beginning and end of the period;
- (c) when the presentation currency is different from the functional currency - that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency;
- (d) in case of change in functional currency of either the reporting entity or a significant foreign operation:
  - (i) fact of such change;
  - (ii) reason for the change and;
  - (iii) date of change in functional currency;
- (e) if presentation currency is different from functional currency, the financial statements can be described as complying with Ind AS only if all Ind AS including the translation method of this Standard is complied with.

However, if an entity presents its financial statements or supplementary financial information in a currency other than its functional or presentation currency:

- (i) the information should be clearly identified as supplementary information to distinguish it from the information that complies with Ind AS;
- (ii) the currency in which the supplementary information is displayed should be disclosed; and
- (iii) the entity's functional currency and the method of translation used to determine the supplementary information should be disclosed.



## 2.13 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Tata Consultancy Services Limited' for the financial year 2021-2022 with respect to Ind AS 21 'The Effects of Changes in Foreign Exchange Rates'.

### **Basis of preparation**

The functional currency of the Company and its Indian subsidiaries is the Indian Rupee (₹). The functional currency of foreign subsidiaries is the currency of the primary economic environment in which the entity operates. Foreign currency transactions are recorded at exchange rates prevailing on the date of the transaction. Foreign currency denominated monetary assets and liabilities are retranslated at the exchange rate prevailing on the balance sheet dates and exchange gains and losses arising on settlement and restatement are recognised in the statement of profit and loss. Non-monetary assets and liabilities that are measured in terms of historical cost in foreign currencies are not retranslated.

### **Foreign currency translation reserve**

The exchange differences arising from the translation of financial statements of foreign operations with functional currency other than Indian Rupee is recognised in other comprehensive income and is presented within equity in the foreign currency translation reserve.

(Source: Annual Report for 2021-2022 of Tata Consultancy Services Limited)



## 2.14 SIGNIFICANT DIFFERENCES IN IND AS 21 VIS-À-VIS AS 11

| S. No. | Particulars                                                        | Ind AS 21                                                                                                                                    | AS 11                                                                                                                                                                                                          |
|--------|--------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.     | Forward Exchange Contracts and other similar Financial Instruments | Excludes from its scope forward exchange contracts and other similar financial instruments, which are treated in accordance with Ind AS 109. | AS 11 deals with accounting for forward exchange contracts (except forward exchange contracts entered into to hedge the foreign currency risks of future transactions in respect of which firm commitments are |

|    |                                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|----|-------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|    |                                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | made or which are highly probable forecast transactions).                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 2. | <i>Exchange Differences arising on Translation of Certain Long-term Monetary Items from Foreign Currency to Functional Currency</i> | <p>Ind AS 21 does not give the above option. However, Ind AS 21 does not apply to long-term foreign currency monetary items recognised in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP, i.e. AS 11.</p> <p>However, as provided in Ind AS 101, such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items as per the previous GAAP.</p> | AS 11, gives an option to recognise exchange differences arising on translation of certain long-term monetary items from foreign currency to functional currency directly in equity, to be transferred to profit or loss over the life of the relevant liability/asset if such items are not related to acquisition of depreciable capital assets; where such items are related to acquisition of depreciable capital assets, the foreign exchange differences can be recognised as part of the cost of the asset. (paragraphs 46 and 46A of AS 11) |
| 3. | <i>Approach for Translation</i>                                                                                                     | Ind AS 21 is based on functional currency approach. An entity is required to determine its functional currency which can be different from its presentation currency based on factors envisaged in the standard.                                                                                                                                                                                                                                                             | Under AS 11 there is no concept of functional currency. The method used to translate the financial statements of a foreign operation depends on the classification of foreign operation (integral foreign operation or non-integral foreign operation).                                                                                                                                                                                                                                                                                             |
| 4. | <i>Presentation Currency</i>                                                                                                        | As per Ind AS 21, presentation currency can be different from local currency and it gives detailed guidance in this regard.                                                                                                                                                                                                                                                                                                                                                  | AS 11 does not explicitly state so.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 5. | <i>Exchange differences on monetary items,</i>                                                                                      | As per Ind AS 21 (paragraph 32), exchange differences on                                                                                                                                                                                                                                                                                                                                                                                                                     | As per AS 11, exchange differences on monetary items,                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |

|    |                                                                            |                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                    |
|----|----------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|    | <i>forming part of net investment in a foreign operation</i>               | monetary items, that in substance, form part of net investment in a foreign operation, are recognised in profit or loss in the period in which they arise in the separate financial statements and in other comprehensive income in the consolidated financial statements and reclassified from equity to profit or loss on disposal of the net investment. | that in substance, form part of net investment in a foreign operation, are recognised in 'Foreign Currency Translation Reserve' both in the separate and consolidated financial statements until the disposal of the net investment, at which time income or expense on the same are recognised in profit or loss. |
| 6. | <i>Guidance on foreign Currency Transactions and Advance Consideration</i> | Ind AS 21 includes Appendix B which gives guidance on foreign Currency Transactions and Advance Consideration                                                                                                                                                                                                                                               | AS 11 does not contain such guidance.                                                                                                                                                                                                                                                                              |

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## TEST YOUR KNOWLEDGE

### Questions

- Parent P acquired 90 percent of subsidiary S some years ago. P now sells its entire investment in S for ₹ 1,500 lakhs. The net assets of S are 1,000 and the NCI in S is ₹ 100 lakhs. The cumulative exchange differences that have arisen during P's ownership are gains of ₹ 200 lakhs, resulting in P's foreign currency translation reserve in respect of S having a credit balance of ₹ 180 lakhs, while the cumulative amount of exchange differences that have been attributed to the NCI is ₹ 20 lakhs

Calculate P's gain on disposal in its consolidated financial statements.

- Entity A, whose functional currency is Rupees (₹), has a foreign operation, Entity B, with a Euro functional currency. Entity B issues to A perpetual debt (i.e. it has no maturity) denominated in euros with an annual interest rate of 6 per cent. The perpetual debt has no issuer call option or holder put option. Thus, contractually it is just an infinite stream of interest payments in Euros.

Analyse in A's consolidated financial statements, whether the perpetual debt can be considered in accordance with para 15 of Ind AS 21, a monetary item "for which settlement is neither planned nor likely to occur in the foreseeable future" (i.e. part of A's net investment in B), with the exchange gains and losses on the perpetual debt therefore being recorded in equity?

- Infotech Global Ltd. has a functional currency of USD and needs to translate its financial statements into the functional and presentation currency of Infotech Inc. (L\$).

The following balances appear in the books of Infotech Global Ltd. at the year-end prior to translation:

|                               | <u>USD</u> | <u>L\$</u> |
|-------------------------------|------------|------------|
| Property, plant and equipment | 50,000     |            |

|                                         |                        |        |
|-----------------------------------------|------------------------|--------|
| Receivables                             | <u>9,35,000</u>        |        |
| <b>Total assets</b>                     | <b><u>9,85,000</u></b> |        |
| Issued capital                          | 50,000                 | 30,055 |
| Opening retained earnings               | 28,000                 | 15,274 |
| Profit & Loss A/c (Profit for the year) | 20,000                 |        |
| Accounts payable                        | 8,40,000               |        |
| Accrued liabilities                     | <u>47,000</u>          |        |
| <b>Total equity and liabilities</b>     | <b><u>9,85,000</u></b> |        |

Translate the above balances of Infotech Global Ltd. into L\$ ready for consolidation by Infotech Inc. (Share capital and opening retained earnings have been pre-populated.)

Prepare a working of the cumulative balance of the foreign currency translation reserve.

**Additional information:**

Relevant exchange rates are:

Rate at beginning of the year L\$ 1 = USD 1.22

Average rate for the year L\$ 1 = USD 1.175

Rate at end of the year L\$ 1 = USD 1.13

- On 30<sup>th</sup> January, 20X1, A Ltd. purchased a machinery for \$ 5,000 from USA supplier on credit basis. A Ltd.'s functional currency is Rupees. The exchange rate on the date of transaction is 1 \$ = ₹ 60. The fair value of the machinery determined on 31<sup>st</sup> March, 20X1 is \$ 5,500. The exchange rate on 31<sup>st</sup> March, 20X1 is 1\$ = ₹ 65. The payment to overseas supplier done on 31<sup>st</sup> March 20X2 and the exchange rate on 31<sup>st</sup> March 20X2 is 1\$ = ₹ 67. The fair value of the machinery remains unchanged for the year ended on 31<sup>st</sup> March 20X2. Tax rate is 30%. A Ltd. follows revaluation method in respect of Plant & Machinery.

Pass the Journal entries for the year ended on 31<sup>st</sup> March 20X1 and year 20X2 according to Ind AS 21.

- On 1<sup>st</sup> January, 20X2, P Ltd. purchased a machine for \$ 2 lakhs. The functional currency of P Ltd. is Rupees. At that date the exchange rate was \$1 = ₹ 68. P Ltd. is not required to pay for this purchase until 30<sup>th</sup> June, 20X2. Rupees strengthened against the \$ in the three months following purchase and by 31<sup>st</sup> March, 20X2 the exchange rate was \$1 = ₹ 65. CFO of P Ltd. feels that these exchange fluctuations wouldn't affect the financial statements because P Ltd. has an asset and a liability denominated in rupees, which was initially the same amount. He also feels that P Ltd. depreciates this machine over four years so the future year-end amounts won't be the same.

Examine the impact of this transaction on the financial statements of P Ltd. for the year ended 31<sup>st</sup> March, 20X2 as per Ind AS.

6. Supplier, A Ltd., enters into a contract with a customer, B Ltd., on 1<sup>st</sup> January, 20X2 to deliver goods in exchange for total consideration of USD 50 million and receives an upfront payment of USD 20 million on this date. The functional currency of the supplier is Rupees (₹). The goods are delivered and revenue is recognised on 31<sup>st</sup> March, 20X2. USD 30 million is received on 1<sup>st</sup> April, 20X2 in full and final settlement of the purchase consideration.

The exchange rates on 1<sup>st</sup> January, 20X2 and 31<sup>st</sup> March, 20X2 are ₹ 72 per USD and ₹ 75 per USD respectively.

State the date of transaction for advance consideration and recognition of revenue. Also state the amount of revenue in Rupees (₹) to be recognized on the date of recognition of revenue.

7. Global Limited, an Indian company acquired on 30<sup>th</sup> September, 20X1 70% of the share capital of Mark Limited, an entity registered as company in Germany. The functional currency of Global Limited is Rupees and its financial year end is 31<sup>st</sup> March, 20X2.

- (i) The fair value of the net assets of Mark Limited was 23 million EURO and the purchase consideration paid is 17.5 million EURO on 30<sup>th</sup> September, 20X1.

The exchange rates as at 30<sup>th</sup> September, 20X1 was ₹ 82 / EURO and at 31<sup>st</sup> March, 20X2 was ₹ 84 / EURO.

Determine the value at which the goodwill has to be recognised in the financial statements of Global Limited as on 31<sup>st</sup> March, 20X2, when NCI is valued at proportionate share of fair value of net assets of Mark Limited.

- (ii) Mark Limited sold goods costing 2.4 million EURO to Global Limited for 4.2 million EURO during the year ended 31<sup>st</sup> March, 20X2. The exchange rate on the date of purchase by Global Limited was ₹ 83 / EURO and on 31<sup>st</sup> March, 20X2 was ₹ 84 / EURO. The entire goods purchased from Mark Limited are unsold as on 31<sup>st</sup> March, 20X2.

Determine the unrealised profit to be eliminated in the preparation of consolidated financial statements.

8. On 1<sup>st</sup> April, 20X1, Makers Ltd. raised a long term loan from foreign investors. The investors subscribed for 6 million Foreign Currency (FCY) loan notes at par. It incurred incremental issue costs of FCY 2,00,000. Interest of FCY 6,00,000 is payable annually on 31<sup>st</sup> March, starting from 31<sup>st</sup> March, 20X2. The loan is repayable in FCY on 31<sup>st</sup> March, 20X7 at a premium and the effective annual interest rate implicit in the loan is 12%. The appropriate measurement basis for this loan is amortised cost. Relevant exchange rates are as follows:

- 1<sup>st</sup> April, 20X1 - FCY 1 = ₹ 2.50.

- 31<sup>st</sup> March, 20X2 – FCY 1 = ₹ 2.75.
- Average rate for the year ended 31<sup>st</sup> March, 20X2 – FCY 1 = ₹ 2.42. The functional currency of the group is Indian Rupee.

Advise the appropriate accounting treatment for the foreign currency loan in the books of Makers Ltd. for the financial year 20X1-20X2. Also calculate the initial measurement amount for the loan, finance cost for the year, closing balance and exchange gain / loss.

## Answers

1. P's gain on disposal in its consolidated financial statements would be calculated in the following manner:

|                                      | (₹ in Lakhs) |
|--------------------------------------|--------------|
| Sale proceeds                        | 1,500        |
| Net assets of S                      | (1,000)      |
| NCI derecognised                     | 100          |
| Foreign currency translation reserve | 180          |
| Gain on disposal                     | 780          |

2. Yes, as per Ind AS 21 net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

As per para 15 of Ind AS 21, an entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

### Analysis on the basis of above mentioned guidance

Through the origination of the perpetual debt, A has made a permanent investment in B. The interest payments are treated as interest receivable by A and interest payable by B, not as repayment of the principal debt. Hence, the fact that the interest payments are perpetual does not mean that settlement is planned or likely to occur. The perpetual debt can be considered part of A's net investment in B.

In accordance with para 15 of Ind AS 21, the foreign exchange gains and losses should be recorded in equity at the consolidated level because settlement of that perpetual debt is neither planned nor likely to occur.



## 3. Translation of the balances for the purpose of consolidation

|                                                          | USD                    | Rate  | L\$                    |
|----------------------------------------------------------|------------------------|-------|------------------------|
| Property, plant and equipment                            | 50,000                 | 1.13  | 44,248                 |
| Receivables                                              | <u>9,35,000</u>        | 1.13  | <u>8,27,434</u>        |
| <b>Total assets</b>                                      | <b><u>9,85,000</u></b> |       | <b><u>8,71,682</u></b> |
| Issued capital                                           | 50,000                 | —     | 30,055                 |
| Opening retained earnings                                | 28,000                 | —     | 15,274                 |
| Profit for the year                                      | 20,000                 | 1.175 | 17,021                 |
| Accounts payable                                         | 8,40,000               | 1.13  | 7,43,363               |
| Accrued liabilities                                      | <u>47,000</u>          | 1.13  | <u>41,593</u>          |
| <b>Total equity and liabilities USD</b>                  | <b><u>9,85,000</u></b> |       | <b><u>8,47,306</u></b> |
| <b>Foreign Currency Translation Reserve (Refer WN-1)</b> |                        |       | <b><u>24,376</u></b>   |
| <b>Total equity and liabilities L\$</b>                  |                        |       | <b><u>8,71,682</u></b> |

## Working Note

## 1 Cumulative balance of the FCTR

| Particulars               | Actual translated amount in L\$ | Amount (Refer WN-2)  | Difference           |
|---------------------------|---------------------------------|----------------------|----------------------|
|                           | <b>A</b>                        | <b>B</b>             | <b>B-A</b>           |
| Issued capital            | 30,055                          | 44,248               | 14,193               |
| Opening retained earnings | 15,274                          | 24,779               | 9,505                |
| Profit for the year       | <u>17,021</u>                   | <u>17,699</u>        | <u>678</u>           |
|                           | <b><u>62,350</u></b>            | <b><u>86,726</u></b> | <b><u>24,376</u></b> |

## 2 Translated amount if the same conversion rate is applied to following items as applied on other items

|                           |                      |             | Translated amount    |
|---------------------------|----------------------|-------------|----------------------|
| Issued capital            | 50,000               | 1.13        | 44,248               |
| Opening retained earnings | 28,000               | 1.13        | 24,779               |
| Profit for the year       | <u>20,000</u>        | <u>1.13</u> | <u>17,699</u>        |
|                           | <b><u>98,000</u></b> |             | <b><u>86,726</u></b> |

4.

**Journal Entries**Purchase of Machinery on credit basis on 30<sup>th</sup> January 20X1:

|                                                                                    | ₹        | ₹        |
|------------------------------------------------------------------------------------|----------|----------|
| Machinery A/c (\$ 5,000 x ₹ 60) Dr.                                                | 3,00,000 |          |
| To Creditors-Machinery A/c                                                         |          | 3,00,000 |
| (Initial transaction will be recorded at exchange rate on the date of transaction) |          |          |

Exchange difference arising on translating monetary item on 31st March 20X1:

|                                                                                         | ₹      | ₹      |
|-----------------------------------------------------------------------------------------|--------|--------|
| Profit & Loss A/c [(\$ 5,000 x ₹ 65) – (\$ 5,000 x ₹ 60)] Dr.                           | 25,000 |        |
| To Creditors-Machinery A/c                                                              |        | 25,000 |
| Machinery A/c Dr.                                                                       | 30,000 |        |
| To Revaluation Surplus (OCI)                                                            |        | 30,000 |
| [Being Machinery revalued to USD 5,500; (₹ 60 x (\$ 5,500 - \$ 5,000))]                 |        |        |
| Machinery A/c Dr.                                                                       | 27,500 |        |
| To Revaluation Surplus (OCI)                                                            |        | 27,500 |
| (Being Machinery measured at the exchange rate on 31.3.20X1 [\$ 5,500 x (₹ 65 - ₹ 60)]) |        |        |
| Revaluation Surplus (OCI) Dr.                                                           | 17,250 |        |
| To Deferred Tax Liability                                                               |        | 17,250 |
| (DTL created @ of 30% of the total OCI amount)                                          |        |        |

Exchange difference arising on translating monetary item and settlement of creditors on 31<sup>st</sup> March 20X2:

|                                                 | ₹        | ₹        |
|-------------------------------------------------|----------|----------|
| Creditors-Machinery A/c (\$ 5,000 x ₹ 65) Dr.   | 3,25,000 |          |
| Profit & loss A/c [(5,000 x (₹ 67 - ₹ 65))] Dr. | 10,000   |          |
| To Bank A/c                                     |          | 3,35,000 |
| Machinery A/c [{\$ 5,500 x (₹ 67 - ₹ 65)}] Dr.  | 11,000   |          |

|                                                                             |     |        |
|-----------------------------------------------------------------------------|-----|--------|
| To Revaluation Surplus (OCI)                                                |     | 11,000 |
| Revaluation Surplus (OCI)                                                   | Dr. | 3,300  |
| To Deferred Tax Liability<br>(DTL created @ of 30% of the total OCI amount) |     | 3,300  |

5. As per Ind AS 21 'The Effects of Changes in Foreign Exchange Rates' the asset and liability would initially be recognised at the rate of exchange in force at the transaction date ie 1<sup>st</sup> January, 20X2. Therefore, the amount initially recognised would be ₹ 1,36,00,000 (\$ 2,00,000 x ₹ 68).

The liability is a monetary item, so it is retranslated using the rate of exchange in force at 31<sup>st</sup> March, 20X2. This makes the closing liability of ₹ 1,30,00,000 (\$ 2,00,000 x ₹ 65).

The gain on re-translation of ₹ 6,00,000 (₹ 1,36,00,000 – ₹ 1,30,00,000) is recognised in the Statement of profit and loss.

The machine is a non-monetary asset carried at historical cost. Therefore, it continues to be translated using the rate of ₹ 68 to \$ 1.

Depreciation of ₹ 8,50,000 (₹ 1,36,00,000 x  $\frac{1}{4}$  x  $\frac{3}{12}$ ) would be charged to profit or loss for the year ended 31<sup>st</sup> March, 20X2.

The closing balance in property, plant and equipment would be ₹ 1,27,50,000 (₹ 1,36,00,000 – ₹ 8,50,000). This would be shown as a non-current asset in the balance sheet.

6. This is the case of Revenue recognised at a single point in time with multiple payments. As per the guidance given in Appendix B to Ind AS 21:

A Ltd. will recognise a non-monetary contract liability amounting ₹ 1,440 million, by translating USD 20 million at the exchange rate on 1<sup>st</sup> January, 20X2 ie ₹ 72 per USD.

A Ltd. will recognise revenue at 31<sup>st</sup> March, 20X2 (that is, the date on which it transfers the goods to the customer).

A Ltd. determines that the date of the transaction for the revenue relating to the advance consideration of USD 20 million is 1<sup>st</sup> January, 20X2. Applying paragraph 22 of Ind AS 21, A Ltd. determines that the date of the transaction for the remainder of the revenue as 31<sup>st</sup> March, 20X2.

On 31<sup>st</sup> March, 20X2, A Ltd. will:

- derecognise the non-monetary contract liability of USD 20 million and recognise USD 20 million of revenue using the exchange rate as at 1<sup>st</sup> January, 20X2 ie ₹ 72 per USD; and

- recognise revenue and a receivable for the remaining USD 30 million, using the exchange rate on 31<sup>st</sup> March, 20X2 ie ₹ 75 per USD.
  - the receivable of USD 30 million is a monetary item, so it should be translated using the closing rate until the receivable is settled.
7. (i) Para 47 of Ind AS 21 requires that goodwill arose on business combination shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate in accordance with paragraphs 39 and 42. In this case the amount of goodwill in EURO will be as follows:

|                        |     |              |
|------------------------|-----|--------------|
| Net identifiable asset | Dr. | 23 million   |
| Goodwill (bal. fig.)   | Dr. | 1.4 million  |
| To Bank                |     | 17.5 million |
| To NCI (23 x 30%)      |     | 6.9 million  |

Thus, goodwill on reporting date would be 1.4 million EURO x ₹ 84 = ₹ 117.6 million

(ii)

| Particulars             | EURO in million |
|-------------------------|-----------------|
| Sale price of Inventory | 4.20            |
| Unrealised Profit [a]   | 1.80            |

Exchange rate as on date of purchase of Inventory [b]` 83 / Euro

Unrealized profit to be eliminated [a x b]` 149.40 million

As per para 39 of Ind AS 21 “income and expenses for each statement of profit and loss presented (ie including comparatives) shall be translated at exchange rates at the dates of the transactions”.

In the given case, purchase of inventory is an expense item shown in the statement profit and loss. Hence, the exchange rate on the date of purchase of inventory is taken for calculation of unrealized profit which is to be eliminated while preparation of financial statements.

#### 8. Initial carrying amount of loan in books

Loan amount received = 60,00,000 FCY

Less: Incremental issue costs = 2,00,000 FCY

58,00,000 FCY

Ind AS 21, “The Effect of Changes in Foreign Exchange Rates” states that foreign currency transactions are initially recorded at the rate of exchange in force when the transaction was

first recognized.

$$\begin{aligned}\text{Loan to be converted in Rupees (₹)} &= 58,00,000 \text{ FCY} \times ₹ 2.50/\text{FCY} \\ &= ₹ 1,45,00,000\end{aligned}$$

Therefore, the loan would initially be recorded at ₹ 1,45,00,000.

**Calculation of amortized cost of loan (in FCY) at the year end:**

| Period    | Opening Financial Liability (FCY)<br>A | Interest @ 12% (FCY)<br>B | Cash Flow (FCY)<br>C | Closing Financial Liability (FCY)<br>A+B-C |
|-----------|----------------------------------------|---------------------------|----------------------|--------------------------------------------|
| 20X1-20X2 | 58,00,000                              | 6,96,000                  | 6,00,000             | 58,96,000                                  |

The finance cost in FCY is 6,96,000

The finance cost would be recorded at an average rate for the period since it accrues over a period of time.

Hence, the finance cost for financial year 20X1-20X2 in Rupees (₹) is ₹ 16,84,320 (6,96,000 FCY x ₹ 2.42 / FCY)

The actual payment of interest would be recorded at  $6,00,000 \times 2.75 = ₹ 16,50,000$

The loan balance is a monetary item, so it is translated at the rate of exchange at the reporting date.

So, the closing loan balance in Rupees (₹) is  $58,96,000 \text{ FCY} \times ₹ 2.75 / \text{FCY} = ₹ 1,62,14,000$

The exchange differences that are created by this treatment are recognized in profit and loss.

In this case, the exchange difference is

$$₹ [1,62,14,000 - (1,45,00,000 + 16,84,320 - 16,50,000)] = ₹ 16,79,680.$$

This exchange difference is taken to profit and loss.

[illegible]



# IND AS ON DISCLOSURES IN THE FINANCIAL STATEMENTS



## UNIT 1: INDIAN ACCOUNTING STANDARD 24: RELATED PARTY DISCLOSURES

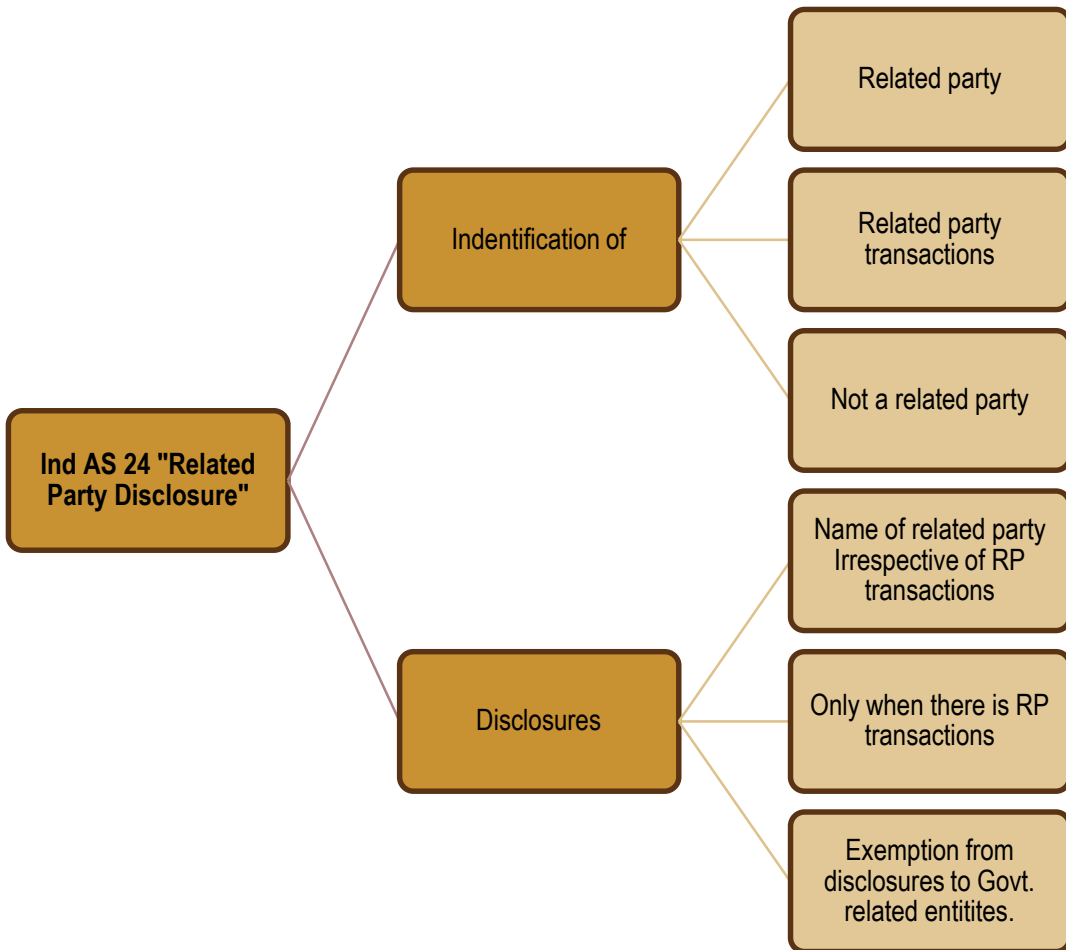
### LEARNING OUTCOMES

**After studying this unit, you will be able to:**

- ☐ Understand the objective, scope and purpose of related party disclosures in the financial statements
- ☐ Define the terms related party, related party transactions, close members of the family of a person, key management personnel, government related entity and other related terms.
- ☐ Ensure the necessary disclosures to be made by an entity in its financial statements.
- ☐ Analyse the effect of related party transactions in the financial position & profit or loss due to existence of such related parties.
- ☐ Understand the significant differences between Ind AS 24 and AS 18.



## UNIT OVERVIEW





## 1.1 INTRODUCTION

An entity in the course of its commerce and business enters into numerous transactions and gets impacted by various related party relationships. It is a normal feature of commerce and business to have related party relationships. Entities frequently carry on their business activities through subsidiaries, joint ventures or associates. The entity has the ability to affect the financial and operating policy of a subsidiary generally as it has control over it. In the case of joint venture, it has joint control whereas in the case of an associate it has significant influence.

It is quite probable that related party relationship may have an effect on the profit or loss and financial position of an entity. The effect gets manifested through:

(a) Transactions that are entered between related parties may not be entered with unrelated parties;

• **Example :** An entity may sell goods to its parent at cost. It may not sell goods at cost to an unrelated party.

(b) Transactions with unrelated parties get influenced because of related party relationships.

• **Example :** S Limited, a subsidiary of H Limited, in steel manufacturing used to purchase billets from UR Limited. H Limited acquires 100% stake in FS Limited who also manufactures billets. FS Limited is now a fellow subsidiary of S Limited. H Limited instructs S Limited not to purchase billets from UR Limited but from FS Limited.

Therefore, the users of the financial statements of any entity should have:

(a) the knowledge of:

- related party relationships of an entity;
- entity's transactions, outstanding balances, commitments etc. with such related parties;

(b) as it may affect the user's assessments:

- of operations of the entity and
- the risks and opportunities faced by the entity.



## 1.2 OBJECTIVE

The objective of the Standard is to ensure that the financial statements of an entity contains necessary disclosures with respect to:

(a) related party relationships;

(b) related party transactions;

(c) outstanding balances with related parties; and

(d) commitments with related parties.

The disclosures are necessary so that users' attention could be drawn to the possibility that financial statements may be affected by such related party relationships and other items as mentioned above.



## 1.3 SCOPE

The Standard has to be applied in:

(a) identifying related party relationships;

(b) identifying related party transactions;

(c) identifying outstanding balances between an entity and its related parties;

(d) identifying commitments between an entity and its related parties;

(e) identifying the circumstances in which disclosures of above items is to be made; and

(f) determining the disclosures to be made about the above items.

The disclosures are to be made in:

(a) Individual financial statements of the entity.

- (b) Consolidated and separate financial statements of a parent, venturer or an investor prepared in accordance with Ind AS 110 'Consolidated Financial Statements' or Ind AS 27, 'Separate Financial Statements'.
- Related party transactions and outstanding balances with other entities in a group are disclosed in an entity's financial statements, however, intra-group related party transactions and outstanding balances are eliminated in the preparation of consolidated financial statements of the group.

**Exception:**

If the above intra group related party transactions & outstanding balances between investment entity and its subsidiary are measured at fair value through profit or loss, then not eliminated.

- Disclosures not required when either
  - ◆ such disclosures are in conflict with the entity's duties of confidentiality in terms of a statute, regulator or similar competent authority governing the entity; or
  - ◆ the entity is prohibited by the statute, regulator or similar competent authority to disclose certain information otherwise required to be disclosed as per this Standard.

**Example 1**

Banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings.

## 1.4 DEFINITIONS

The following definitions are relevant for understanding the Standard:

1. A **related party** is (i) a person or (ii) an entity that is related to the reporting entity.
2. A **reporting entity** in this Standard is an entity that is preparing its financial statements.

Thus two types of related party relationships are envisaged.

- ◆ One relationship is between the reporting entity and a person or persons.
- ◆ The other relationship is between the reporting entity and another entity or entities.

**Note:** The Standard clarifies that in considering each possible related party relationship, the attention should be directed to the substance of the relationship and not merely the legal form.

### 1.4.1 Understanding relationship between the reporting entity and a person(s)

3. A **person** or **a close member of that person's family is related to a reporting entity** if that person:
- (a) has control or joint control over the reporting entity;
  - (b) has significant influence over the reporting entity; or
  - (c) is a member of the key management personnel of
    - the reporting entity or
    - a parent of the reporting entity.
4. **Close members of the family of a person** are the one who may be expected to influence or be influenced by that person in their dealings with the entity. It includes:
- (a) that person's children, spouse or domestic partner, brother, sister, father and mother;
  - (b) children of that person's spouse or domestic partner; and
  - (c) dependents of that person or that person's spouse or domestic partner.
5. A **parent** is an entity that controls one or more entities and present consolidated financial statements.

#### Examples 2-5

- 2. Mr. A holds 51% in equity share capital of A Limited. A Limited has no other form of share capital. As Mr. A controls A Limited, he is a related party.
- 3. Mrs. A is wife of Mr. A. Mr. A holds 51% of equity shares of A Limited. A Limited has no other form of share capital. Mr. A controls A Limited. Since Mr. A is a related party, Mrs. A is also a related party of A Limited.
- 4. Mr. D is a director of A Limited. Being a member of key management personnel of A Limited, he is related to A Limited.
- 5. Mr. D is a director of H Limited. S Limited is a subsidiary of H Limited. Mr. D is related to S Limited.

### 1.4.2 Understanding relationship between the reporting entity and another entity/entities

6. An **entity is related to a reporting entity** if any of the following conditions applies:
- (a) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

**Example 6**

SA Limited and SB Limited are subsidiaries of H Limited. SA Limited, SB Limited and H Limited are related to each other.

- (b) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

**Example 7**

AS Limited is an associate of S Limited. S Limited is a subsidiary of H Limited. SH Limited is another subsidiary of H Limited. AS Limited and SH Limited are related parties.

- (c) Both entities are joint ventures of the same third party.

**Example 8**

H Limited has entered into 2 joint ventures, JHA Limited (joint venture with A Limited) and JHB Limited (joint venture with B Limited). JHA Limited and JHB Limited are related parties.

- (d) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

**Example 9**

JH Limited is a joint venture of H Limited. AH limited is an associate of H Limited. JH Limited and AH Limited are related parties.

- (e) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
- (f) The entity is controlled or jointly controlled by a person identified in 3 above.

**Example 10**

Mr. A controls A Limited (the reporting entity). He also controls B Limited. A Limited and B Limited are related to each other.

- (g) A person identified in 3(a) above has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

**Example 11**

Mr. A controls A Limited (the reporting entity). He is a non-executive director in B Limited. A Limited and B Limited are related parties.

- (h) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

**Example 12**

A Ltd is a parent company with 3 subsidiary companies- B Ltd, C Ltd & D Ltd. It also has an associate company E Ltd. Subsidiary F Ltd of E Ltd provides key management personnel services to A Ltd. F Ltd. is in a related party relationship with A, B, C D & E Ltd.

The aforesaid definition is wide and exhaustive. It is quite possible that the identification of related parties may become an onerous task. The standard, therefore, as has been stated above, lays emphasis on the substance of the relationship rather than legal form.

7. **Control** exists when the investor is exposed or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over investee.
8. **Joint Control** is the contractually agreed sharing of control of an arrangement which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
9. **Significant influence** is the power to participate in the financial and operating policy decisions of the investee, but is not control of those policies.

The terms 'control', 'joint control' and 'significant influence' are discussed in detail in chapters on Ind AS 110, *Consolidated Financial Statements*, Ind AS 111 *Joint Arrangements* & Ind AS 28, *Investments in Associates & Joint Ventures*.

10. **Key management personnel** are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

**Analysis:**

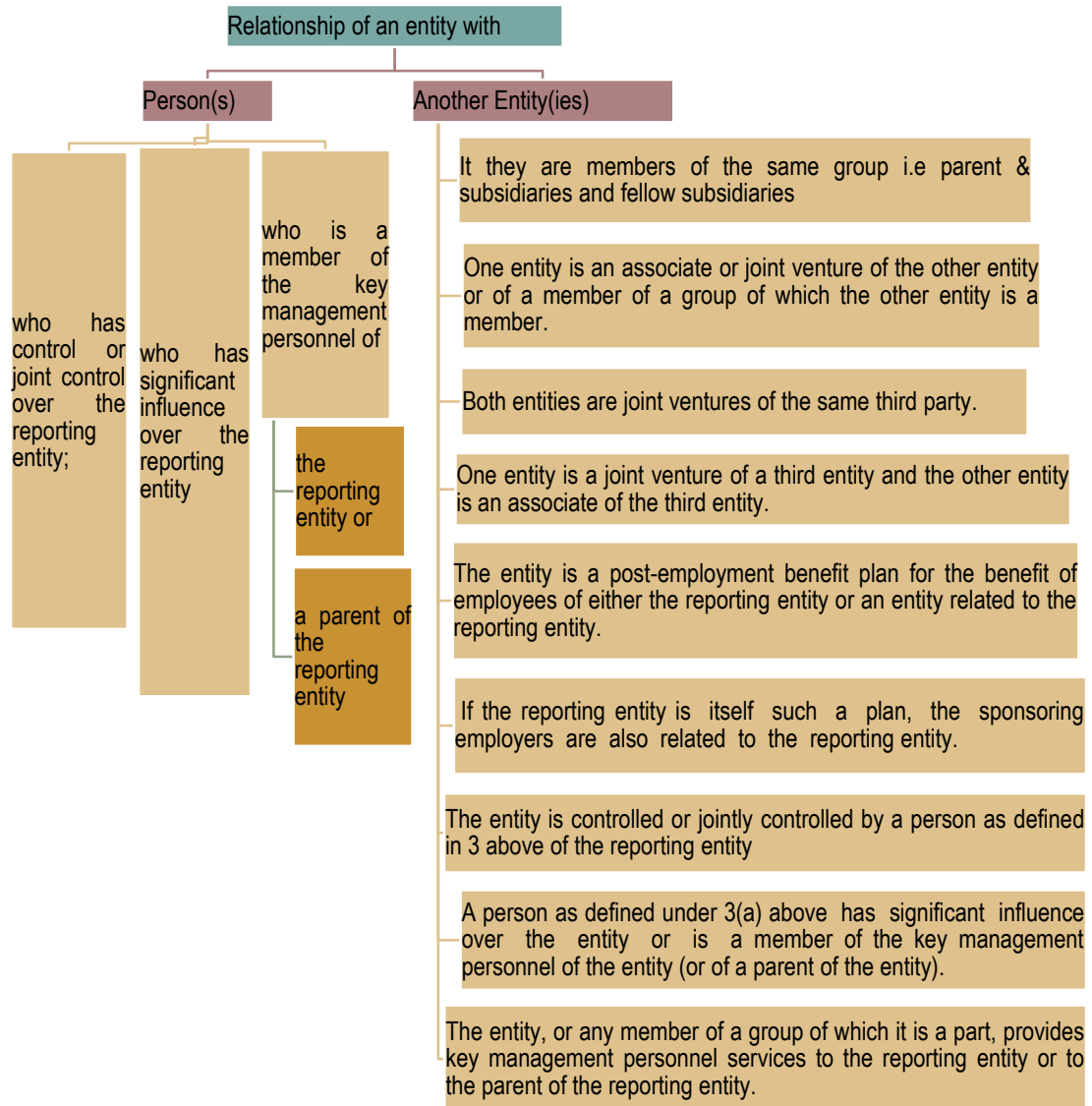
The definition includes executive as well as non-executive directors who have responsibility for the management and direction of a significant part of the business. It is not necessary that these people should have the 'director' designation. The term also includes members of the management committee(s), if those committee(s) have the authority for planning, directing and controlling the entity's activities.

The Standard further states that in the definition of a related party, an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture.

**Example 13**

R Limited has an associate B Limited. B Limited has a subsidiary S Limited, a joint venture J Limited and an associate A Limited. R Limited is the reporting entity. It identifies B Limited and S Limited as its related parties. J Limited and A Limited are not related parties of R Limited.





### 1.4.3 Understanding who are not related parties

The Standard clarifies that certain relationships are not related party relationships. These are as follows:

- (a) Two entities are not related parties 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.

**Examples 14 & 15**

14. Mr. A is a director in X Limited. He is also a director in Y Limited. He has no other interest in either of these companies. There are no transactions between these two entities. X Limited and Y Limited are not related parties.
15. Mr. A is a director in X Limited. He is also a director in Y Limited. He has no other interest in either of these companies. Y Limited purchases the entire production of X Limited. The transactions are always at arm's length. X Limited and Y Limited may be related parties as it is quite possible that Y Limited may be able to exercise control/significant control over X Limited. As per this Standard substance is more important than mere legal form. Further information and analysis are required here to conclude; by virtue of the transaction only, it cannot be said that they are related parties.

- (b) Two venturers are not related parties simply because they share joint control over a joint venture.

**Example 16**

JV Limited is an equal joint venture of J Limited and V Limited. J Limited and V Limited are not related parties.

- (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, are not related parties 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).

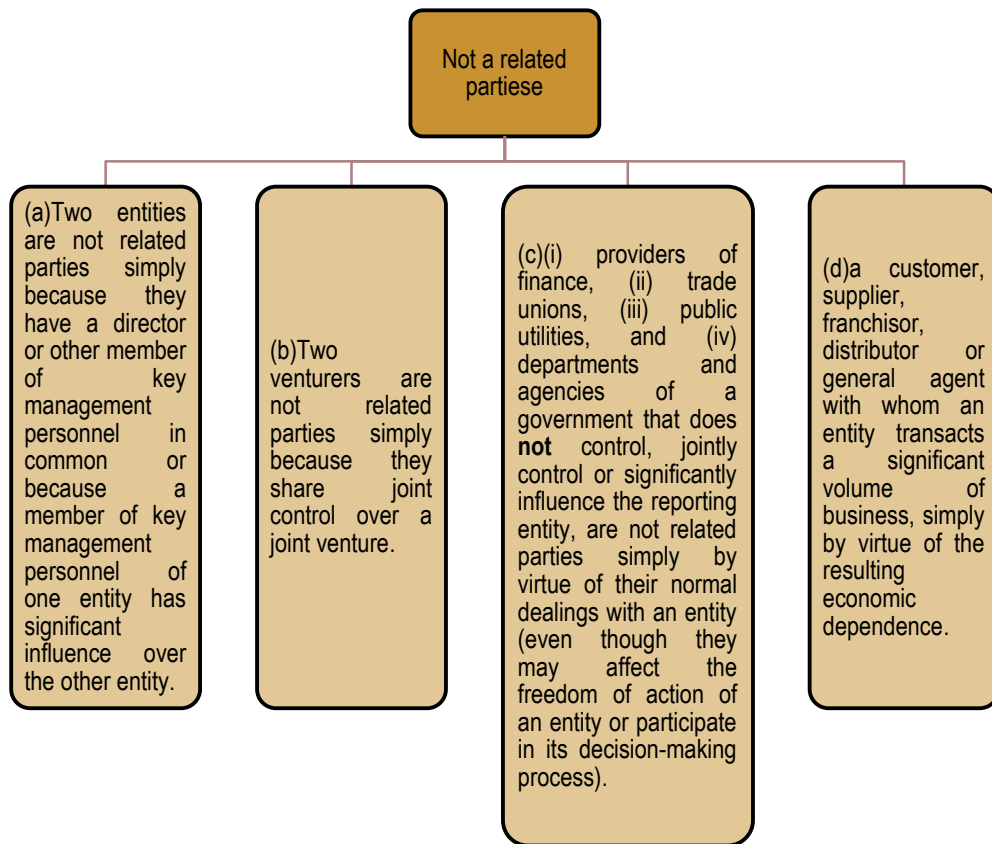
**Example 17**

A Bank and B Bank has provided finance to XY Limited. By virtue of loan agreement, they occupy a non-executive observer seat on the Board of Directors of XY Limited. A Bank and B Bank are not related parties of XY Limited.

- (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.

**Example 18**

A Limited is an auto ancillary of an automobile company. It supplies all its production to the automobile company. Automobile company has no other interest in A Limited. A Limited and automobile company are not related parties.



### 1.4.4 Understanding related party transactions

11. A **related party transaction** is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

#### Examples

- (a) purchases or sales of goods (finished or unfinished);
- (b) purchases or sales of property and other assets;
- (c) rendering or receiving of services;
- (d) leases;
- (e) transfers of research and development;
- (f) transfers under licence agreements;
- (g) transfers under finance arrangements (including loans and equity contributions in cash or in kind);

- (h) provision of guarantees or collateral;
- (i) commitments to do something if a particular event occurs or does not occur in the future, including executory contracts<sup>1</sup> (recognised and unrecognised);
- (j) settlement of liabilities on behalf of the entity or by the entity on behalf of that related party; and
- (k) management contracts including for deputation of employees.

**Note:** It is not necessary for any consideration to be passed for the related party transactions.

Also, participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities is a transaction between related parties.

### 1.4.5 Other Important Definitions

12. **Compensation** includes all employee benefits (as defined in Ind AS 19, *Employee Benefits*) including employee benefits to which Ind AS 102, *Share-based Payments*, applies. Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity. Compensation includes:
- (a) short-term employee benefits, monetary such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non—monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;
  - (b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;
  - (c) other long-term employee benefits, including long service leave or sabbatical leave, jubilee or other long service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;
  - (d) termination benefits; and
  - (e) share-based payment.
13. **Government** refers to government, government agencies and similar bodies whether local, national or international.
14. A **government-related entity** is an entity that is controlled, jointly controlled or significantly influenced by a government.



## 1.5 DISCLOSURES

The disclosure requirements can be broadly classified into two categories.

- (a) Category 1 requires disclosures of relationships even though there are no related party transactions between the disclosed related parties.
- (b) Category 2 requires disclosures of relationships and transactions only when there are related party transactions.

### 1.5.1 Disclosure- Relationships between parent and subsidiaries

The following disclosures of relationships, if exist, must be made irrespective of the fact whether there have been related party transactions by the entity:

- Under this an entity is required to disclose the name of its parent and, if different, the ultimate controlling party. It may be noted that the ultimate controlling party may be a person.

#### Example 19

S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. S4 Limited, S3 Limited, S2 Limited and S1 Limited must disclose the name and relationship with S3 Limited, S2 Limited and S1 Limited respectively and with H Limited.

- If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

#### Examples 20 & 21

20. S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. Only S2 Limited and S1 Limited produces consolidated financial statements for public use. S4 Limited must disclose the name and relationship with S3 Limited, S2 Limited, S1 Limited and H Limited.

21. S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. S3 Limited, S2 Limited, S1 Limited and H Limited all produces consolidated financial statements for public use. S4 Limited must disclose the name and relationship with S3 Limited and H Limited.

- The disclosure of relationship between a parent and its subsidiary (reporting entity) is important because the existence of control relationship may prevent the reporting entity

from being independent in making its financial and operating decisions. The disclosure of the name of the related party and the nature of the related party relationship where control exists may sometimes be at least as relevant in appraising an entity's prospects as are the operating results and the financial position presented in its financial statements. Such a related party may establish the entity's credit standing, determine the source and price of its raw materials, and determine to whom and at what price the product is sold.

- The Standard clarifies that the requirement to disclose related party relationships between a parent and its subsidiaries is in addition to the disclosure requirements in Ind AS 110, *Consolidated Financial Statements*, Ind AS 28, *Investments in Associates*, and *Joint Ventures*.

### 1.5.2 Category 2 Disclosure

---

Under this category, two types of disclosures are required. The first requires disclosures related to compensation to key management personnel. The second requires other disclosures where there have been related party transactions during the year.

#### 1.5.2.1 Disclosures of compensation to key management personnel

An entity is required to disclose

- (i) total compensation to key management personnel and
- (ii) Compensation for each of the following categories:
  - (a) short-term employee benefits;
  - (b) post-employment benefits;
  - (c) other long-term benefits;
  - (d) termination benefits;
  - (e) share-based payments.

If an entity obtains key management personnel services from another entity (the 'management entity'), the entity is not required to apply the requirements to the compensation paid or payable by the management entity to the management entity's employees or directors.

#### 1.5.2.2 Disclosures where there have been related party transactions during the year

- Where an entity has had related party transactions during the periods covered by the financial statements, it shall disclose, in addition to disclosures listed above, the following for the users to understand the potential effect of these relationships and transactions on the financial statements:
  - (a) the nature of the related party relationship;

- (b) the information about these related party transactions and outstanding balances, including commitments.
- The disclosures, at a minimum, shall include:
  - (a) the amount of the transactions;
  - (b) the amount of outstanding balances, including commitments, and:
    - their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
    - details of any guarantees given or received;
  - (c) provisions for doubtful debts related to the amount of outstanding balances; and
  - (d) the expense recognized during the period in respect of bad or doubtful debts due from related parties.
- Amounts incurred by the entity for the provision of key management personnel services that are provided by a separate management entity shall be disclosed.
- The aforesaid disclosures shall be made separately for each of the following categories:
  - (a) the parent;
  - (b) entities with joint control or significant influence over the entity;
  - (c) subsidiaries;
  - (d) associates;
  - (e) joint ventures in which the entity is a joint venturer;
  - (f) key management personnel of the entity or its parent; and
  - (g) other related parties.
- The classification of amounts payable to, and receivable from, related parties in the different categories is an extension of the disclosure requirements in Ind AS 1, *Presentation of Financial Statements*, for information to be presented either in the balance sheet or in the notes. The categories are extended to provide a more comprehensive analysis of related party balances and apply to related party transactions.
- However, disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made only if such terms can be substantiated.
- Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

- Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions.

### Example 22

Purchases or sales of goods are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

*Following is the extract from the financial statements of the listed entity 'ITC Limited' for the financial year 2021-2022 with respect to 'Related Party disclosure as per Ind AS 24'.*

#### 29. Related Party Disclosures

##### 1. ENTERPRISES WHERE CONTROL EXISTS:

###### Subsidiaries:

- a) Srinivasa Resorts Limited
- b) Fortune Park Hotels Limited
- c) Bay Islands Hotels Limited
- d) WelcomHotels Lanka (Private) Limited, Sri Lanka
- e) Landbase India Limited
- f) Russell Credit Limited and its subsidiary  
Greenacre Holdings Limited
- g) Technico Pty Limited, Australia and its subsidiaries  
Technico Technologies Inc., Canada  
Technico Asia Holdings Pty Limited, Australia and its subsidiary  
Technico Horticultural (Kunming) Co. Limited, China
- h) Technico Agri Sciences Limited
- i) Wimco Limited
- j) Pavan Poplar Limited
- k) Prag Agro Farm Limited
- l) ITC Infotech India Limited and its subsidiaries  
ITC Infotech Limited, UK  
ITC Infotech (USA), Inc. and its subsidiary  
Indivate Inc., USA
- m) Gold Flake Corporation Limited

##### 2. OTHER RELATED PARTIES WITH WHOM THE COMPANY HAD TRANSACTIONS

###### i) Associates & Joint Ventures:

###### Associates

- a) Gujarat Hotels Limited
- b) International Travel House Limited
- c) Delectable Technologies Private Limited  
– being associates of the Company, and
- d) Tobacco Manufacturers (India) Limited (of which the Company is an associate)  
and the subsidiaries of its ultimate parent company (British American Tobacco p.l.c.)

###### Associates of the Company's subsidiaries

- a) ATC Limited  
– being associate of Gold Flake Corporation Limited
- b) Divya Management Limited, and
- c) Antrang Finance Limited  
– being associates of Russell Credit Limited

###### Joint Ventures

Maharaja Heritage Resorts Limited

###### Joint Venture of the Company's subsidiary

ITC Essentra Limited

– being joint venture of Gold Flake Corporation Limited



**ii) a) Key Management Personnel:**

|                           |                                            |
|---------------------------|--------------------------------------------|
| S. Puri                   | Chairman & Managing Director               |
| N. Anand                  | Executive Director                         |
| B. Sumant                 | Executive Director                         |
| R. Tandon                 | Executive Director                         |
| S. Banerjee <sup>#</sup>  | Non-Executive Director                     |
| H. Bhargava <sup>#</sup>  | Non-Executive Director @                   |
| N. Doda                   | Non-Executive Director (w.e.f. 11.08.2021) |
| A. Duggal <sup>#</sup>    | Non-Executive Director                     |
| M. Gupta                  | Non-Executive Director (w.e.f. 27.10.2021) |
| S. Mukherjee <sup>#</sup> | Non-Executive Director (w.e.f. 11.08.2021) |
| A. Nayak <sup>#</sup>     | Non-Executive Director                     |
| S. Panray                 | Non-Executive Director (w.e.f. 11.08.2021) |
| N. Rao <sup>#</sup>       | Non-Executive Director                     |
| A. K. Seth <sup>#</sup>   | Non-Executive Director                     |
| M. Shankar <sup>#</sup>   | Non-Executive Director                     |
| D. R. Simpson             | Non-Executive Director                     |
| A. Jerath                 | Non-Executive Director (up to 30.04.2021)  |
| S. B. Mathur <sup>#</sup> | Non-Executive Director (up to 14.09.2021)  |

@ Non-Executive Director up to 22.08.2021. Appointed as Independent Director w.e.f. 20.12.2021.

<sup>#</sup> Independent Directors

Chief Financial Officer

S. Dutta

Company Secretary

R. K. Singhi

**b) Relatives of Key Management Personnel:**

- T. Anand (wife of N. Anand)
- R. Tandon (wife of R. Tandon)
- N. Singhi (wife of R. K. Singhi)

**iii) Employee Trusts:**

- a) IATC Provident Fund
- b) ITC Defined Contribution Pension Fund
- c) ITC Management Staff Gratuity Fund
- d) ITC Employees Gratuity Fund
- e) ITC Gratuity Fund 'C'
- f) ITC Pension Fund
- g) ILTD Seasonal Employees Pension Fund
- h) ITC Platinum Jubilee Pension Fund
- i) ITC Bhadrachalam Paperboards Limited Management Staff Pension Fund
- j) ITC Bhadrachalam Paperboards Limited Gratuity Fund 'A'
- k) ITC Bhadrachalam Paperboards Limited Gratuity Fund 'C'
- l) ITC Hotels Limited Employees Superannuation Scheme
- m) Sunrise Spices Limited Employees Gratuity Fund

29. Related Party Disclosures (Contd.)

3. DISCLOSURE OF TRANSACTIONS BETWEEN THE COMPANY AND RELATED PARTIES AND THE STATUS OF OUTSTANDING BALANCES AS AT 31.03.2022

(₹ in Crores)

| RELATED PARTY TRANSACTIONS SUMMARY                              | Enterprises where control exists |        | Associates |         | Joint Ventures |        | Key Management Personnel |       | Relatives of Key Management Personnel |      | Employee Trusts |        | Total   |         |
|-----------------------------------------------------------------|----------------------------------|--------|------------|---------|----------------|--------|--------------------------|-------|---------------------------------------|------|-----------------|--------|---------|---------|
|                                                                 | Subsidiaries                     |        |            |         |                |        |                          |       |                                       |      |                 |        |         |         |
|                                                                 | 2022                             | 2021   | 2022       | 2021    | 2022           | 2021   | 2022                     | 2021  | 2022                                  | 2021 | 2022            | 2021   | 2022    | 2021    |
| 1. Sale of Goods/Services                                       | 322.83                           | 255.72 | 1080.07    | 773.43  | 54.19          | 34.04  |                          |       |                                       |      |                 |        | 1457.09 | 1063.19 |
| 2. Purchase of Goods/Services                                   | 394.12                           | 422.08 | 66.18      | 60.37   | 280.30         | 229.79 |                          |       |                                       |      |                 |        | 740.60  | 712.24  |
| 3. Acquisition cost of Property, Plant and Equipment            | 10.58                            | 2.07   |            |         |                |        |                          |       |                                       |      |                 |        | 10.58   | 2.07    |
| 4. Sale of Property, Plant and Equipment                        | -                                | 12.62  |            |         |                |        |                          |       |                                       |      |                 |        | -       | 12.62   |
| 5. Investment in Subsidiaries/Associate                         | 427.24                           | 360.57 | 1.87       | -       |                |        |                          |       |                                       |      |                 |        | 429.11  | 360.57  |
| 6. Renunciation of Rights Issue entitlement                     | -                                | 6.45   |            |         |                |        |                          |       |                                       |      |                 |        | -       | 6.45    |
| 7. Value of Share Based Payment                                 |                                  |        |            |         |                |        |                          |       |                                       |      |                 |        |         |         |
| 7A. Capital Contribution for Share Based Payments               | (22.06)                          | (9.80) |            |         |                |        |                          |       |                                       |      |                 |        | (22.06) | (9.80)  |
| 7B. Reimbursement for Share Based Payments                      | 1.66                             | 1.94   | 0.41       | 0.39    | 0.08           | 0.09   |                          |       |                                       |      |                 |        | 2.15    | 2.42    |
| 8. Rent Received                                                | 25.60                            | 25.86  | 0.72       | 0.63    |                |        |                          |       |                                       |      |                 |        | 26.32   | 26.49   |
| 9. Rent Paid*                                                   | 9.89                             | 8.05   | 2.51       | 1.17    |                |        | 1.05                     | 0.58  | 0.32                                  | 0.32 |                 |        | 13.77   | 10.12   |
| 10. Remuneration of Managers on Deputation reimbursed           | 2.41                             | 2.50   | 5.36       | 6.00    |                |        |                          |       |                                       |      |                 |        | 7.77    | 8.50    |
| 11. Remuneration of Managers on Deputation recovered            | 36.32                            | 30.65  | 6.83       | 6.23    | 1.43           | 1.29   |                          |       |                                       |      |                 |        | 44.58   | 38.17   |
| 12. Contribution to Employees' Benefit Plans                    |                                  |        |            |         |                |        |                          |       |                                       |      | 178.43          | 112.98 | 178.43  | 112.98  |
| 13. Dividend Income                                             | 857.14                           | 723.43 | 0.31       | 0.43    |                |        |                          |       |                                       |      |                 |        | 857.45  | 723.86  |
| 14. Dividend Payments                                           |                                  |        | 3981.58    | 5483.72 |                |        | 5.70                     | 5.51  |                                       |      |                 |        | 3987.28 | 5489.23 |
| 15. Interest Income                                             | 2.42                             | 2.70   |            |         |                |        |                          |       |                                       |      |                 |        | 2.42    | 2.70    |
| 16. Expenses Recovered                                          | 10.01                            | 10.75  | 21.59      | 4.98    | 0.11           | 0.20   |                          |       |                                       |      |                 |        | 31.71   | 15.93   |
| 17. Expenses Reimbursed                                         | 2.81                             | 3.08   | 0.26       | 0.23    |                |        | 0.05                     | 0.02  |                                       |      |                 |        | 3.12    | 3.33    |
| 18. Advances Given during the year                              | 0.45                             | -      | -          | 0.06    |                |        |                          |       |                                       |      |                 |        | 0.45    | 0.06    |
| 19. Adjustment/Receipt towards Refund of Advances               | 0.45                             | -      | ...        | 0.11    |                |        |                          |       |                                       |      |                 |        | 0.45    | 0.11    |
| 20. Advances Received during the year                           | 85.32                            | 127.76 | 1496.60    | 598.34  |                |        |                          |       |                                       |      |                 |        | 1581.92 | 726.10  |
| 21. Adjustment/Payment towards Refund of Advances               | 152.01                           | 108.61 | 972.02     | 659.70  |                |        |                          |       |                                       |      |                 |        | 1124.03 | 768.31  |
| 22. Deposits Given during the year                              |                                  |        |            |         |                |        | ...                      | -     |                                       |      |                 |        | ...     | -       |
| 23. Deposits Refunded during the year                           |                                  |        | -          | 0.02    |                |        |                          |       |                                       |      |                 |        | -       | 0.02    |
| 24. Remuneration to Key Management Personnel (KMP) <sup>1</sup> |                                  |        |            |         |                |        |                          |       |                                       |      |                 |        |         |         |
| 24A. - Short term benefits                                      |                                  |        |            |         |                |        | 69.33                    | 49.64 |                                       |      |                 |        | 69.33   | 49.64   |
| 24B. - Other remuneration                                       |                                  |        |            |         |                |        | 10.51                    | 8.96  |                                       |      |                 |        | 10.51   | 8.96    |
| 24C. - Stock options granted <sup>2</sup>                       |                                  |        |            |         |                |        |                          |       |                                       |      |                 |        |         |         |
| 25. Outstanding Balances <sup>4</sup>                           |                                  |        |            |         |                |        |                          |       |                                       |      |                 |        |         |         |
| i) Receivables                                                  | 68.76                            | 50.40  | 78.17      | 59.16   | 14.66          | 11.13  |                          |       |                                       |      |                 |        | 161.59  | 120.69  |
| ii) Advances Given                                              |                                  |        | -          | ...     |                |        |                          |       |                                       |      |                 |        | -       | ...     |
| iii) Deposits Given                                             | 0.60                             | 0.60   |            |         |                |        | 0.08                     | 0.08  | 0.07                                  | 0.07 |                 |        | 0.75    | 0.75    |
| iv) Advance Taken                                               | 147.83                           | 214.52 | 692.41     | 167.83  |                |        |                          |       |                                       |      |                 |        | 840.24  | 382.35  |
| v) Deposits Taken                                               |                                  |        | 0.04       | 0.04    |                |        |                          |       |                                       |      |                 |        | 0.04    | 0.04    |
| vi) Payables                                                    | 12.17                            | 10.58  | 5.91       | 5.72    | 13.83          | 20.98  |                          |       |                                       |      | 29.20           | 130.53 | 61.11   | 167.81  |
| 26. Commitments                                                 | 1.51                             | 0.07   |            |         |                |        |                          |       |                                       |      |                 |        | 1.51    | 0.07    |

\* Includes rent pertaining to leases classified as Right of Use Assets.

<sup>4</sup> The amounts outstanding are unsecured and will be settled in cash.

<sup>1</sup> Post employment benefits are actuarially determined on overall basis and hence not separately provided.

<sup>2</sup> During the year, the Company granted Stock Options to eligible employees, including Executive Directors and KMPs, under its Employee Stock Option Schemes at 'market price' (within the meaning of the Securities and Exchange Board of India (Share Based Employee Benefits and Sweat Equity) Regulations, 2021). The Company has also granted Employee Stock Appreciation Linked Reward Units (ESAR Units) to the aforesaid persons in the previous years under the 'ITC Employee Cash Settled Stock Appreciation Linked Reward Plan'. Since such Stock Options and ESAR Units are not tradable, no perquisite or benefit is immediately conferred upon the employee by grant of such Stock Options/ESAR Units, and accordingly the said grants have not been considered as remuneration. However, in accordance with Ind AS-102, the Company has recorded employee benefits expense by way of share based payments to employees at ₹ 61.20 Crores for the year ended 31st March, 2022 (2021 - ₹ 56.69 Crores), of which ₹ 23.14 Crores (2021 - ₹ 27.71 Crores) is attributable to Executive Directors and KMPs.

(Source: Annual Report for 2021-2022 of 'ITC Limited')



## 1.6 EXEMPTION TO GOVERNMENT-RELATED ENTITIES

- A reporting entity is exempt from the disclosure requirements in relation to (i) related party transactions (ii) outstanding balances and (iii) commitments with:
  - (a) a government that has control, joint control or significant influence over the reporting entity; and
  - (b) another entity that is a related party because the same government has control, joint – control or significant influence over both the reporting entity and the other entity.
- However, in case the reporting entity opts to apply the exemption, it shall disclose:
  - (a) the name of the government;
  - (b) the nature of the government's relationship with the entity (whether the government has control, joint control or significant influence over the entity);
  - (c) to enable the users of the entity's financial statements to understand the effect of related party transactions on its financial statements, the following information in sufficient details:
    - the nature and amount of each individually significant transaction;
    - for other transactions that are not significant individually but are significant when aggregated, either a qualitative or quantitative indication of their extent.
- Thus, the reporting entity is expected to apply its judgment to determine the level of details it is required to disclose as per above. To enable the reporting entity to arrive at decision, it shall consider:
  - (a) the closeness of the related party relationship;
  - (b) whether the transaction is significant in size;
  - (c) whether the transaction is carried out on non-market terms;
  - (d) whether these are outside the normal day to day business operations, such as purchase and sales of businesses
  - (e) whether they are disclosed to regulatory or supervisory authorities;
  - (f) whether they are reported to senior management;
  - (g) whether they are subject to shareholder approval.

Following is the extract from the financial statements of the listed entity 'Cochin Shipyard Limited' for the financial year 2021-2022 with respect to 'Related Party disclosure as per Ind AS 24'.

#### Nature of transaction - Transaction with other related parties

As CSL is a Government company under the control of Ministry of Shipping (MoS), the Company has availed exemption from detailed disclosures prepared under Ind AS 24 with respect to related party transactions with Government and Government related entities. However, as required under Ind AS 24, following are the individually significant transactions:

#### Transactions/balances with Government and Government related entities by the parent company.

(₹ in Lakhs)

| Particulars                                                   | As at<br>March 31, 2022 | As at<br>March 31, 2021 |
|---------------------------------------------------------------|-------------------------|-------------------------|
| Secondment to subsidiary - Hooghly Cochin Shipyard Ltd.(HCSL) | 0.00                    | 6.15                    |
| Secondment to subsidiary - Udupi Cochin Shipyard Limited      | 0.00                    | 13.05                   |
| Investment in NCDs issued by subsidiary - HCSL                | 7500.00                 | 4400.00                 |
| Investment in NCDs issued by subsidiary - UCSL                | 1000.00                 | -                       |
| Investment in Right Issue in subsidiary - HCSL                | 2800.00                 | 2800.00                 |

(Source: Annual Report for 2021-2022 of 'Cochin Shipyard Limited')

#### Disclosure requirements when exemption applies

In Entity A's financial statements, an example of disclosure to comply for **individually** significant transactions could be:

- **Example** of disclosure for individually significant transaction carried out on non-market terms

#### Example 23

On 15 January, 20X1 Entity A, a utility company in which Government G indirectly owns 75 per cent of outstanding shares, sold a 10-hectare piece of land to another government-related utility company for ₹ 5 million. On 31, December 20X0 a plot of land in a similar location, of a similar size and with similar characteristics, was sold for ₹ 3 million. There had not been any appreciation or depreciation of the land in the intervening period. See note X [of the financial statements] for disclosure of government assistance as required by Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, and notes Y and Z [of the financial statements] for compliance with other relevant Indian Accounting Standards.

- **Example** of disclosure for individually significant transaction because of **size** of transaction

#### Example 24

In the year ended December 20X1 Government G provided Entity A, a utility company in which Government G indirectly owns 75 per cent of outstanding shares, with a loan equivalent to 50 percent of its funding requirement, repayable in quarterly instalments over the next five years. Interest is charged on the loan at a rate of 3 per cent, which is comparable to that charged on Entity A's bank loans.\* See notes Y and Z [of the financial statements] for compliance with other relevant Indian Accounting Standards.

- **Example** of disclosure of collectively significant transactions in Entity A's financial statements, an example of disclosure to comply with for **collectively** significant transactions could be:

#### Example 25

Government G, indirectly, owns 75 per cent of Entity A's outstanding shares. Entity A's significant transactions with Government G and other entities controlled, jointly controlled or significantly influenced by Government G are [a large portion of its sales of goods and purchases of raw materials] or [about 50 per cent of its sales of goods and about 35 per cent of its purchases of raw materials]. The company also benefits from guarantees by Government G of the company's bank borrowing. See note X [of the financial statements] for disclosure of government assistance as required by Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, and notes Y and Z [of the financial statements] for compliance with other relevant Indian Accounting Standards.

## 1.7 SIGNIFICANT DIFFERENCES IN IND AS 24 VIS-A-VIS AS 18

| S. No. | Particulars                   | Ind AS 24                                                                                                                                                                                              | AS 18                                                                                                                                                |
|--------|-------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.     | <i>Definition of Relative</i> | Ind AS 24 uses the term "a close member of the family of a person".                                                                                                                                    | AS 18 uses the term "relatives of an individual"                                                                                                     |
|        |                               | Definition of close members of family as per Ind AS 24 includes those family members, who may be expected to influence, or be influenced by, that person in their dealings with the entity, including: | AS 18 covers the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in |

\*If the reporting entity had concluded that this transaction constituted government assistance it would have needed to consider the disclosure in Ind AS 20.



| S. No. | Particulars                             | Ind AS 24                                                                                                                                                                                                                                                                                                                                                                                            | AS 18                                                                                                                                             |
|--------|-----------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|
|        |                                         | <p>(a) that person's children, spouse or domestic partner, brother, sister, father and mother;</p> <p>(b) children of that person's spouse or domestic partner; and</p> <p>(c) dependents of that person or that person's spouse or domestic partner.</p> <p>Hence, the definition as per Ind AS 24 is much wider.</p>                                                                               | his/her dealings with the reporting enterprise.                                                                                                   |
| 2.     | <i>State Controlled Enterprise:</i>     | Ind AS 24, has extended coverage of Government Enterprises, as it defines a government-related entity as "an entity that is controlled, jointly controlled or significantly influenced by a government." Further, "Government refers to government, government agencies and similar bodies whether local, national or international."                                                                | AS 18 defines state-controlled enterprise as "an enterprise which is under the control of the Central Government and/or any State Government(s)". |
| 3.     | <i>Key Management Personnel</i>         | Ind AS 24 covers KMP of the parent as well. Ind AS 24 also covers the entity, or any member of a group of which it is a part, providing key management personnel services to the reporting entity or to the parent of the reporting entity. Further definition of KMP under Ind AS 24 specifically includes Directors whether executive or not and also those KMP who control the entity indirectly. | AS 18 covers key management personnel (KMP) of the entity only                                                                                    |
| 4.     | <i>Related Parties in case of Joint</i> | Under Ind AS 24 there is extended coverage in case of joint                                                                                                                                                                                                                                                                                                                                          | As per AS 18, co-venturers or co-associates                                                                                                       |

| S. No. | Particulars                                                                       | Ind AS 24                                                                                                                                                                                                                     | AS 18                                                                                                                                                                                                                 |
|--------|-----------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|        | <i>Venture</i>                                                                    | ventures. Two entities are related to each other in both their financial statements, if they are either co-venturers or one is a venturer and the other is an associate.                                                      | are not related to each other.                                                                                                                                                                                        |
| 5.     | <i>Effect of influences which do not lead to transactions</i>                     | Ind AS 24 does not specifically mention this.                                                                                                                                                                                 | AS 18 mentions that where there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, disclosure of such effects is not required. (Paragraph 18 of AS 18) |
| 6.     | <i>Post-employment Benefits</i>                                                   | Ind AS 24 specifically includes post-employment benefit plans for the benefit of employees of an entity or its related entity as related parties.                                                                             | AS 18 does not specifically cover entities that are post-employment benefit plans, as related parties.                                                                                                                |
| 7.     | <i>Next Most Senior Parent</i>                                                    | Ind AS 24 requires an additional disclosure as to the name of the next most senior parent which produces consolidated financial statements for public use. (Paragraph 13 of Ind AS 24)                                        | AS 18 has no such requirement.                                                                                                                                                                                        |
| 8.     | <i>Disclosure for Compensation</i>                                                | Ind AS 24 requires extended disclosures for compensation of KMP under different categories viz. short-term employee benefits, post-employment benefits, other long-term benefits, termination benefits, share-based payments. | AS 18 does not specifically require                                                                                                                                                                                   |
| 9.     | <i>Disclosure of 'Amount of the Transactions' vs 'Volume of the Transactions'</i> | Ind AS 24 requires "the amount of the transactions" need to be disclosed. (Paragraph 18 (a) of Ind AS 24)                                                                                                                     | AS 18 gives an option to disclose the "Volume of the transactions either as an amount or as an appropriate proportion".                                                                                               |

| S. No. | Particulars                                                                     | Ind AS 24                                                                                                                            | AS 18                                                                                                                                                                                |
|--------|---------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|        |                                                                                 |                                                                                                                                      | (Paragraph 23(iv) of AS 18)                                                                                                                                                          |
| 10.    | <i>Government Related Entities:</i>                                             | Ind AS 24 requires disclosures of certain information by the government related entities.                                            | AS 18 exempts the disclosure of such information.                                                                                                                                    |
| 11.    | <i>Clarification of Control, Substantial Interest and Significant Influence</i> | Ind AS 24 neither defines these terms nor it includes such clarificatory text and allows respective standards to deal with the same. | AS 18 includes definition and clarificatory text, primarily with regard to control, substantial interest (including 20% threshold), significant influence (including 20% threshold). |

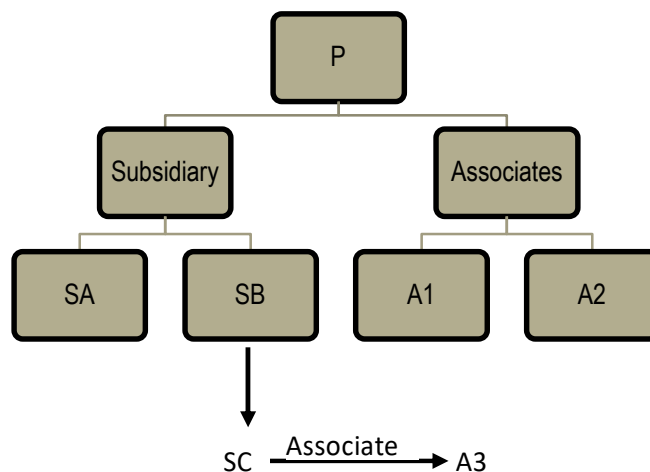
**Note:** It is strongly advised to draw the diagrams of related party relationships for the following illustrations to test the understanding of the subject matter.

#### Illustration 1 : Associates and subsidiaries

*Entity P Limited has a controlling interest in subsidiaries SA Limited and SB Limited and SC Limited. SC Limited is a subsidiary of SB Limited. P Limited also has significant influence over associates A1 Limited and A2 Limited. Subsidiary SC Limited has significant influence over associate A3 Limited*

*Examine related party relationships of various entities.*

#### Solution





- In Separate Financial Statements of P Limited: SA Limited, SB Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SA Limited: P Limited, SB Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SB Limited: P Limited, SA Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SC Limited: P Limited, SA Limited, SB Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of associates A1 Limited, A2 Limited and A3 Limited; P Limited, SA Limited, SB Limited and SC Limited are related parties.
- A1 Limited, A2 Limited and A3 Limited are not related to each other.
- For Parent's consolidated financial statements: A1 Limited, A2 Limited and A3 Limited are related to the Group

\*\*\*\*\*

#### **Illustration 2 : Key management personnel**

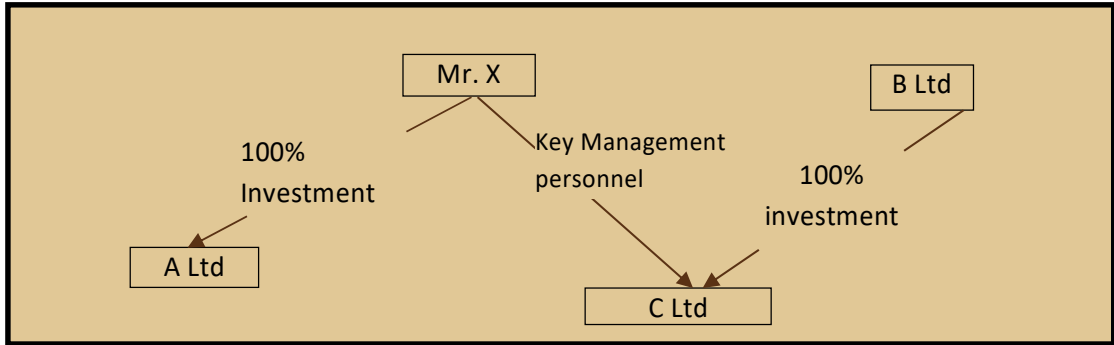
*Mr. X has a 100% investment in A Limited. He is also a member of the key management personnel (KMP) of C Limited. B Limited has a 100% investment in C Limited.*

*Required*

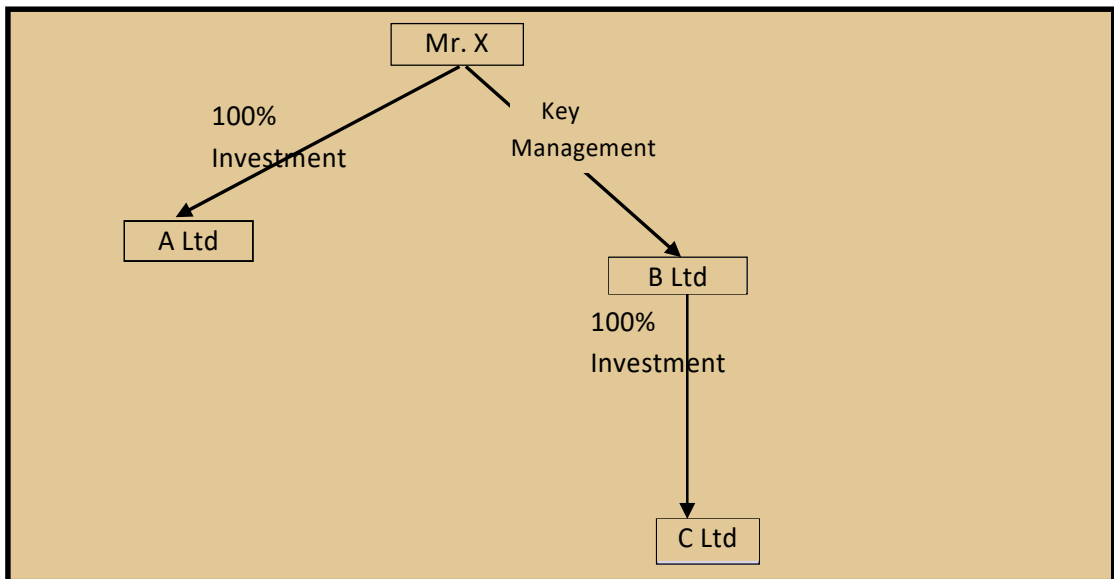
- (a) Examine related party relationships from the perspective of C Ltd. for A Ltd.*
- (b) Examine related party relationships from the perspective of C Ltd. for A Ltd. if Mr. X is a KMP of B Ltd. and not C Ltd.*
- (c) Will the outcome in (a) & (b) would be different if Mr. X has joint control over A Ltd.*
- (d) Will the outcome in (a) & (b) would be different if Mr. X has significant influence over A Ltd.*

#### **Solution**

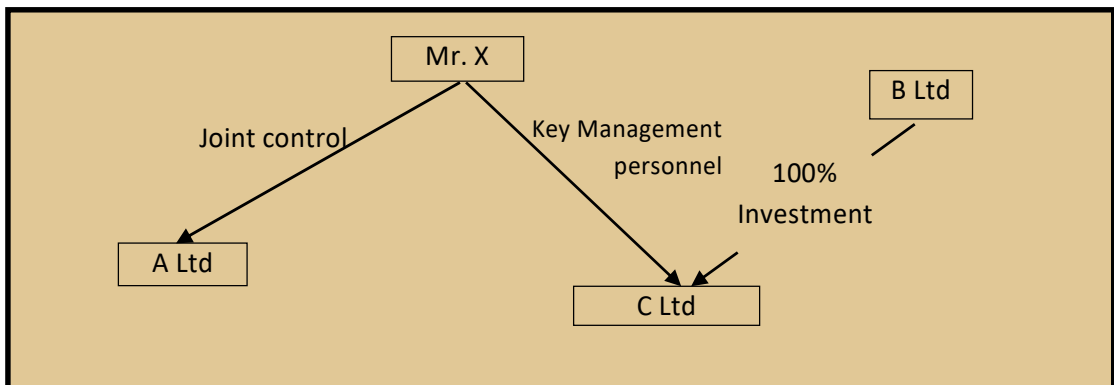
- (a) A Ltd. is related to C Ltd. because Mr. X controls A Ltd. and is a member of KMP of C Ltd.*



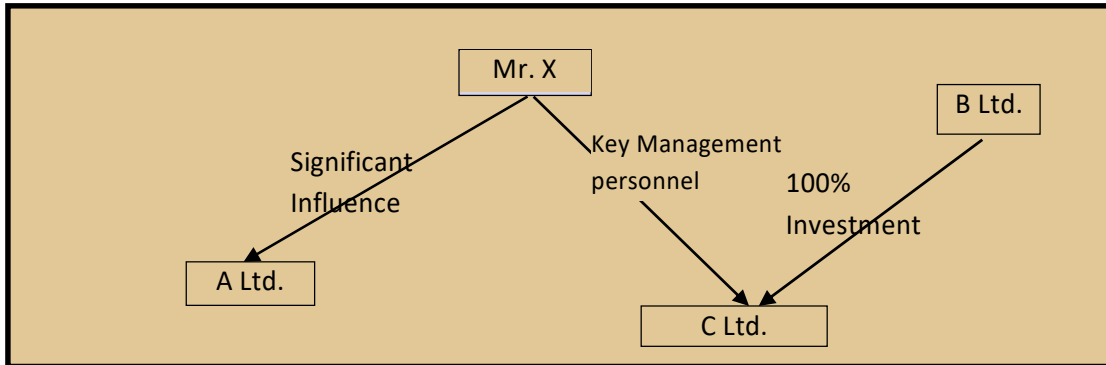
(b) Still A Ltd. will be related to C Ltd.



(c) No, Still A Ltd. will be related to C Ltd.



- (d) Yes, A Ltd. is not controlled by Mr. X. Therefore, despite Mr. X being KMP of C Ltd., A Ltd., having significant influence of Mr. X, will not be considered as related party of C Ltd.



\*\*\*\*\*

### Illustration 3 : Person as investor

Mr. X has an investment in A Limited and B Limited.

Required

- (i) Examine when can related party relationship be established
  - (a) from the perspective of A Limited's financial statements:
  - (b) from the perspective of B Limited's financial statements:
- (ii) Will A Limited and B Limited be related parties if Mr. X has only significant influence over both A Limited and B Limited

### Solution

- (i)
  - (a) If Mr. X controls or jointly controls A Limited, B Limited is related to A Limited when Mr. X has control, joint control or significant influence over Entity B.
  - (b) If Mr. X controls or jointly controls A Limited, A Limited is related to Entity B when Mr. X has control, joint control or significant influence over Entity B.
- (ii) No, A Ltd. & B Ltd., will not be considered as related party since no direct or indirect control is exercised on each other in any of the manner.

\*\*\*\*\*

### Illustration 4 : Partial exemption for government related entities

Government G directly controls Entity 1 and Entity 2. It indirectly controls Entity A and Entity B through Entity 1, and Entity C and Entity D through Entity 2. Person X is a member of the key management personnel in Entity 1.

*Examine the entity to whom the exemption for disclosure to be given and for transaction with whom.*

**Solution**

For Entity A's financial statements, the exemption of Ind AS 24 applies to:

- (a) transactions with Government G; and
- (b) transactions with Entities 1 and 2 and Entities B, C and D. However, that exemption does not apply to transactions with Person X.

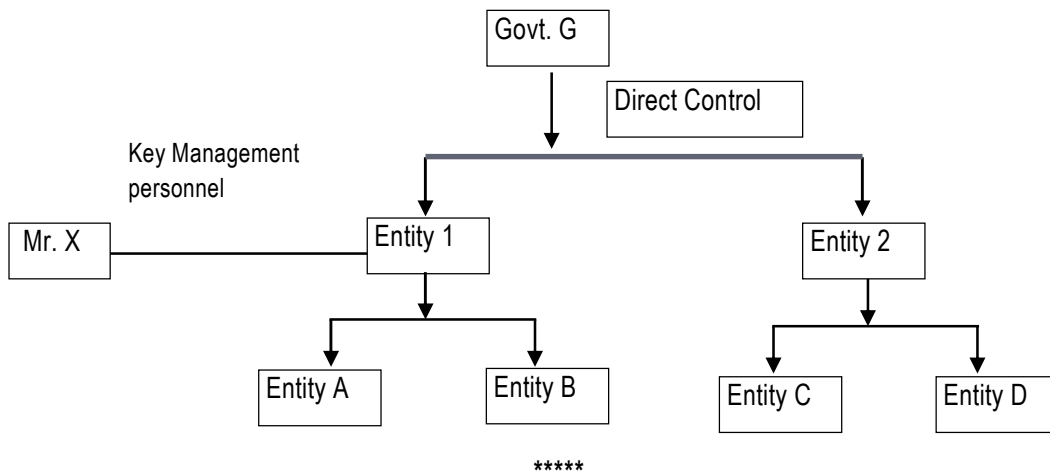


**Illustration 5**

*Power Limited is a producer of electricity. Transmission Limited regularly purchases electricity from Power Limited. Power Limited whose financial year ends on March 31, 20X2, acquired 100% shareholding of Transmission Limited on July 15, 20X1. However, the entire shareholding is disposed of on March 21, 20X2. Power Limited and Transmission Limited had transactions when Transmission Limited was a subsidiary of Power Limited and also in the period when it was not a subsidiary of Power Limited.*

*For which period, related party disclosure should Power Limited make in its financial statements for the year ended March 31, 20X2 with respect to transactions with Transmission Limited.*

**Solution**

Power Limited should in its financial statements for the year ended March 31, 20X2 make related party disclosures for the period from July 15, 20X1 to March 21, 20X2 when Transmission Limited was its subsidiary.

\*\*\*\*\*

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## **TEST YOUR KNOWLEDGE**

### **Questions**

1. Mr. X is a domestic partner of Ms. Y. Mr. X has an investment in A Limited and Ms. Y has an investment in B Limited.

Required

- (a) Examine when can a related party relationship is established, from the perspective of A Limited's financial statements:
  - (b) Examine when can related party relationship is established, from the perspective of B Limited's financial statements:
  - (c) Will A Limited and B Limited be related parties if Mr. X has only significant influence over A Limited and Ms. Y also has significant influence over B Limited:
2. A Limited has both (i) joint control over B Limited and (ii) joint control or significant influence over C Limited

Required

- (a) Examine related party relationship from the perspective of C Limited's financial statements.
  - (b) Examine related party relationship from the perspective of B Limited's financial statements.
3. ABC Ltd. is a long-standing customer of XYZ Ltd. Mrs. P whose husband is a director in XYZ Ltd. purchased a controlling interest in entity ABC Ltd. on 1<sup>st</sup> June, 20X1. Sales of products from XYZ Ltd. to ABC Ltd. in the two-month period from 1<sup>st</sup> April 20X1 to 31<sup>st</sup> May 20X1 totalled ₹ 8,00,000. Following the share purchase by Mrs. P, XYZ Ltd. began to supply the products at a discount of 20% to their normal selling price and allowed ABC Ltd. three months' credit (previously ABC Ltd. was only allowed one month's credit,

XYZ Ltd.'s normal credit policy). Sales of products from XYZ Ltd. to ABC Ltd. in the ten-month period from 1<sup>st</sup> June 20X1 to 31<sup>st</sup> March 20X2 totalled ₹ 60,00,000. On 31<sup>st</sup> March 20X2, the trade receivables of XYZ Ltd. included ₹ 18,00,000 in respect of amounts owing by ABC Ltd.

Analyse and show (where possible by quantifying amounts) how the above event would be reported in the financial statements of XYZ Ltd. for the year ended 31<sup>st</sup> March 20X2 as per Ind AS. You are required to mention the disclosure requirements as well.

4. Mr. Atul is an independent director of a company X Ltd. He plays a vital role in the Management of X Ltd. and contributes in major decision making process of the organisation. X Ltd. pays sitting fee of ₹ 2,00,000 to him for every Board of Directors' (BOD) meeting he attends. Throughout the year, X Ltd. had 5 such meetings which was attended by Mr. Atul.

Similarly, a non-executive director, Mr. Naveen also attended 5 BOD meetings and charged ₹ 1,50,000 per meeting. The Accountant of X Ltd. believes that they being not the employees of the organisation, their fee should not be disclosed as per related party transaction in accordance with Ind AS 24.

Examine whether the sitting fee paid to independent director and non-executive director is required to be disclosed in the financial statements prepared as per Ind AS?

5. Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31<sup>st</sup> March, 20X2 to the managing director Mr. Y for approval. Mr. Y, who is not an accountant, had raised following query from Mr. X after going through the draft financial statements:

One of the notes to the financial statements gives details of purchases made by ABC Ltd. from PQR Ltd. during the period 20X1-20X2. Mr. Y owns 100% of the shares in PQR Ltd. However, he feels that there is no requirement for any disclosure to be made in ABC Ltd.'s financial statements since the transaction is carried out on normal commercial terms and is totally insignificant to ABC Ltd., as it represents less than 1% of ABC Ltd.'s purchases.

Provide answers to the query raised by the Managing Director Mr. Y as per Ind AS.

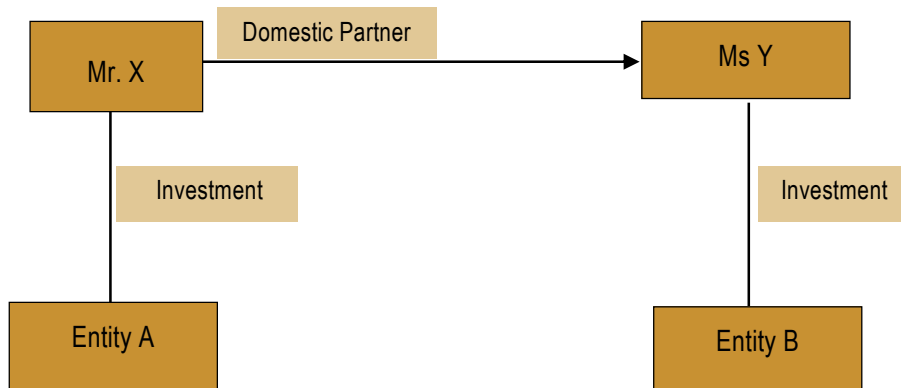
6. Uttar Pradesh State Government holds 60% shares in PQR Limited and 55% shares in ABC Limited. PQR Limited has two subsidiaries namely P Limited and Q Limited. ABC Limited has two subsidiaries namely A Limited and B Limited. Mr. KM is one of the Key management personnel in PQR Limited.
- (a) Determine the entity to whom exemption from disclosure of related party transactions is to be given. Also examine the transactions and with whom such exemption applies.
  - (b) What are the disclosure requirements for the entity which has availed the exemption?

7. 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 in the financial statements of S Ltd.? What should be the disclosures in this regard?

## Answers

1. (a) If Mr. X controls or jointly controls A Limited, B Limited is related to A Limited when Ms. Y has control, joint control or significant influence over B Limited.
- (b) If Mr. X controls or jointly controls A Limited, A Limited is related to B Limited when Ms. Y has control, joint control or significant influence over B Limited.
- (c) No, significant influence does not lead to direct/indirect control between the A Ltd. & B Ltd. i.e., if Mr. X has significant influence (but not control or joint control) over Entity A and Ms. Y has significant influence (but not control or joint control) over Entity B, Entities A and B are not related to each other.



If Mr X is a member of the key management personnel of Entity A and Ms Y is a member of the key management personnel of Entity B, Entities A and B are not, in the absence of any other indicator of a related party relationship, related to each other.

2. (a) C Limited is related to B Limited and A Limited
- (b) B Limited is related to C Limited and A Limited.
3. XYZ Ltd. would include the total revenue of ₹ 68,00,000 (₹ 60,00,000 + ₹ 8,00,000) from ABC Ltd. received / receivable in the year ended 31<sup>st</sup> March 20X2 within its revenue and show ₹ 18,00,000 within trade receivables at 31<sup>st</sup> March 20X2.

Mrs. P would be regarded as a related party of XYZ Ltd. because she is a close family member of one of the key management personnel of XYZ Ltd.

From 1<sup>st</sup> June 20X1, ABC Ltd. would also be regarded as a related party of XYZ Ltd. because from that date ABC Ltd. is an entity controlled by another related party.

Because ABC Ltd. is a related party with whom XYZ Ltd. has transactions, then XYZ Ltd. should disclose:

- The nature of the related party relationship.
- The revenue of ₹ 60,00,000 from ABC Ltd. since 1<sup>st</sup> June 20X1.
- The outstanding balance of ₹ 18,00,000 at 31<sup>st</sup> March 20X2.

In the current circumstances it may well be necessary for XYZ Ltd. to also disclose the favourable terms under which the transactions are carried out.

4. As per paragraph 9 of Ind AS 24, Related Party Disclosures, “Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.”

Accordingly, key management personnel (KMP) includes any director of the entity who are having authority and responsibility for planning, directing and controlling the activities of the entity. Hence, independent director Mr. Atul and non-executive director Mr. Naveen are covered under the definition of KMP in accordance with Ind AS.

Also as per paragraph 7 and 9 of Ind AS 19, ‘Employee Benefits’, an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of the Standard, Employees include directors and other management personnel. So, they should not be reported as related party.

Therefore, contention of the Accountant is wrong that they are not employees of X Ltd.

Paragraph 17 of Ind AS requires disclosure about employee benefits for key management personnel. Therefore, an entity shall disclose key management personnel compensation in total i.e. disclosure of directors’ fee of (₹ 10,00,000 + ₹ 7,50,000) ₹ 17,50,000 is to be made as employees benefits (under various categories).

Since short-term employee benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services, the sitting fee paid to directors will fall under it (as per Ind AS 19) and is required to be disclosed in accordance with the paragraph 17 of Ind AS 24.

5. Ongoing through the queries raised by the Managing Director Mr. Y, the financial controller Mr. X explained the notes and reasons for their disclosures as follows:



Related parties are generally characterised by the presence of control or influence between the two parties.

Ind AS 24 'Related Party Disclosures' identifies related parties as, *inter alia*, key management personnel and companies controlled by key management personnel. On this basis, PQR Ltd. is a related party of ABC Ltd.

The transaction is required to be disclosed in the financial statements of ABC Ltd. since Mr. Y is Key Management personnel of ABC Ltd. Also at the same time, it owns 100% shares of PQR Ltd. i.e. he controls PQR Ltd. This implies that PQR Ltd. is a related party of ABC Ltd.

Where transactions occur with related parties, Ind AS 24 requires that details of the transactions are disclosed in Notes to the financial statements. This is required even if the transactions are carried out on an arm's length basis.

Transactions with related parties are material by their nature, so the fact that the transaction may be numerically insignificant to ABC Ltd. does not affect the need for disclosure.

6. (a) As per para 18 of Ind AS 24, 'Related Party Disclosures', if an entity had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements.

However, as per para 25 of the standard a reporting entity is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with:

- (i) a government that has control or joint control of, or significant influence over, the reporting entity; and
- (ii) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity

According to the above paras, for Entity P's financial statements, the exemption in paragraph 25 applies to:

- (i) transactions with Government Uttar Pradesh State Government; and
- (ii) transactions with Entities PQR and ABC and Entities Q, A and B.

Similar exemptions are available to Entities PQR, ABC, Q, A and B, with the transactions with UP State Government and other entities controlled directly or indirectly by UP State Government. However, that exemption does not apply to

transactions with Mr. KM. Hence, the transactions with Mr. KM needs to be disclosed under related party transactions.

- (b) It shall disclose the following about the transactions and related outstanding balances referred to in paragraph 25:
- (a) the name of the government and the nature of its relationship with the reporting entity (ie control, joint control or significant influence);
  - (b) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:
    - (i) the nature and amount of each individually significant transaction; and
    - (ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.
7. 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 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).
- (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.

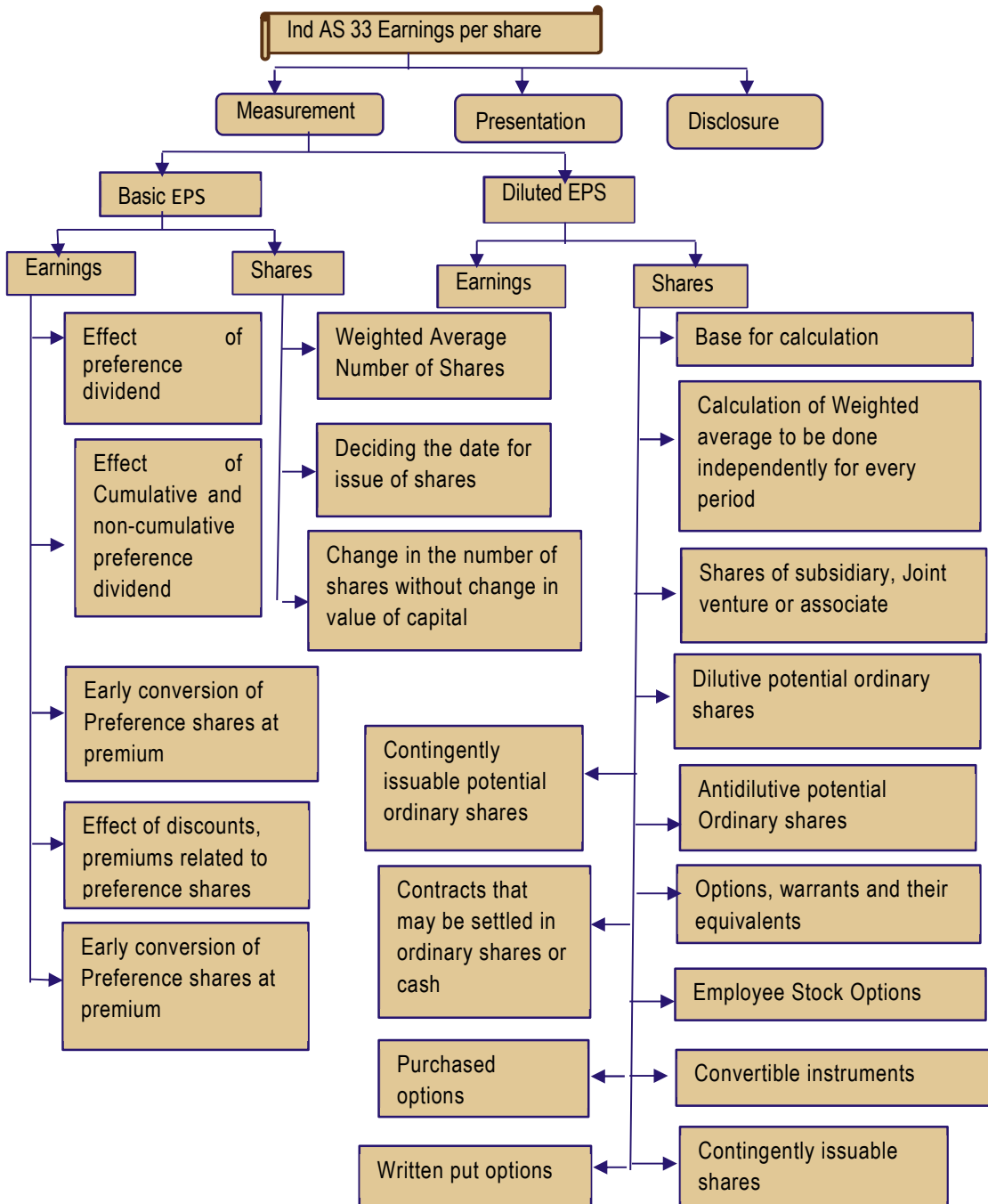
## UNIT 2 : INDIAN ACCOUNTING STANDARD 33 : EARNINGS PER SHARE

### LEARNING OUTCOMES

**After studying this unit, you will be able to:**

- ❑ Understand the objectives behind calculation and disclosure of EPS
- ❑ Define the terms used in the Standard such as basic EPS, dilution, anti-dilution, contingent share agreement, potential ordinary shares, etc.
- ❑ Work out the basic EPS after considering the important points for calculation of earnings and weighted average number of shares
- ❑ Determine the diluted EPS after considering the important points for calculation of diluted earnings and weighted average number of shares
- ❑ Deal with various peculiar situations of potential ordinary shares, contingently convertible shares, etc.
- ❑ Disclose the information regarding EPS in the financial statements

## UNIT OVERVIEW





## 2.1 INTRODUCTION

Earnings per share (EPS) is an important measure of the performance of the company. The equity shareholders (ordinary shareholders as per Ind AS 33) invest their money in the entity as owners of the company. They undertake business risks and financial risks along with all allied systematic and non-systematic risks of the company. Generally, they would expect a higher return as compared to a debt-holder considering the risks involved on their investments.

EPS is a ratio that is widely used by financial analysts, investors and other users to gauge an entity's profitability. Its purpose is to indicate how effective an entity has been in using the resources provided by the ordinary shareholders, and to assess the entity's current net earnings. EPS also forms the basis for calculating the price-earnings ratio, which is widely used by investors and analysts to value shares.



## 2.2 OBJECTIVE

**To prescribe principles for the determination and presentation of earnings per share:**

Ind AS 33 provides detailed guidelines and lays down the principles about how to calculate earnings, weighted average number of shares and basic and diluted earnings per share, to facilitate performance comparisons between:

**(i) different entities in the same reporting period:**

For example, if one needs to check whether Hero Motocorp Limited is doing better than Bajaj Auto Limited in terms of profitability, EPS can be considered to be a measure for comparison of performance.

**(ii) different reporting periods for the same entity:**

One can check the performance of a company over last 5 years using EPS as a benchmark.

### 2.2.1 Limitation of EPS

Earnings per share data may have **limitations** because of different accounting policies that companies might have used for determining 'earnings'.



## 2.3 SCOPE

- This Ind AS shall apply to companies (that have issued ordinary shares) to which Ind AS notified under the Companies Act apply. In Indian context, the term 'ordinary shares' is equivalent to 'equity shares'.
- An entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.
- When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with Ind AS 110, *Consolidated Financial Statements*, and Ind AS 27, *Separate Financial Statements*, respectively, the disclosures required by this Standard shall be presented both in the consolidated financial statements and separate financial statements. In consolidated financial statements such disclosures shall be based on consolidated information and in separate financial statements such disclosures shall be based on information given in separate financial statements.

The above mentioned provisions are summarised below in the following table:

| Sr. No. | Type of Financial statements | EPS disclosure required | EPS computation should be based on                          |
|---------|------------------------------|-------------------------|-------------------------------------------------------------|
| 1       | Consolidated                 | Yes                     | Information given in consolidated financial statements only |
| 2       | Separate                     | Yes                     | Information given in separate financial statements only     |



## 2.4 DEFINITIONS

1. An **ordinary share** is an equity instrument that is subordinate to all other classes of equity instruments. Ordinary shares participate in profit for the period only after other types of shares such as preference shares have participated. An entity may have more than one class of ordinary shares. Ordinary shares of the same class have the same rights to receive dividends.

In accordance with Ind AS 32, *Financial Instruments: Presentation*, an equity instrument is defined as a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

2. A **potential ordinary share** is a financial instrument or other contract that may entitle its holder to ordinary shares.

Examples of potential ordinary shares are:

- (a) financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares;
- (b) options and warrants;
- (c) shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets.

Contracts that might result in the issue of ordinary shares of the entity to the holder of the contract, at the option of the issuer or the holder, are potential ordinary shares.

#### Example 1

ABC & Co has issued preference shares with the option to convert these into an equal number of ordinary shares in 2 years' time. They represent potential ordinary shares, even though it is not certain whether the preference shareholders will convert them into equity shares (since it will depend on the prices of each class of shares at that time). If the price of the ordinary share is higher than that of the preference shares, the holders will convert, and will make a profit. If the price is lower, they will not.

- 3. **Options, warrants and their equivalents** are financial instruments that give the holder the right to purchase ordinary shares.
- 4. **Put options** on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.
- 5. **Dilution** is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.
- 6. **Antidilution** is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

#### Example 2

ABC Ltd. has interest paying debt which are convertible into ordinary shares at the option of the entity. On conversion, ABC Ltd. will save on the interest costs and in return will have to issue additional shares. In case the EPS of ABC Ltd. increases on conversion, the convertible debt would be considered as anti-dilutive. However, if the conversion will decrease the EPS, it would be considered as dilutive.

- 7. **A contingent share agreement** is an agreement to issue shares that is dependent on the satisfaction of specified conditions.



**Example 3**

ABC Ltd. has provided share options to its employees under a ESOP scheme. As per the scheme, the employees have to provide 3 years' services to the company for being eligible to share options at a discounted price. This is a contingent share agreement.

8. **Contingently issuable ordinary shares** are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

**Example 4**

ABC Ltd. acquires XYZ Ltd.'s business in exchange for ABC Ltd.'s shares. If the share price falls by more than 25% within 6 months of the business combination, ABC Ltd. will issue more shares (for free) to XYZ Ltd., as a compensation.

 **2.5 MEASUREMENT**

Measurement can be divided into following categories:

- a. Measurement of basic earnings per share
  - Measurement of earnings
  - Measurement of weighted average number of shares
- b. Measurement of diluted earnings per share
  - Measurement of earnings for diluted EPS
  - Measurement of number of shares for diluted EPS
- c. Measurement in case of dilutive potential ordinary shares
- d. Measurement in case of options, warrants and their equivalents
- e. Measurement in case of convertible instruments
- f. Measurement in case of contingently issuable shares
- g. Measurement in case of contracts that may be settled in ordinary shares or cash
- h. Measurement in case of purchased options and written put options
- i. Dealing with retrospective adjustments



## 2.6 MEASUREMENT OF BASIC EARNINGS PER SHARE

### 2.6.1 Meaning and Formula

#### 1. Meaning

An entity shall calculate basic earnings per share for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

The objective of basic earnings per share information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

#### 2. Formula

Basic earnings per share shall be calculated by dividing profit or loss for the period attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary (equity) shares outstanding during the period (the denominator). It can be expressed mathematically as follows:

$$\frac{\text{Profit/Loss attributable to Equity share holders}}{\text{Weighted average number of Equity shares outstanding during the period}}$$

### 2.6.2 Measurement of Earnings

- ◆ For the purpose of calculating basic earnings per share, the amounts attributable to ordinary equity holders of the parent entity in respect of:

- (a) profit or loss from continuing operations attributable to the parent entity; and
- (b) profit or loss attributable to the parent entity

shall be the amounts in (a) and (b) adjusted for the after-tax amounts of preference dividend, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

An entity that has preference shares in issue, will classify those shares as financial liabilities or equity in accordance with the principles under Ind AS 32. An adjustment is required to the profit or loss for the period, to arrive at the profit or loss attributable to ordinary equity holders for the purpose of calculating EPS, if preference shares are classified as equity. Any dividends and other appropriations would be debited directly to equity under Ind AS 32. Any dividends or other appropriations for preference shares classified as liabilities should be accounted for as finance

costs in arriving at profit or loss for the period. No adjustment is required for the purpose of calculating EPS.

- ◆ Where any item of income or expense, which is otherwise required to be recognised in profit or loss in accordance with Ind AS, is debited or credited to securities premium account/other reserves, the amount in respect thereof shall be deducted from profit or loss from continuing operations for the purpose of calculating basic earnings per share.
- ◆ All items of income and expense attributable to ordinary equity holders of the parent entity that are recognised in a period, including tax expense and dividends on preference shares classified as liabilities are included in the determination of profit or loss for the period attributable to ordinary equity holders of the parent entity.
- ◆ The amount of dividends declared in respect of the year should be deducted in arriving at the profit attributable to ordinary shareholders for preference dividends that are non-cumulative.
- ◆ The dividend for the period should be taken into account, whether or not it has been declared for cumulative preference dividends. If an entity is unable to pay or declare a cumulative preference dividend, the undeclared amount of the cumulative preference dividend (net of tax, if applicable) should still be deducted in arriving at earnings for the purpose of the EPS calculation. The amount paid is not deducted in arriving at earnings for the purpose of the EPS calculation in the period in which arrears of cumulative preference dividends are paid.
- ◆ Preference shares that provide for a low initial dividend to compensate an entity for selling the preference shares at a discount, or an above-market dividend in later periods to compensate investors for purchasing preference shares at a premium, are sometimes referred to as increasing rate preference shares. Any original issue discount or premium on increasing rate preference shares is amortised to retained earnings using the effective interest method and treated as a preference dividend for the purposes of calculating earnings per share (irrespective of whether such discount or premium is debited or credited to securities premium account in view of requirements of any law).

### Example 1 Increasing rate preference shares

**Reference:** Ind AS 33, paragraphs 12 and 15

Entity D issued non-convertible, non-redeemable class A cumulative preference shares of Rs. 100 par value on 1 January 20X1. The class A preference shares are entitled to a cumulative annual dividend of Rs. 7 per share starting in 20X4.

At the time of issue, the market rate dividend yield on the class A preference shares was 7 per cent a year. Thus, Entity D could have expected to receive proceeds of approximately Rs. 100 per class A preference share if the dividend rate of Rs. 7 per share had been in effect at the date of issue.

In consideration of the dividend payment terms, however, the class A preference shares were issued at Rs. 81.63 per share, ie at a discount of Rs. 18.37 per share. The issue price can be calculated by taking the present value of Rs. 100, discounted at 7 per cent over a three-year period.

Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes. To calculate basic earnings per share, the following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity:

| Year        | Carrying<br>amount of class<br>A preference<br>shares 1<br>January | Imputed <sup>(a)</sup><br>Dividend | Carrying<br>amount <sup>(b)</sup> of<br>class A<br>preference<br>shares<br>31 December | Dividend paid |
|-------------|--------------------------------------------------------------------|------------------------------------|----------------------------------------------------------------------------------------|---------------|
|             | Rs.                                                                | Rs.                                | Rs.                                                                                    | Rs.           |
| 20X1        | 81.63                                                              | 5.71                               | 87.34                                                                                  | —             |
| 20X2        | 87.34                                                              | 6.12                               | 93.46                                                                                  | —             |
| 20X3        | 93.46                                                              | 6.54                               | 100.00                                                                                 | —             |
| Thereafter: | 100.00                                                             | 7.00                               | 107.00                                                                                 | (7.00)        |

(a) at 7 %

(b) This is before dividend payment.

#### 2.6.2.1 Redemption/Repurchase of preference shares at premium

Preference shares may be repurchased under an entity's tender offer to the holders. The excess of the fair value of the consideration paid to the preference shareholders over the carrying amount of the preference shares represents a return to the holders of the preference shares and a charge to retained earnings for the entity. This amount is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

#### Example 5

ABC Ltd. had issued preference shares at ₹ 100 each 10 years ago. Now ABC Ltd. buys back the shares for ₹ 120 each. ₹ 20 premium for each share is charged to retained earnings. No amount is recorded in the statement of profit and loss for this transaction. However, for EPS purposes, ₹ 20 for each share is charged to the statement of profit or loss for the period of the transaction.

### 2.6.2.2 Early conversion of Preference shares at premium

Early conversion of convertible preference shares may be induced by an entity through favourable changes to the original conversion terms or the payment of additional consideration. The excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms is a return to the preference shareholders and is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

#### Illustration 1

*ABC Ltd. issues 9% preference shares of fair value of ₹ 10 each on 1.4.20X1. Total value of the issue is ₹ 10,00,000. The shares are issued for a period of 5 years and would be redeemed at the end of 5<sup>th</sup> year. The shares are to be redeemed at ₹ 11 each.*

*At the end of the year 3, i.e. on 31.3.20X4, company finds that it has earned good returns than expected over last three years and can make the redemption of preference shares early. To compensate the shareholders for two years of dividend which they need to forego, company decided to redeem the shares at ₹ 12 each instead of original agreement of ₹ 11. Comment on the impact of early conversion of preference shares at a premium on earnings for the year 20X3-20X4 attributable to ordinary equity holders of ABC Ltd. for basic EPS.*

*Ignore the applicability of the standards on Financial Instruments (i.e., ignore EIR; further, the additional payment to be made can be met from Securities Premium/Reserves as Premium on Redemption) and answer on the basis of Ind AS 33 only.*

#### Solution

In the given situation, ₹ 1 per share is the excess payment made by the company amounting to ₹ 1,00,000 in all. The amount of ₹ 1,00,000 will be deducted from the earnings of the year 20X3-20X4 while calculating the basic EPS of year 20X3-20X4.

\*\*\*\*\*

### 2.6.2.3 Excess payment to Preference share holders

Any excess of the carrying amount of preference shares over the fair value of the consideration paid to settle them is added in calculating profit or loss attributable to ordinary equity holders of the parent entity.

#### Illustration 2

*An entity has following preference shares in issue at the end of 20X4:*

- **5% redeemable, non-cumulative preference shares:** *These shares are classified as liabilities. During the year, an amount of Rs. 1,00,000 (computed using the coupon rate of 5% - Rs. 20,00,000 x 5%) was paid to the preference shareholders*
- **Increasing-rate, cumulative, non-redeemable preference shares issued at a discount in 20X0, with a cumulative dividend rate from 20X5 of 10%:** *The shares were issued at a discount*

to compensate the holders, because dividend payments will not commence until 20X5. The accrual for the discount in the current year, calculated using the effective interest method amounted to, say, ₹ 18,000. These shares are classified as equity – ₹ 200,000.

- **8% non-redeemable, non-cumulative preference shares:** At the beginning of the year, the entity had ₹ 100,000 8% preference shares outstanding but, at 30 June 20X4, it repurchased ₹ 50,000 of these at a discount of ₹ 1,000 – ₹ 50,000.
- **7% cumulative, convertible preference shares (converted in the year):** These shares were classified as equity, until their conversion into ordinary shares at the beginning of the year. No dividend was accrued in respect of the year, although the previous year's dividend was paid immediately prior to conversion. To induce conversion, the terms of conversion of the 7% convertible preference shares were also amended, and the revised terms entitled the preference shareholders to an additional 100 ordinary shares on conversion with a fair value of ₹ 300 – Nil.

The profit after tax for the year 20X4 is ₹ 150,000.

Determine the adjustments for the purpose of calculating EPS.

### Solution

Adjustments for the purpose of calculating EPS are made as follows:

| Particulars                                                                           | Amount<br>(₹)   | Amount<br>(₹)   |
|---------------------------------------------------------------------------------------|-----------------|-----------------|
| Profit after tax                                                                      |                 | 150,000         |
| Amortisation of discount on issue of increasing-rate preference shares (Refer Note 1) | (18,000)        |                 |
| Discount on repurchase of 8% preference shares (Refer Note 2)                         | 1,000           |                 |
| Premium to induce Conversion                                                          | <u>(30,000)</u> | <u>(47,000)</u> |
| Profit attributable to ordinary equity holders for basic EPS (Refer Note 3-5)         |                 | <u>1,03,000</u> |

### Notes:

1. The original discount on issue of the increasing-rate preference shares is treated as amortised to retained earnings and treated as preference dividends for EPS purposes and adjusted against profit attributable to the ordinary equity holders. There is no adjustment in respect of dividend, because these do not commence until 20X5. Instead, the finance cost is represented by the amortisation of the discount in the dividend-free period. In future years, the accrual for the dividend of ₹ 20,000 will be deducted from profits.
2. The discount on repurchase of the 8% preference shares has been credited to equity so should be added to profit.

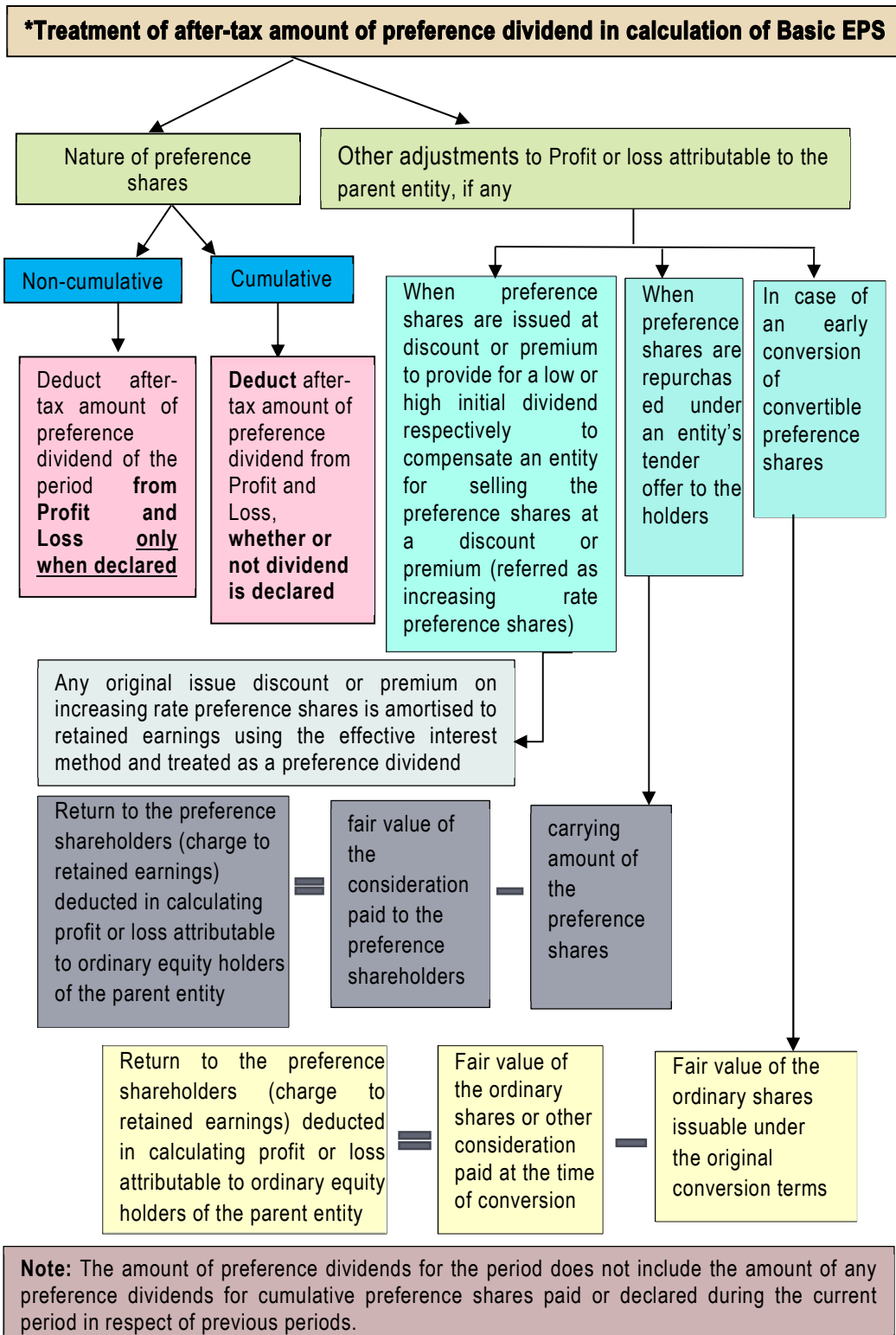
3. The dividend on the 5% preference shares has been charged to the income statement, because the preference shares are treated as liabilities, so no adjustment is required for it from the profit.
4. No accrual for the dividend on the 8% preference shares is required, because they are non-cumulative. If a dividend had been declared for the year, it would have been deducted from profit for the purpose of calculating basic EPS, because the shares are treated as equity and the dividend would have been charged to equity in the financial statements.
5. The 7% preference shares are convertible and hence correctly classified as equity. Accordingly, the additional amount paid (100 additional shares x fair value ₹ 300 per share = ₹ 30,000) to induce conversion would be taken to Equity Share Capital and Retained Earnings or Securities Premium, as the case may be (transaction with 'owners'). Therefore, this excess amount paid would require to be deducted from the Net Profit to arrive at Net Profit attributable to Equity Shareholders.

It may be noted that as per Sections 53 and 55 of the Companies Act, 2013, a company cannot issue shares at discount or any irredeemable preference shares. However, the above illustration has been given only to explain the concept given in Ind AS.

\*\*\*\*\*

The changes given in the above two questions do not consider the impact of the Companies Act, 2013. Since Ind AS is based on IFRS which ignores country-specific statutory requirements and instead opts for a principle-based approach, solutions are given accordingly. However, the statute gains precedence over Ind AS, and hence the same needs to be followed practically.

Here, in this paper of Financial Reporting, the discussion has been restricted to the concepts of Ind AS provisions.





## 2.6.3 Shares

### 2.6.3.1 Weighted Average Number of Shares

- For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period.

The weighted average number of ordinary shares outstanding during the period is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period *multiplied by a time-weighting factor*.

- The time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

#### Weighted average number of equity shares:

|                                                      |                    |
|------------------------------------------------------|--------------------|
| Ordinary shares outstanding at the beginning         | xxxx               |
| Less: Ordinary shares bought back during the period* | xxxx               |
| Add: Ordinary shares issued during the period*       | <u>xxxx</u>        |
| <b>Ordinary shares outstanding during the period</b> | <b><u>xxxx</u></b> |

\*to be multiplied by time-weighting factor. The time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period.

#### Illustration 3

Following is the data for company XYZ in respect of number of equity shares during the financial year 20X1-20X2. Find out the number of shares for the purpose of calculation of basic EPS as per Ind AS 33.

| S. No. | Date        | Particulars                                           | No of shares |
|--------|-------------|-------------------------------------------------------|--------------|
| 1      | 1-Apr-20X1  | Opening balance of outstanding equity shares          | 100,000      |
| 2      | 15-Jun-20X1 | Issue of equity shares                                | 75,000       |
| 3      | 8-Nov-20X1  | Conversion of convertible preference shares in Equity | 50,000       |
| 4      | 22-Feb-20X2 | Buy back of shares                                    | (20,000)     |
| 5      | 31-Mar-20X2 | Closing balance of outstanding equity shares          | 205,000      |

### Solution

The closing balance of the outstanding shares is 2,05,000 by a normal addition and subtraction. But as per weighted average concept, one need to find out for how many days each type of shares was actually held during the year.

The shares which were there on 1<sup>st</sup> April 20X1, were held for the whole year. Therefore, weighted average number of such shares will be given by the formula:

$$\begin{aligned} & \text{No of shares} \times \text{no of days the shares were held during the year} / 365 \\ & = 1,00,000 \times 365 / 365 = 1,00,000 \end{aligned}$$

But the shares which were issued on 15<sup>th</sup> June 20X1, were held for only 290 days. Therefore, the weighted average number of shares will be  $75,000 \times 290 / 365 = 59,589$ .

Following the above formula, the weighted average number of shares for calculation of EPS for the year 20X1-20X2 will be as follows:

| Sr. No. | Date        | Particulars                                           | No of shares    | No of days shares were outstanding | Weighted average no of shares |
|---------|-------------|-------------------------------------------------------|-----------------|------------------------------------|-------------------------------|
| 1       | 1-Apr-20X1  | Opening balance of outstanding equity shares          | 1,00,000        | 365                                | 1,00,000                      |
| 2       | 15-Jun-20X1 | Issue of equity shares                                | 75,000          | 290                                | 59,589                        |
| 3       | 8-Nov-20X1  | Conversion of convertible preference shares in Equity | 50,000          | 144                                | 19,726                        |
| 4       | 22-Feb-20X2 | Buy back of shares                                    | <u>(20,000)</u> | (38)*                              | <u>(2,082)</u>                |
| 5       | 31-Mar-20X2 | Closing balance of outstanding equity shares          | <u>2,05,000</u> |                                    | <u>1,77,233</u>               |

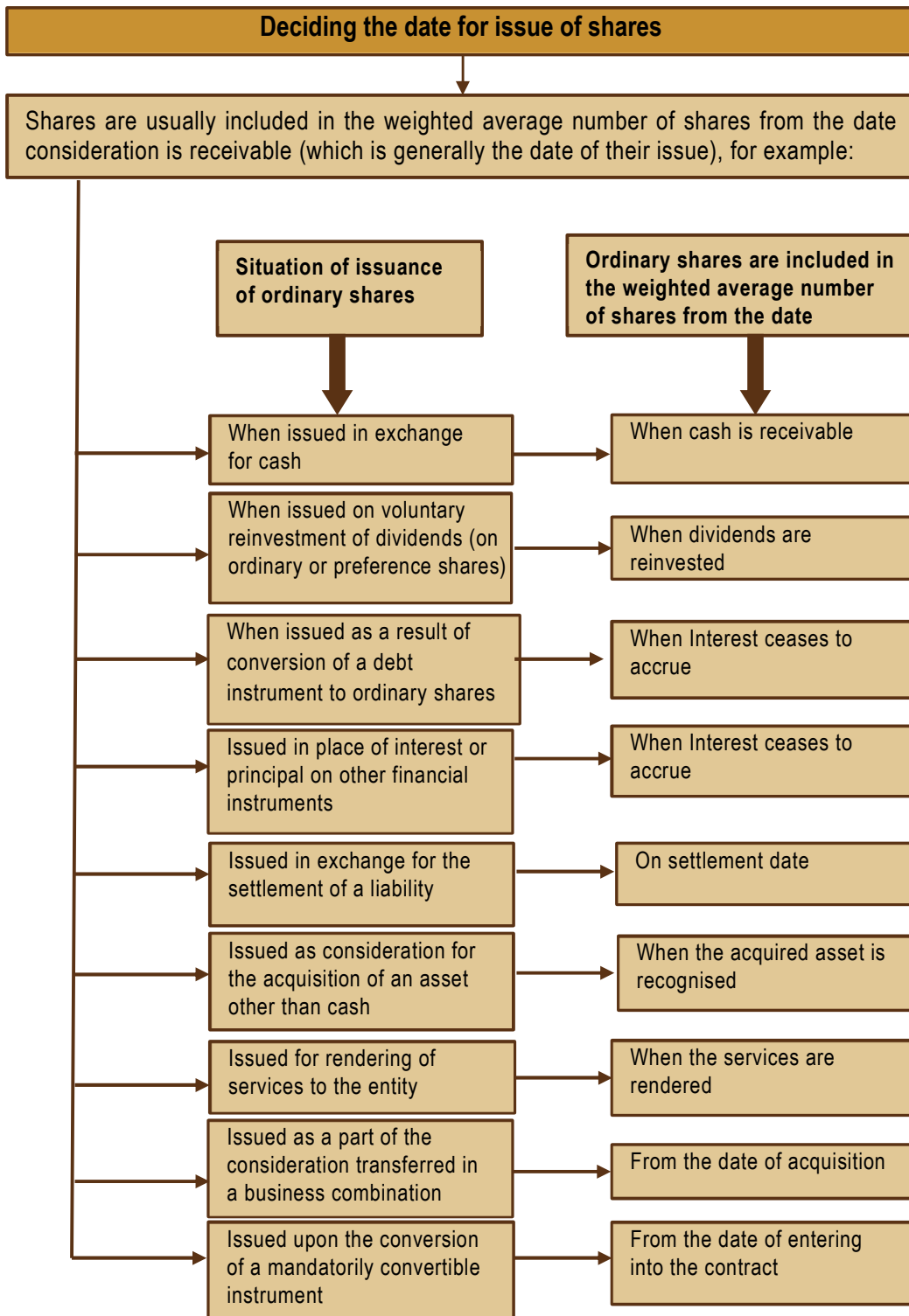
\* These shares had already been considered in the shares issued. The same has been deducted assuming that the bought back shares have been extinguished immediately.

\*\*\*\*\*

From the above illustration, one can notice that the date of issue/ conversion/ repurchase/ transaction affecting the addition or deletion in number of shares is very crucial for calculation of weighted average number of shares.

### 2.6.3.2 Deciding the date for issue of shares

- Shares are usually **included** in the weighted average number of shares **from the date consideration is receivable** (which is generally the date of their issue), for example:
  - (a) ordinary shares issued in **exchange for cash** are included from the date when **cash is receivable**;
  - (b) ordinary shares issued on the **voluntary reinvestment of dividend** on ordinary or preference shares are included from the date when **dividend are reinvested**;
  - (c) ordinary shares issued as a result of the **conversion of a debt instrument** to ordinary shares are included from the date that **interest ceases to accrue**;
  - (d) ordinary shares issued **in place of interest or principal** on other financial instruments are included from the date that **interest ceases to accrue**;
  - (e) ordinary shares issued in **exchange for the settlement of a liability** of the entity are included from the **settlement date**;
  - (f) ordinary shares issued as **consideration for the acquisition** of an asset other than cash are included from the **date on which the acquisition is recognised**; and
  - (g) ordinary shares issued for the **rendering of services** to the entity are included from the date on which as the **services are rendered**.
- Ordinary shares issued as part of the consideration transferred in a business combination are included in the weighted average number of shares from the acquisition date of the business. This is because the acquirer incorporates into its statement of profit and loss the acquiree's profits and losses from that date.
- Entities often issue instruments that are convertible into ordinary shares that may be either mandatorily convertible or convertible at the option of the issuer or holder. The issue of ordinary shares is solely dependent on the passage of time for a mandatorily convertible instrument. Ordinary shares that are issuable on the conversion of a mandatorily convertible instrument should be included in basic EPS from the date the contract is entered into.



### 2.6.3.3 Contingently issuable shares

- Contingently issuable shares are treated as outstanding and are included in the calculation of basic earnings per share only from the date when all necessary conditions are satisfied (i.e. the events have occurred).
- Shares that are issuable solely after the passage of time are not contingently issuable shares, because the passage of time is a certainty.
- Outstanding ordinary shares that are contingently returnable (ie subject to recall) are not treated as outstanding and are excluded from the calculation of basic earnings per share until the date the shares are no longer subject to recall.

#### Example 6

ABC Ltd. acquires a company in 20X1 for consideration paid in shares. If the profits for calendar years 20X1 and 20X2 meet budget, ABC Ltd. will issue more shares to the vendor in February 20X3. These additional shares will be included in the weighted-average calculation from 1 January 20X3 (considering reporting date as December end), if the targets are met.

### 2.6.3.4 Change in the number of shares without change in value of capital

- The weighted average number of ordinary shares outstanding during the period and for all periods presented shall be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of ordinary shares outstanding without a corresponding change in resources.
- There are certain events, which will not change the total equity of the company. Still the number of outstanding equity shares will undergo a change.
- Ordinary shares may be issued, or the number of ordinary shares outstanding may be reduced, without a corresponding change in resources. Examples include:
  - (a) a capitalisation or bonus issue (sometimes referred to as a stock dividend);
  - (b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;
  - (c) a share split; and
  - (d) a reverse share split (consolidation of shares).
- In a capitalisation or bonus issue or a share split, ordinary shares are issued to existing shareholders for no additional consideration. Therefore, the number of ordinary shares outstanding is increased without an increase in resources. The number of ordinary shares outstanding before the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period presented.

**Example 7**

On a two-for-one bonus issue, the number of ordinary shares outstanding before the issue is multiplied by three to obtain the new total number of ordinary shares, or by two to obtain the number of additional ordinary shares.

- We have seen above that for calculation of weighted average number of shares, the date of issue/contract etc. is very important. However, in case of bonus shares where the number of shares change without the change in the resources, the date will be considered from the beginning of the earliest period presented, irrespective of the fact of the date of actual capitalisation of the reserves.

**Illustration 4**

On 31 March, 20X2, the issued share capital of a company consisted of ₹ 100,000,000 in ordinary shares of ₹ 25 each and ₹ 500,000 in 10% cumulative non-redeemable preference shares (classified as equity) of Re 1 each. On 1 October, 20X2, the company issued 1,000,000 ordinary shares fully paid by way of capitalisation of reserves in the proportion 1:4 for the year ended 31 March, 20X3.

Profit for 20X1-20X2 and 20X2-20X3 is ₹ 450,000 and ₹ 550,000 respectively.

Calculate the basic EPS for 20X1-20X2 and 20X2-20X3.

**Solution**

|                                  | 20X2-20X3<br>₹'000 | 20X1-20X2<br>₹'000 |
|----------------------------------|--------------------|--------------------|
| <b>Calculation of earnings</b>   |                    |                    |
| Profit for the year              | 550                | 450                |
| Less: Preference shares dividend | <u>(50)</u>        | <u>(50)</u>        |
| Earnings (A)                     | <u>500</u>         | <u>400</u>         |

|                                        | No. of shares<br>in '000 | No. of shares<br>in '000 |
|----------------------------------------|--------------------------|--------------------------|
| <b>Number of ordinary shares</b>       |                          |                          |
| Shares in issue for full year          | 4,000                    | 4,000                    |
| Capitalisation issue at 1 October 20X2 | <u>1,000</u>             | <u>1,000</u>             |
| Number of shares (B)                   | <u>5,000</u>             | <u>5,000</u>             |
| Earnings per ordinary share (A/B)      | 10 Paise                 | 8 Paise*                 |

\*The comparative EPS for 20X1-20X2 can alternatively be calculated by adjusting the previously disclosed EPS in 20X1-20X2 (in this example, 10 Paise) by the following factor:

Number of shares before the bonus issue/ Number of shares after the bonus issue

\*Adjusted EPS for 20X1-20X2                      10 Paise x (4,000/ 5,000) = 8 Paise

\*\*\*\*\*

**Illustration 5**

X Ltd.

|             |                                       |
|-------------|---------------------------------------|
| 1 January   | 1,000,000 shares in issue             |
| 28 February | Issued 200,000 shares at fair value   |
| 31 August   | Bonus issue 1 share for 3 shares held |
| 30 November | Issued 250,000 shares at fair value   |

Calculate the number of shares which would be used in the basic EPS calculation. Consider reporting date as December end.

**Solution**

| Period                    | Calculations                           | Weighted average number of shares |
|---------------------------|----------------------------------------|-----------------------------------|
| 1 January - 28 February   | $1,000,000 \times 2 / 12 \times 4 / 3$ | 222,222                           |
| 1 March - 31 August       | $1,200,000 \times 6 / 12 \times 4 / 3$ | 800,000                           |
| 1 September - 30 November | $1,600,000 \times 3 / 12$              | 400,000                           |
| 1 December - 31 December  | $1,850,000 \times 1 / 12$              | 154,167                           |
|                           |                                        | <u>1,576,389</u>                  |

\*\*\*\*\*

**2.6.3.5 Rights issues**

Entities might raise additional capital by issuing shares to existing shareholders, on a pro rata basis to their existing holdings, in the form of a rights issue. The rights shares can either be offered at the current market price or at a price that is below the current market price. Ordinary shares might be issued during the year by way of a rights issue at a discount to the market price. The weighting calculation should reflect the fact that the discount is effectively a bonus (stock dividend) given to the shareholders in the form of shares for no consideration. This bonus element should be factored into the calculation of the weighted average number of shares. A rights issue is equivalent to a capitalisation issue of part of the shares for no consideration and an issue of the remainder of the shares at full market price. The notional capitalisation issue reflects the bonus element inherent in the rights issue and is measured by the following fraction:

$$\frac{\text{Fair value per share immediately before the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

where,

### Theoretical ex-rights fair value per share

Fair value of all outstanding shares before exercise of right + Total amount received from exercise of rights

No of shares outstanding after the exercise of rights

#### Illustration 6

*At 31 December 20X1, the issued share capital of a company consisted of 1.8 million ordinary shares of ₹ 10 each, fully paid. The profits for the year ended 31 December 20X1 and 20X2 amounted to ₹ 630,000 and ₹ 875,000 respectively. On 31 March 20X2, the company made a rights issue on a 1 for 4 basis at ₹ 30. The market price of the shares immediately before the rights issue was ₹ 60.*

*Calculate EPS.*

#### Solution

#### Calculation of theoretical ex rights price:

|                    | Number of shares |                          | ₹                 |
|--------------------|------------------|--------------------------|-------------------|
| Initial holding    | 4                | Market Value (4 x 60)    | 240               |
| Rights taken up    | <u>1</u>         | Cost (1 x 30)            | <u>30</u>         |
| <b>New holding</b> | <b><u>5</u></b>  | <b>Theoretical price</b> | <b><u>270</u></b> |

**Theoretical ex rights price =  $270/5 = ₹ 54$**

#### Calculation of bonus element

The bonus element of the rights issue is given by the fraction:

Market price before rights issue/Theoretical ex-rights price =  $60 / 54 = 10/9$

This corresponds to a bonus issue of 1 for 9. The bonus ratio will usually be greater than 1 (that is, the market price of the shares immediately prior to the exercise of rights is greater than the theoretical ex-rights price). If the ratio is less than 1, it might indicate that the market price has fallen significantly during the rights period, which was not anticipated when the rights issue was announced. In this situation, the rights issue should be treated as an issue of shares for cash at full market price.



It can be demonstrated, using the figures in the illustration, that a rights issue of 1 for 4 at ₹ 30 is equivalent to a bonus issue of 1 for 9 combined with an issue of shares at full market price of ₹ 54 per share. Consider an individual shareholder holding 180 shares:

|                            | Number of shares<br>(in '000s) | Value                  | ₹<br>(in million) |
|----------------------------|--------------------------------|------------------------|-------------------|
| Original holding           | 1,800                          | Value at ₹60 per share | 108.00            |
| Rights shares (1:4)        | <u>450</u>                     | Value at ₹30 per share | <u>13.50</u>      |
| Holding after rights issue | <u>2,250</u>                   | Value at ₹54 per share | <u>121.50</u>     |

The additional 450 thousand rights shares at ₹30 can be shown to be equivalent to a bonus issue of 1 for 9 on the original holding, followed by an issue of 1:8 at full market price of ₹54 following the bonus issue, as follows:

|                                          | Number of shares<br>(in '000s) | Value                          | ₹<br>(in million)    |
|------------------------------------------|--------------------------------|--------------------------------|----------------------|
| Original holding                         | 1,800                          | Value at ₹60 per share         | 108.00               |
| Bonus issue of 1 for 9                   | <u>200</u>                     | Value Nil                      | <u>nil</u>           |
|                                          | <b>2000</b>                    | <b>Value at ₹ 54 per share</b> | <b>108.00</b>        |
| Issue of 1 for 8 at full price (450-200) | <u>250</u>                     | Value at ₹ 54 per share        | <u>13.50</u>         |
| <b>Total holding</b>                     | <b><u>2250</u></b>             | <b>Value at ₹54 per share</b>  | <b><u>121.50</u></b> |

The shareholder is therefore indifferent as to whether the entity makes a rights issue of 1 for 4 at ₹ 30 per share, or a combination of a bonus issue of 1 for 9 followed by a rights issue of 1 for 8 at full market price of ₹ 54 per share.

Having calculated the bonus ratio, the ratio should be applied to adjust the number of shares in issue before the rights issue, both for the current year and for the previous year. Therefore, the weighted average number of shares in issue for the current and the previous period, adjusted for the bonus element, would be:

**Weighted average number of shares:**

|                                                 | 20X2             | 20X1             |
|-------------------------------------------------|------------------|------------------|
| No of actual shares in issue before rights      | 1,800,000        | 1,800,000        |
| Correction for bonus issue (1:9)                | <u>200,000</u>   | <u>200,000</u>   |
| Deemed no of shares in issue before right issue | <u>2,000,000</u> | <u>2,000,000</u> |

(1.8 million x 10/9 for the whole year)

The no of shares after the rights issue would be

$$= 1.8 \text{ million} \times 5/4 = 2,250,000$$

Therefore, the weighted average number of shares would be

|                                                 |                         |                         |
|-------------------------------------------------|-------------------------|-------------------------|
| 2.0 million for the whole year                  |                         | 2,000,000               |
| 1.8 million x 10/9 x 3/12 (before rights issue) | 500,000                 | -                       |
| 2.25 million x 9/12 (after rights issue)        | <u>1,687,500</u>        | <u>-</u>                |
| <b>Weighted average number</b>                  | <b><u>2,187,500</u></b> | <b><u>2,000,000</u></b> |

**20X2                      20X1**

**Calculation of earnings** **(as previously stated)**

Profits for the year                      ₹ 875,000                      ₹ 630,000

Weighted average number                      2,187,500                      1,800,000

*Basic EPS*                      **40p**                      **35p**

*Basic EPS for 20X1 (as restated)*                      ₹ 630,000 / 2,000,000

**= 31.50p**

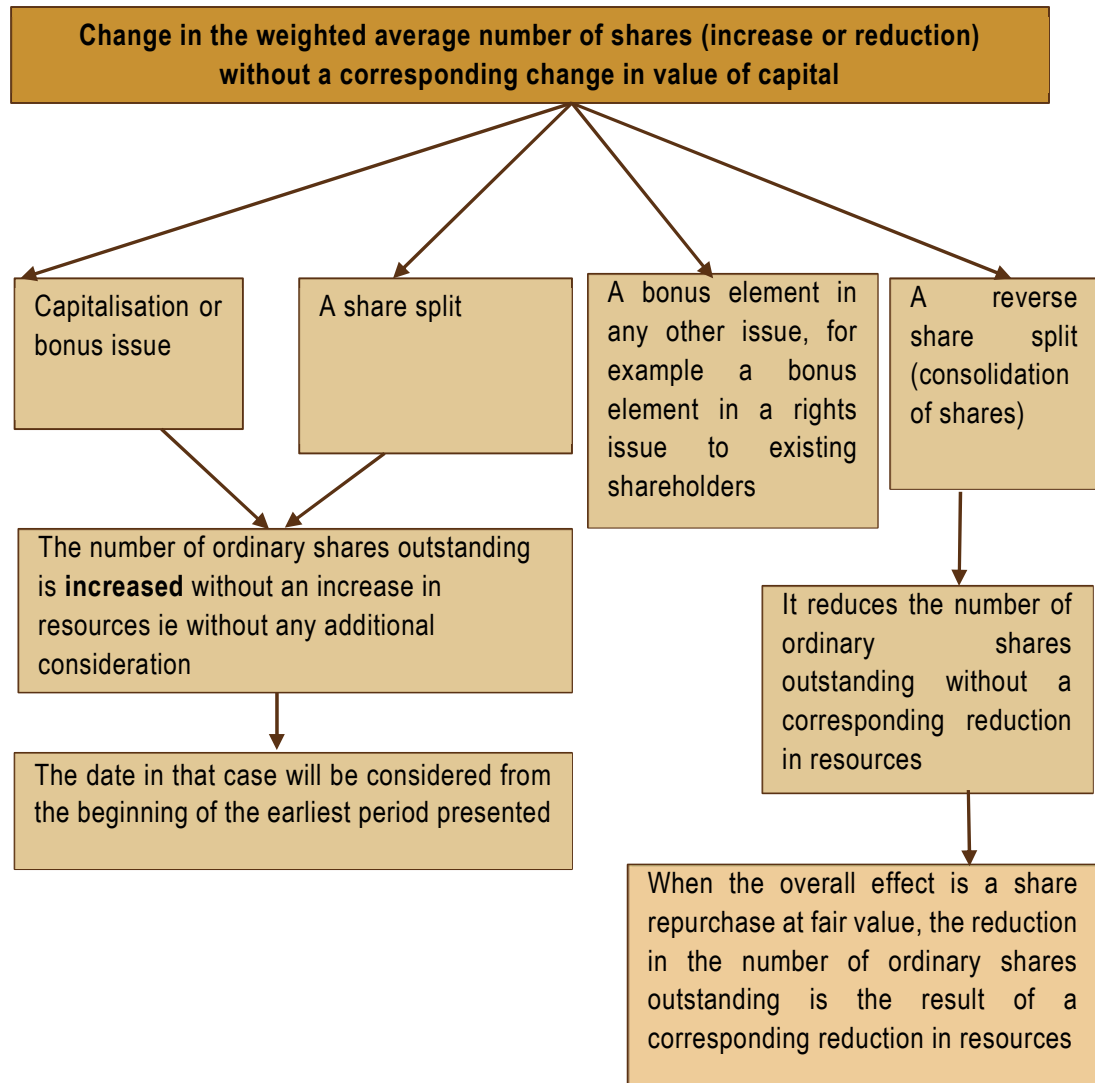
In practice, the restated EPS for 20X1 can also be calculated by adjusting the EPS figure of the previous year by the reciprocal of the bonus element factor:

$$* 35p \times 9/10 = 31.50 p$$

\*\*\*\*\*

A consolidation of ordinary shares generally reduces the number of ordinary shares outstanding without a corresponding reduction in resources. However, when the overall effect is a share repurchase at fair value, the reduction in the number of ordinary shares outstanding is the result of a corresponding reduction in resources.

An example is a share consolidation combined with a special dividend. The weighted average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognised.



## 2.7 DILUTED EARNINGS PER SHARE

### 2.7.1 Scope, meaning and formula

- An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.
- For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares.

- The objective of diluted earnings per share is consistent with that of basic earnings per share—to provide a measure of the interest of each ordinary share in the performance of an entity—while giving effect to all dilutive potential ordinary shares outstanding during the period. As a result:
  - ✓ profit or loss attributable to ordinary equity holders of the parent entity is increased by the after-tax amount of dividend and interest recognised in the period in respect of the dilutive potential ordinary shares and is adjusted for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares; and
  - ✓ the weighted average number of ordinary shares outstanding is increased by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

**The formula can be mathematically expressed as follows:**

$$\frac{\text{Profit/Loss attributable to Equity share holders when dilutive potential shares are converted into ordinary shares}}{\text{Weighted average number of Equity shares} + \text{Weighted average number of dilutive potential ordinary shares}}$$

## 2.7.2 Earnings

- For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, by the after-tax effect of:
  - (a) any dividend or other items related to dilutive potential ordinary shares is deducted in arriving at profit or loss attributable to ordinary equity holders of the parent entity;
  - (b) any interest recognised in the period related to dilutive potential ordinary shares; and
  - (c) any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.
- After the potential ordinary shares are converted into ordinary shares, the new ordinary shares are entitled to participate in profit or loss attributable to ordinary equity holders of the parent entity. Therefore, profit or loss attributable to ordinary equity holders of the parent entity is adjusted for the items in (a)-(c) above and any related taxes. The expenses associated with potential ordinary shares include transaction costs and discounts accounted for in accordance with the effective interest method under Ind AS 109.

### Illustration 7

*Entity A has in issue 25,000 4% debentures with a nominal value of ₹ 1. The debentures are convertible to ordinary shares at a rate of 1:1 at any time until 20X9. The entity's management receives a bonus based on 1% of profit before tax.*

*Entity A's results for 20X2 showed a profit before tax of ₹ 80,000 and a profit after tax of ₹ 64,000 (for simplicity, a tax rate of 20% is assumed in this question).*

*Calculate Earnings for the purpose of diluted EPS.*

**Solution**

For the purpose of calculating diluted EPS, the earnings should be adjusted for the reduction in the interest charge that would occur if the debentures were converted, and for the increase in the management bonus payment that would arise from the increased profit.

|                                                                     | Amount (₹)           |
|---------------------------------------------------------------------|----------------------|
| Profit after tax                                                    | 64,000               |
| Add: Reduction in interest cost (25,000 × 4%) ( <i>Refer Note</i> ) | 1,000                |
| Less: Tax expense (1,000 × 20%)                                     | (200)                |
| Less: Increase in management bonus (1,000 × 1%)                     | (10)                 |
| Add: Tax benefit (10 × 20%)                                         | <u>2</u>             |
| <b>Earnings for the purpose of diluted EPS</b>                      | <b><u>64,792</u></b> |

**Note :** For simplicity, this illustration does not classify the components of the convertible debenture as liabilities and equity, as required by Ind AS 32.

\*\*\*\*\*

## 2.7.3 Shares

### 2.7.3.1 Base for calculation

For the purpose of calculating diluted earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares **plus** the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares.

### 2.7.3.2 Calculation of Weighted average to be done independently for every period

- Dilutive potential ordinary shares shall be determined independently for each period presented. The number of dilutive potential ordinary shares included in the year-to-date period is not a weighted average of the dilutive potential ordinary shares included in each interim computation.
- Potential ordinary shares are weighted for the period they are outstanding. Potential ordinary shares that are cancelled or allowed to lapse during the period are included in the calculation of diluted earnings per share only for the portion of the period during which they are outstanding. Potential ordinary shares that are converted into ordinary shares during the period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.
- All potential ordinary shares are assumed converted into ordinary shares at the beginning of the period or, if not in existence at the beginning of the period, at the date of issue of the

potential ordinary shares. The date of issue is the date the financial instrument was issued or the granting of the rights by which they are generated. This is sometimes referred to as the 'if converted' method.

- The conversion into ordinary shares should be determined from the terms of the financial instrument or the rights granted. This determination should assume the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.
- Only potential ordinary shares that are dilutive are considered in the calculation of diluted EPS. Potential ordinary shares should be treated as dilutive only when their conversion to ordinary shares would decrease profit per share or increase loss per share from continuing operations attributable to ordinary equity holders.
- The effects of anti-dilutive potential ordinary shares are ignored in calculating diluted EPS. An entity might have a number of different types of potential ordinary shares in issue. Each one would need to be considered separately rather than in aggregate.
- Convertible preference shares are dilutive where the amount of dividend on such shares, declared or accrued in the period per ordinary share obtainable on conversion, is below basic EPS for continuing operations. If the amount exceeds basic EPS, the convertible preference shares are anti-dilutive.

#### Illustration 8

*ABC Ltd. has 1,000,000 ₹ 1 ordinary shares and 1,000 ₹ 100 10% convertible bonds (issued at par), each convertible into 20 ordinary shares on demand, all of which have been in issue for the whole of the reporting period.*

*ABC Ltd.'s share price is ₹ 4.50 per share and earnings for the period are ₹ 500,000. The tax rate applicable to the entity is 21%.*

*Calculate basic EPS, earnings per incremental share for the convertible bonds and diluted EPS. Ignore the requirements of Financial Instruments (Ind AS 109) for the purpose of this question.*

#### Solution

Basic EPS is ₹ 0.50 per share (ie 500,000/1,000,000)

The earnings per incremental share for the convertible bonds is calculated as follows:

$$\begin{aligned} \text{Earnings effect} &= \text{No. of bonds} \times \text{nominal value} \times \text{interest cost} \times (1 - \text{applicable tax rate}) \\ &= 1,000 \times 100 \times 10\% \times (1 - 0.21) = ₹ 7,900. \end{aligned}$$

#### Incremental shares calculation

Assume all bonds are converted to shares, even though this converts ₹ 100 worth of bonds into 20 shares worth only ₹ 90 and is therefore not economically rational.

This gives  $1000 \times 20 = 20,000$  additional shares.

**Earnings per incremental share** = ₹ 7,900 / 20,000 = ₹ 0.395

**Diluted EPS** = (₹ 500,000 + ₹ 7,900) / (1,000,000 + 20,000) = ₹ 0.498 per share.

\*\*\*\*\*

### Illustration 9

At 30 June 20X1, the issued share capital of an entity consisted of 1,500,000 ordinary shares of ₹ 1 each. On 1 October 20X1, the entity issued ₹ 1,250,000 of 8% convertible loan stock for cash at par. Each ₹ 100 nominal value of the loan stock may be converted, at any time during the years ended 20X6 to 20X9, into the number of ordinary shares set out below:

30 June 20X6: 135 ordinary shares;

30 June 20X7: 130 ordinary shares;

30 June 20X8: 125 ordinary shares; and

30 June 20X9: 120 ordinary shares.

If the loan stocks are not converted by 20X9, they would be redeemed at par.

The written equity conversion option is accounted for as a derivative liability and marked to market through profit or loss. The change in the options' fair value reported in 20X2 and 20X3 amounted to losses of ₹ 2,500 and ₹ 2,650 respectively. It is assumed that there are no tax consequences arising from these losses.

The profit before interest, fair value movements and taxation for the year ended 30 June 20X2 and 20X3 amounted to ₹ 825,000 and ₹ 895,000 respectively and relate wholly to continuing operations. The rate of tax for both periods is 33%.

Calculate Basic and Diluted EPS.

### Solution

|                                                                           | 20X3                  | 20X2                  |
|---------------------------------------------------------------------------|-----------------------|-----------------------|
| <b>Trading results</b>                                                    | ₹                     | ₹                     |
| A. Profit before interest, fair value movements and tax                   | 895,000               | 825,000               |
| B. Interest on 8% convertible loan stock (20X2: $9/12 \times ₹ 100,000$ ) | (100,000)             | (75,000)              |
| C. Change in fair value of embedded option                                | <u>(2,650)</u>        | <u>(2,500)</u>        |
| Profit before tax                                                         | 792,350               | 747,500               |
| Taxation @ 33% on (A-B)                                                   | <u>(262,350)</u>      | <u>(247,500)</u>      |
| <b>Profit after tax</b>                                                   | <b><u>530,000</u></b> | <b><u>500,000</u></b> |

|                                     |           |           |
|-------------------------------------|-----------|-----------|
| <b>Calculation of basic EPS</b>     |           |           |
| Number of equity shares outstanding | 1,500,000 | 1,500,000 |
| Earnings                            | ₹ 530,000 | ₹ 500,000 |
| Basic EPS                           | 35 paise  | 33 paise  |

### Calculation of diluted EPS

#### Test whether convertibles are dilutive:

The saving in after-tax earnings, resulting from the conversion of ₹ 100 nominal of loan stock, amounts to  $\text{₹ } 100 \times 8\% \times 67\% + \text{₹ } 2,650/12,500 = \text{₹ } 5.36 + \text{₹ } 0.21 = \text{₹ } 5.57$ .

There will then be 135 extra shares in issue.

Therefore, the incremental EPS is 4 paise (ie. ₹ 5.57/135). As this incremental EPS is less than the basic EPS at the continuing level, it will have the effect of reducing the basic EPS of 35 paise. Hence the convertibles are dilutive.

|                                                                                    | 20X3                         | 20X2                       |
|------------------------------------------------------------------------------------|------------------------------|----------------------------|
| <b>Adjusted earnings</b>                                                           | ₹                            | ₹                          |
| Profit for basic EPS                                                               | 530,000                      | 500,000                    |
| Add: Interest and other charges on earnings saved<br>as a result of the conversion | 102,650<br>(100,000 + 2,650) | 77,500<br>(75,000 + 2,500) |
| Less: Tax relief thereon                                                           | <u>(33,000)</u>              | <u>(24,750)</u>            |
| <b>Adjusted earnings for equity</b>                                                | <b><u>599,650</u></b>        | <b><u>552,750</u></b>      |

#### Adjusted number of shares

From the conversion terms, it is clear that the maximum number of shares issuable on conversion of ₹ 1,250,000 loan stock after the end of the financial year would be at the rate of 135 shares per ₹ 100 nominal (that is, 1,687,500 shares).

|                                                             | 20X3             | 20X2             |
|-------------------------------------------------------------|------------------|------------------|
| Number of equity shares for basic EPS                       | 1,500,000        | 1,500,000        |
| Maximum conversion at date of issue $1,687,500 \times 9/12$ |                  | 1,265,625        |
| Maximum conversion after balance sheet date                 | <u>1,687,500</u> | —                |
| <b>Adjusted shares</b>                                      | <b>3,187,500</b> | <b>2,765,625</b> |
| Adjusted earnings for equity                                | ₹ 599,650        | ₹ 552,750        |
| <b>Diluted EPS (approx.)</b>                                | <b>19 paise</b>  | <b>20 paise</b>  |



**Note:** Since Effective Interest Rate is not given, splitting of the convertible loan into liability and equity components as envisaged under Ind AS 109 cannot be done. However, since fair values of derivatives are given, the same is considered for accounting at FVTPL.

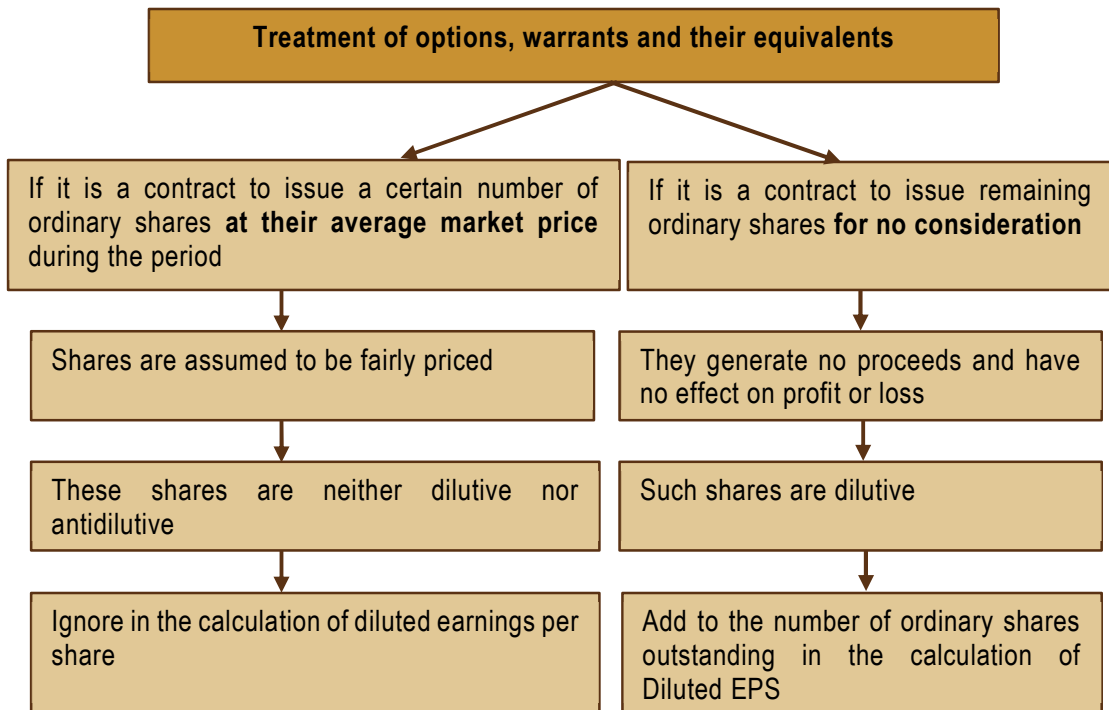
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### 2.7.3.3 Shares of subsidiary, joint venture or associate

A subsidiary, joint venture or associate may issue to parties other than the parent or investors with joint control of, or significant influence over, the investee potential ordinary shares that are convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the parent or investors with joint control of, or significant influence (the reporting entity) over, the investee. If these potential ordinary shares of the subsidiary, joint venture or associate have a dilutive effect on the basic earnings per share of the reporting entity, they are included in the calculation of diluted earnings per share.

### 2.7.3.4 Options, warrants and their equivalents

- For the purpose of calculating diluted earnings per share, an entity shall assume the exercise of dilutive options and warrants of the entity. The assumed proceeds from these instruments shall be regarded as having been received from the issue of ordinary shares at the average market price of ordinary shares during the period. The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period shall be treated as an issue of ordinary shares for no consideration.
- Options and warrants are dilutive when they would result in the *issue of ordinary shares for less than the average market price of ordinary shares during the period*. The amount of the dilution is the average market price of ordinary shares during the period minus the issue price. Therefore, to calculate diluted earnings per share, potential ordinary shares are treated as consisting of both the following:
  - (a) a contract to issue a certain number of the ordinary shares at their average market price during the period. Such ordinary shares are assumed to be fairly priced and to be neither dilutive nor antidilutive. They are ignored in the calculation of diluted earnings per share.
  - (b) a contract to issue the remaining ordinary shares for no consideration. Such ordinary shares generate no proceeds and have no effect on profit or loss attributable to ordinary shares outstanding. Therefore, such shares are dilutive and are added to the number of ordinary shares outstanding in the calculation of diluted earnings per share.



#### Examples 8-10

8. ABC Ltd. has issued 20 lacs shares. It has also issued 1 lac warrants convertible into shares at ₹ 45 per share. The average market price of shares during the current period was ₹ 45. Such shares are assumed to be fairly priced, and to be neither dilutive, nor anti-dilutive. They are ignored in the calculation of diluted earnings per share.
9. ABC Ltd. has issued 20 lacs shares. It has also issued 1 lac warrants convertible into shares at ₹ 30 per share. The average market price of shares during the current period was ₹ 37. ₹ 7 (i.e. ₹ 37 - ₹ 30) is the dilution per share of the warrants. Such shares generate no proceeds and have no effect on profit attributable to the ordinary shares outstanding. They are dilutive and are added to the number of shares outstanding in the calculation of diluted earnings per share.
10. In 20X1, ABC Ltd. issued some staff share options that can be exercised after 3 years' service. They are treated as outstanding on the grant date in 20X1 for diluted earnings per share purposes.

#### Illustration 10

*At 31 December 20X7 and 20X8, the issued share capital of an entity consisted of 4,000,000 ordinary shares of ₹ 25 each. The entity has granted options that give holders the right to subscribe for ordinary shares between 20Y6 and 20Y9 at ₹ 70 per share. Options outstanding at 31 December 20X7 and 20X8 were 630,000. There were no grants, exercises or lapses of options during the year. The profit after tax, attributable to ordinary equity holders for the years ended 31*

December 20X7 and 20X8, amounted to ₹ 500,000 and ₹ 600,000 respectively (wholly relating to continuing operations).

**Average market price of share:**

Year ended 31 December 20X7 = ₹ 120

Year ended 31 December 20X8 = ₹ 160

Calculate basic and diluted EPS.

**Solution**

|                                        | 20X8           | 20X7           |
|----------------------------------------|----------------|----------------|
| <b>Calculation of basic EPS</b>        |                |                |
| Profit after tax                       | ₹ 600,000      | ₹ 500,000      |
| Number of share                        | 4,000,000      | 4,000,000      |
| Basic EPS (approx.)                    | 15 paise       | 13 paise.      |
| <b>Calculation of diluted EPS</b>      |                |                |
| <b>Adjusted number of shares</b>       |                |                |
| Number of shares under option:         |                |                |
| Issued at full market price:           |                |                |
| $(630,000 \times 70) \div 120$         |                | 367,500        |
| $(630,000 \times 70) \div 160$         | 275,625        |                |
| Issued at nil consideration — dilutive | <u>354,375</u> | <u>262,500</u> |
| Total number of shares under option    | 630,000        | 630,000        |
| Number of equity shares for basic EPS  | 4,000,000      | 4,000,000      |
| Number of dilutive shares under option | <u>354,375</u> | <u>262,500</u> |
| Adjusted number of shares (A)          | 4,354,375      | 4,262,500      |
| Profit after tax (B)                   | ₹ 600,000      | ₹ 500,000      |
| Diluted EPS (B/A)                      | 14 paise       | 12 paise       |

**Note:** If options had been granted or exercised during the period, the number of 'nil consideration' shares in respect of these options would be included in the diluted EPS calculation on a weighted average basis for the period prior to exercise.

\*\*\*\*\*

- Options and warrants have a dilutive effect only when the average market price of ordinary shares during the period exceeds the exercise price of the options or warrants (i.e. they are 'in the money'). Previously reported earnings per share are not retroactively adjusted to reflect changes in prices of ordinary shares.

- For share options and other share-based payment arrangements to which Ind AS 102, *Share-based Payment*, applies, the issue price and the exercise price shall include the fair value (measured in accordance with Ind AS 102) of any goods or services to be supplied to the entity in the future under the share option or other share-based payment arrangement.

### 2.7.3.5 Employee Stock Options

Employee share options with fixed or determinable terms and non-vested ordinary shares are treated as options in the calculation of diluted earnings per share, even though they may be contingent on vesting. They are treated as outstanding on the grant date. Performance-based employee share options are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time.

#### Illustration 11- Effects of share options on diluted earnings per share

|                                                                                   |                |
|-----------------------------------------------------------------------------------|----------------|
| Profit attributable to ordinary equity holders of the parent entity for year 20X1 | ₹ 1,200,000    |
| Weighted average number of ordinary shares outstanding during year 20X1           | 500,000 shares |
| Average market price of one ordinary share during year 20X1                       | ₹ 20.00        |
| Weighted average number of shares under option during year 20X1                   | 100,000 shares |
| Exercise price for shares under option during year 20X1                           | ₹ 15.00        |
| Calculate basic and diluted EPS.                                                  |                |

#### Solution

#### Calculation of earnings per share

|                                                                                                                         | Earnings           | Shares         | Per share     |
|-------------------------------------------------------------------------------------------------------------------------|--------------------|----------------|---------------|
| Profit attributable to ordinary equity holders of the parent entity for year 20X1                                       | ₹ 1,200,000        |                |               |
| Weighted average shares outstanding during year 20X1                                                                    |                    | 500,000        |               |
| <b>Basic earnings per share</b>                                                                                         |                    |                | <b>₹ 2.40</b> |
| Weighted average number of shares under option                                                                          |                    | 100,000        |               |
| Weighted average number of shares that would have been issued at average market price:<br>(100,000 × ₹ 15.00) ÷ ₹ 20.00 | Refer Note         | (75,000)       |               |
| <b>Diluted earnings per share</b>                                                                                       | <b>₹ 1,200,000</b> | <b>525,000</b> | <b>₹ 2.29</b> |

**Note:** Earnings have not increased because the total number of shares has increased only by the number of shares (25,000) deemed to have been issued for no consideration.

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### 2.7.3.6 Convertible instruments

- The dilutive effect of convertible instruments shall be reflected in diluted earnings per share.
- Convertible preference shares are antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per ordinary share obtainable on conversion exceeds basic earnings per share. Similarly, convertible debt is antidilutive whenever its interest (net of tax and other changes in income or expense) per ordinary share obtainable on conversion exceeds basic earnings per share.
- The redemption or induced conversion of convertible preference shares may affect only a portion of the previously outstanding convertible preference shares. In such cases, any excess consideration is attributed to those shares that are redeemed or converted for the purpose of determining whether the remaining outstanding preference shares are dilutive. The shares redeemed or converted are considered separately from those shares that are not redeemed or converted.

### 2.7.3.7 Contingently issuable shares

- As in the calculation of basic earnings per share, contingently issuable ordinary shares are treated as outstanding and included in the calculation of diluted earnings per share if the conditions are satisfied (i.e. the events have occurred). Contingently issuable shares are included from the beginning of the period (or from the date of the contingent share agreement, if later). If the conditions are not satisfied, the number of contingently issuable shares included in the diluted earnings per share calculation is based on the number of shares that would be issuable if the end of the period were the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period expires.
- If attainment or maintenance of a specified amount of earnings for a period is the condition for contingent issue and if that amount has been attained at the end of the reporting period but must be maintained beyond the end of the reporting period for an additional period, then the additional ordinary shares are treated as outstanding, if the effect is dilutive, when calculating diluted earnings per share. In that case, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period. Because earnings may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied.
- The number of ordinary shares contingently issuable may depend on the future market price of the ordinary shares. In that case, if the effect is dilutive, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period.

If the condition is based on an average of market prices over a period of time that extends beyond the end of the reporting period, the average for the period of time that has lapsed is used. Because the market price may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied.

- The number of ordinary shares contingently issuable may depend on future earnings and future prices of the ordinary shares. In such cases, the number of ordinary shares included in the diluted earnings per share calculation is based on both conditions (ie earnings to date and the current market price at the end of the reporting period). Contingently issuable ordinary shares are not included in the diluted earnings per share calculation unless both conditions are met.
- In other cases, the number of ordinary shares contingently issuable depends on a condition other than earnings or market price (for example, the opening of a specific number of retail stores). In such cases, assuming that the present status of the condition remains unchanged until the end of the contingency period, the contingently issuable ordinary shares are included in the calculation of diluted earnings per share according to the status at the end of the reporting period.
- Contingently issuable potential ordinary shares (other than those covered by a contingent share agreement, such as contingently issuable convertible instruments) are included in the calculation of diluted earnings per share as follows:
  - ✓ An entity determines whether the potential ordinary shares may be assumed to be issuable on the basis of the conditions specified for their issue in accordance with the contingent ordinary share provisions; and
  - ✓ if those potential ordinary shares are to be reflected in diluted earnings per share, an entity determines their impact on the calculation of diluted earnings per share by following the provisions for options and warrants, the provisions for convertible instruments, the provisions for contracts that may be settled in ordinary shares or cash, or other provisions, as appropriate.
- However, exercise or conversion is not assumed for the purpose of calculating diluted earnings per share unless exercise or conversion of similar outstanding potential ordinary shares that are not contingently issuable is assumed.

#### **Illustration 12- Contingently issuable shares**

|                                                |                                                                                                             |
|------------------------------------------------|-------------------------------------------------------------------------------------------------------------|
| <i>Ordinary shares outstanding during 20X1</i> | <i>1,000,000 (there were no options, warrants or convertible instruments outstanding during the period)</i> |
|------------------------------------------------|-------------------------------------------------------------------------------------------------------------|

*An agreement related to a recent business combination provides for the issue of additional ordinary shares based on the following conditions:*

5,000 additional ordinary shares for each new retail site opened during 20X1

1,000 additional ordinary shares for each ₹ 1,000 of consolidated profit in excess of ₹ 2,000,000 for the year ended 31 December 20X1

Retail sites opened during the year: one on 1 May 20X1

one on 1 September 20X1

Consolidated year-to-date profit attributable to ordinary equity holders of the parent entity: ₹ 1,100,000 as of 31 March 20X1

₹ 2,300,000 as of 30 June 20X1

₹ 1,900,000 as of 30 September 20X1 (including a ₹ 450,000 loss from a discontinued operation)

₹ 2,900,000 as of 31 December 20X1

Calculate basic and diluted EPS on quarterly as well as annual basis.

### Solution

| Basic earnings per share          |               |                    |                    |                |                    |
|-----------------------------------|---------------|--------------------|--------------------|----------------|--------------------|
|                                   | First quarter | Second quarter     | Third quarter      | Fourth quarter | Full year          |
| Numerator (₹)                     | 1,100,000     | 1,200,000          | (400,000)          | 1,000,000      | 2,900,000          |
| Denominator:                      |               |                    |                    |                |                    |
| Ordinary shares outstanding       | 1,000,000     | 1,000,000          | 1,000,000          | 1,000,000      | 1,000,000          |
| Retail site contingency           | —             | 3,333 <sup>6</sup> | 6,667 <sup>7</sup> | 10,000         | 5,000 <sup>8</sup> |
| Earnings contingency <sup>9</sup> | —             | —                  | —                  | —              | —                  |
| Total shares                      | 1,000,000     | 1,003,333          | 1,006,667          | 1,010,000      | 1,005,000          |
| Basic earnings per share (₹)      | 1.10          | 1.20               | (0.40)             | 0.99           | 2.89               |

<sup>6</sup> 5,000 shares  $\times \frac{2}{3}$

<sup>7</sup> 5,000 shares + (5,000 shares  $\times \frac{1}{3}$ )

<sup>8</sup> (5,000 shares  $\times \frac{8}{12}$ ) + (5,000 shares  $\times \frac{4}{12}$ )

<sup>9</sup> The earnings contingency has no effect on basic earnings per share because it is not certain that the condition is satisfied until the end of the contingency period. Profits for the year are determined /

finalized on after Q4 / year is completed, i.e. in the year 20X2. Thus, the earliest when these shares can be actually issued is on 1 Jan 20X2.

| Diluted earnings per share     |                 |                       |                      |                       |           |
|--------------------------------|-----------------|-----------------------|----------------------|-----------------------|-----------|
|                                | First quarter   | Second quarter        | Third quarter        | Fourth quarter        | Full year |
| Numerator (₹)                  | 1,100,000       | 1,200,000             | (400,000)            | 1,000,000             | 2,900,000 |
| Denominator:                   |                 |                       |                      |                       |           |
| Ordinary shares outstanding    | 1,000,000       | 1,000,000             | 1,000,000            | 1,000,000             | 1,000,000 |
| Retail site contingency        | –               | 5,000                 | 10,000               | 10,000                | 10,000    |
| Earnings contingency           | – <sup>10</sup> | 300,000 <sup>11</sup> | – <sup>12</sup>      | 900,000 <sup>13</sup> | 900,000   |
| Total shares                   | 1,000,000       | 1,305,000             | 1,010,000            | 1,910,000             | 1,910,000 |
| Diluted earnings per share (₹) | 1.10            | 0.92                  | (0.40) <sup>14</sup> | 0.52                  | 1.52      |

<sup>10</sup> Company A does not have year-to-date profit exceeding ₹ 2,000,000 at 31 March 20X1. The Standard does not permit projecting future earnings levels and including the related contingent shares.

<sup>11</sup> Each quarter is treated as an independent reporting period and hence if the conditions are fulfilled during the quarter, the contingent shares are considered for Diluted EPS right from the beginning of the reporting period i.e., the quarter in the said case.  $[(₹ 2,300,000 - ₹ 2,000,000) \div 1,000] \times 1,000$  shares = 300,000 shares.

<sup>12</sup> Year-to-date profit is less than ₹ 2,000,000.

<sup>13</sup>  $[(₹ 2,900,000 - ₹ 2,000,000) \div 1,000] \times 1,000$  shares = 900,000 shares.

<sup>14</sup> Because the loss during the third quarter is attributable to a loss from a discontinued operation, the antidilution rules do not apply. The control number (ie profit or loss from, continuing operations attributable to the equity holders of the parent entity) is positive. Accordingly, the effect of potential ordinary shares is included in the calculation of diluted earnings per share.

\*\*\*\*\*

### 2.7.3.8 Entity with discontinued operations

An entity that reports a discontinued operation should use income from continuing operations, adjusted for preferred dividends and similar adjustments, if any, as the “control number” in determining whether potential common shares are dilutive. That is, the same number of potential common shares used in computing the diluted per-share amount of income from continuing operations should be used in computing all other reported diluted per-share amounts even if the effect will be anti-dilutive compared to their respective basic per-share amounts.

#### Illustration 13

**Assume the following facts for Company XY:**

|                                      |                 |
|--------------------------------------|-----------------|
| - Income from continuing operations: | INR 30,00,000   |
| - Loss from discontinued operations: | (INR 36,00,000) |
| - Net loss:                          | (INR 6,00,000)  |



- Weighted average Number of shares outstanding 10,00,000
- Incremental common shares outstanding relating to stock options 2,00,000

(a) You are required to calculate the basic and diluted EPS for Company XY from the above information.

(b) Assume, if in above case, Loss from continued operations is ₹ 10,00,000 and income from discontinued operations is ₹ 36,00,000 calculate the diluted EPS.

**Solution:**

**(a) Step 1:**

Basic EPS = Profit for the year / Weighted average Number of shares outstanding

Basic EPS (Continued Operations) = Profit from continued operations / Weighted average Number of shares outstanding  
 = ₹ 30,00,000 / 10,00,000 = ₹ 3.00

Basic Loss per share (Discontinued operations) = Loss from discontinued operations / Weighted average Number of shares outstanding  
 = ₹ (36,00,000) / 10,00,000 = (₹ 3.60)

Overall Basic Loss per share = (₹ 6,00,000) / 10,00,000 = ₹ (0.60) (i)

**Step 2: Calculation of Diluted EPS**

Diluted EPS = Profit for the year / Adjusted Weighted average Number of shares outstanding

EPS (Continued Operations) = Profit from continued operations / Adjusted Weighted average Number of shares outstanding  
 = ₹ 30,00,000 / 12,00,000 = ₹ 2.50

Loss per share (Discontinued operations) = Loss from discontinued operations / Adjusted weighted average number of shares outstanding  
 = ₹ (36,00,000) / 12,00,000 = (₹ 3.00)

Overall Diluted Loss per share = ₹ 6,00,000 / 12,00,000 = ₹ (0.50) (ii)

The income from continuing operations is the control number, there is a dilution in basic EPS for income from continuing operations (reduction of EPS from ₹ 3.00 to ₹ 2.50). Therefore, even though there is an anti-dilution [Loss per share reduced from ₹ 0.60 (i) to ₹ 0.50 (ii) above], diluted loss per share of ₹ 0.50 is reported.

- (b) In case of loss from continuing operations, the potential shares are excluded since including those shares would result into anti-dilution effect on the **control number** (loss from continuing operations). Therefore, the diluted EPS will be calculated as under:

Diluted EPS = Profit for the year / Adjusted weighted average number of shares outstanding

Overall Profit = Loss from continuing operations + Gain from discontinued operations

$$= ₹ (10,00,000) + ₹ 36,00,000$$

$$= ₹ 26,00,000$$

Weighted average number of shares outstanding = 10,00,000

Diluted EPS = ₹ 2.60

The dilutive effect of the potential common shares on EPS for income from discontinued operations and net income would not be reported because of the loss from continuing operations.

\*\*\*\*\*

### 2.7.3.9 Contracts that may be settled in ordinary shares or cash

- When an entity has issued a contract that may be settled in ordinary shares or cash at the entity's option, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is dilutive.
- When an issued contract that may be settled in ordinary shares or cash at the entity's option may give rise to an asset or a liability, or a hybrid instrument with both an equity and a liability component under Ind AS 32, the entity should adjust the numerator (profit or loss attributable to ordinary equity holders) for any changes in the profit or loss that would have resulted during the period if the contract had been classified wholly as an equity instrument.
- For contracts that may be settled in ordinary shares or cash at the holder's option, the more dilutive of cash settlement and share settlement shall be used in calculating diluted earnings per share.

An example of a contract that may be settled in ordinary shares or cash is a debt instrument that, on maturity, gives the entity the unrestricted right to settle the principal amount in cash or in its own ordinary shares.

Another example is a written put option that gives the holder a choice of settling in ordinary shares or cash.

### Illustration 14

*An entity issues 2,000 convertible bonds at the beginning of Year 1. The bonds have a three-year term and are issued at par with a face value of ₹ 1,000 per bond, giving total proceeds of ₹ 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per*

cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. The entity has an option to settle the principal amount of the convertible bonds in ordinary shares or in cash.

When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9 per cent. At the issue date, the market price of one ordinary share is ₹ 3. Income tax is ignored. Entity has accounted for the convertible instrument using the principles of Financial Instruments.

Interest @ 6% for the year has already been adjusted in the profit attributable to shareholders.

Calculate basic and diluted EPS when

|                                                                            |             |
|----------------------------------------------------------------------------|-------------|
| Profit attributable to ordinary equity holders of the parent entity Year 1 | ₹ 1,000,000 |
| Ordinary shares outstanding                                                | 1,200,000   |
| Convertible bonds outstanding                                              | 2,000       |

### Solution

**Assumption: Entity intends to settle only interest in cash**

| Allocation of proceeds of the bond issue: |                    |
|-------------------------------------------|--------------------|
| Liability component (Refer Note 1)        | ₹ 303,755          |
| Equity component                          | ₹ 1,696,245        |
|                                           | <u>₹ 2,000,000</u> |

The liability and equity components would be determined in accordance with Ind AS 32. These amounts are recognised as the initial carrying amounts of the liability and equity components. The amount assigned to the issuer conversion option equity element is an addition to equity and is not adjusted.

### Basic earnings per share Year 1:

$$\frac{₹1,000,000}{1,200,000} = ₹ 0.83 \text{ per ordinary share}$$

### Diluted earnings per share Year 1:

It is presumed that the issuer will settle the contract by the issue of ordinary shares. The dilutive effect is therefore calculated in accordance with the Standard.

$$\frac{₹1,000,000 + ₹27,338}{1,200,000 + 500,000} = ₹ 0.60 \text{ per ordinary share}$$

### Notes:

1. This represents the present value of the interest discounted at 9% – ₹ 120,000 payable annually in arrears for three years. ₹ 2,000,000 assumed to be settled in equity since option is with the entity will not form part of liability.

2. Profit is adjusted for the accretion of ₹ 27,338 ( $₹303,755 \times 9\%$ ) of the liability because of the passage of time.
3.  $500,000 \text{ ordinary shares} = 250 \text{ ordinary shares} \times 2,000 \text{ convertible bonds}$ .

\*\*\*\*\*

### 2.7.3.10 Purchased options

- Contracts such as purchased put options and purchased call options (ie options held by the entity on its own ordinary shares) are not included in the calculation of diluted earnings per share because including them would be antidilutive. The put option would be exercised only if the exercise price were higher than the market price and the call option would be exercised only if the exercise price were lower than the market price.

### 2.7.3.11 Written put options

- Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of diluted earnings per share if the effect is dilutive. If these contracts are 'in the money' during the period (ie the exercise or settlement price is above the average market price for that period), the potential dilutive effect on earnings per share shall be calculated as follows:
  - (a) it shall be assumed that at the beginning of the period sufficient ordinary shares will be issued (at the average market price during the period) to raise proceeds to satisfy the contract;
  - (b) it shall be assumed that the proceeds from the issue are used to satisfy the contract (ie to buy back ordinary shares); and
  - (c) the incremental ordinary shares (the difference between the number of ordinary shares assumed issued and the number of ordinary shares received from satisfying the contract) shall be included in the calculation of diluted earnings per share.

#### Written put options

##### Example 11

Assume that an entity has 160 written put options outstanding on 160 of its ordinary shares, with an exercise price of ₹ 10 per option. The put obligation is therefore ₹ 1,600. The average market price of the entity's ordinary shares is ₹ 8 for the period. In calculating diluted EPS, the entity assumes that it issues 200 ordinary shares at ₹ 8 per share to raise the proceeds necessary to satisfy the put option. The difference between the 200 ordinary shares assumed to be issued and the 160 ordinary shares that would have been received on exercise of the option (that is, 40 shares) is added to the denominator (number of shares) in calculating the diluted EPS. No adjustments are made to the numerator (profit attributable to ordinary shareholders), because the shares are deemed issued for nil proceeds.



## 2.8 RETROSPECTIVE ADJUSTMENTS

- Diluted EPS of any prior period presented should not be restated for changes in the assumptions used (such as for contingently issuable shares) or for the conversion of potential ordinary shares (such as convertible debt) outstanding at the end of the previous period. These factors are already taken into account in calculating the basic and, where applicable, the diluted EPS for the current period. Prior period's EPS data should be restated for the effects of errors and adjustments resulting from changes to accounting policies accounted for retrospectively.
- Basic and diluted EPS figures for the current period and for prior periods should include bonus issues, share splits, share consolidations and other similar events occurring during the period that change the number of shares in issue without a corresponding change in the resources of the entity (that is, retrospective application).



## 2.9 PRESENTATION

- An entity shall present in the statement of profit and loss basic and diluted earnings per share for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period. An entity shall present basic and diluted earnings per share with equal prominence for all periods presented.
- Earnings per share is presented for every period for which a statement of profit and loss is presented. If diluted earnings per share is reported for at least one period, it shall be reported for all periods presented, even if it equals basic earnings per share. If basic and diluted earnings per share are equal, dual presentation can be accomplished in one line in the statement of profit and loss.
- If a company does not have any potential ordinary shares, then the company's basic and diluted EPS will be same. In such a case, the company need not disclose Basic EPS and Diluted EPS separately. It may disclose basic and diluted EPS as follows (illustrative numbers only):

|                       | 20X1 | 20X0 |
|-----------------------|------|------|
| Basic and Diluted EPS | 3.60 | 2.45 |

- An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either in the statement of profit and loss or in the notes.

An entity shall present basic and diluted earnings per share, even if the amounts are negative (ie a loss per share).



## 2.10 DISCLOSURE

- An entity shall disclose the following:
  - (a) The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.
  - (b) the weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.
  - (c) instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future but were not included in the calculation of diluted earnings per share because they are antidilutive for the period(s) presented.
  - (d) a description of ordinary share transactions or potential ordinary share transactions (other than those arising from capitalisation, bonus issue, share split or reverse share split), that occur after the reporting period and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

Examples of transactions in this para include:

- (a) an issue of shares for cash;
  - (b) an issue of shares when the proceeds are used to repay debt or preference shares outstanding at the end of the reporting period;
  - (c) the redemption of ordinary shares outstanding;
  - (d) the conversion or exercise of potential ordinary shares outstanding at the end of the reporting period into ordinary shares;
  - (e) an issue of options, warrants, or convertible instruments; and
  - (f) the achievement of conditions that would result in the issue of contingently issuable shares. Earnings per share amounts are not adjusted for such transactions occurring after the reporting period because such transactions do not affect the amount of capital used to produce profit or loss for the period.
- Financial instruments and other contracts generating potential ordinary shares may incorporate terms and conditions that affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether any potential ordinary shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to profit or loss attributable to ordinary equity holders. The

disclosure of the terms and conditions of such financial instruments and other contracts is encouraged, if not otherwise required.

- If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the statement of profit and loss other than one required by this Standard, such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard.
- Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes. An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax. If a component of the statement of profit and loss is used that is not reported as a line item in the statement of profit and loss, a reconciliation shall be provided between the component used and a line item that is reported in the statement of profit and loss.

## 2.11 ADDITIONAL TOPICS

### 2.11.1 Participating equity instruments and two-class ordinary shares

- The equity of some entities includes:
  - (a) instruments that participate in dividend with ordinary shares according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).
  - (b) a class of ordinary shares with a different dividend rate from that of another class of ordinary shares but without prior or senior rights.
- For the purpose of calculating diluted earnings per share, conversion is assumed for those instruments that are convertible into ordinary shares if the effect is dilutive. For those instruments that are not convertible into a class of ordinary shares, profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights to participate in undistributed earnings. To calculate basic and diluted earnings per share:
  - (a) profit or loss attributable to ordinary equity holders of the parent entity is adjusted (a profit reduced and a loss increased) by the amount of dividend declared in the period for each class of shares and by the contractual amount of dividend (or interest on participating bonds) that must be paid for the period (for example, unpaid cumulative dividend).
  - (b) the remaining profit or loss is allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed. The total profit or loss allocated to each class of equity instrument is determined by adding together the amount allocated for dividend and the amount allocated for a participation feature.

- (c) the total amount of profit or loss allocated to each class of equity instrument is divided by the number of outstanding instruments to which the earnings are allocated to determine the earnings per share for the instrument.
- For the calculation of diluted earnings per share, all potential ordinary shares assumed to have been issued are included in outstanding ordinary shares.

**Illustration 15**

*An entity has two classes of shares in issue:*

- 5,000 non-convertible preference shares
- 10,000 ordinary shares

*The preference shares are entitled to a fixed dividend of ₹ 5 per share before any dividends are paid on the ordinary shares. Ordinary dividends are then paid in which the preference shareholders do not participate. Each preference share then participates in any additional ordinary dividend above ₹ 2 at a rate of 50% of any additional dividend payable on an ordinary share.*

*The entity's profit for the year is ₹ 100,000, and dividends of ₹ 2 per share are declared on the ordinary shares.*

*Compute the allocation of earnings for the purpose of calculation of Basic EPS when an entity has ordinary shares & participating equity instruments that are not convertible into ordinary shares.*

**Solution**

**The calculation of basic EPS is as follows:**

|                                         | ₹             | ₹               |
|-----------------------------------------|---------------|-----------------|
| Profit                                  |               | 100,000         |
| Less: Dividends payable for the period: |               |                 |
| Preference (5,000 × ₹ 5)                | 25,000        |                 |
| Ordinary (10,000 × ₹ 2)                 | <u>20,000</u> | <u>(45,000)</u> |
| Undistributed earnings                  |               | <u>55,000</u>   |

**Allocation of undistributed earnings:**

Allocation per ordinary share = A

Allocation per preference share = B where B = 50% of A

$$(A \times 10,000) + (50\% \times A \times 5,000) = ₹ 55,000$$

$$A = 55,000 / (10,000 + 2,500) = ₹ 4.4$$

$$B = 50\% \text{ of } A \text{ i.e. } B = ₹ 2.2$$



| Dividend per share are: | Preference shares<br>₹ per share | Ordinary shares<br>₹ per share |
|-------------------------|----------------------------------|--------------------------------|
| Distributed earnings    | 5.00                             | 2.00                           |
| Undistributed earnings  | <u>2.20</u>                      | <u>4.40</u>                    |
| <b>Totals</b>           | <b><u>7.20</u></b>               | <b><u>6.40</u></b>             |

Proof:  $(5,000 \times ₹ 7.2) + (10,000 \times ₹ 6.4) = ₹ 100,000$

\*\*\*\*\*

### Illustration 16

*(This illustration does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by Ind AS 32).*

|                                                                                                                                                                           |                  |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|
| Profit for the year                                                                                                                                                       | ₹ 100,000        |
| Ordinary shares outstanding                                                                                                                                               | 10,000           |
| Non-convertible preference shares                                                                                                                                         | 6,000            |
| Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares)                                                                      | ₹ 5.50 per share |
| After ordinary shares have been paid a dividend of ₹ 2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares. |                  |

*Compute the allocation of earnings for the purpose of calculation of Basic EPS when an entity has ordinary shares & participating equity instruments that are not convertible into ordinary shares.*

### Solution

Dividends on preference shares paid  $(6000 \times ₹ 5.50 \text{ per share})$  ₹ 33,000

Dividends on ordinary shares paid  $(10,000 \times ₹ 2.10 \text{ per share})$  ₹ 21,000

| Basic earnings per share is calculated as follows:         | ₹      | ₹        |
|------------------------------------------------------------|--------|----------|
| Profit attributable to equity holders of the parent entity |        | 100,000  |
| Less: Dividend paid:                                       |        |          |
| Preference                                                 | 33,000 |          |
| Ordinary                                                   | 21,000 | (54,000) |
| Undistributed earnings                                     |        | 46,000   |

| Allocation of undistributed earnings:                    |                                                                      |
|----------------------------------------------------------|----------------------------------------------------------------------|
| Allocation per ordinary share = A                        |                                                                      |
| Allocation per preference share = B; $B = \frac{1}{4} A$ |                                                                      |
|                                                          | $(A \times 10,000) + (\frac{1}{4} \times A \times 6,000) = ₹ 46,000$ |
|                                                          | $A = ₹ 46,000 \div (10,000 + 1,500)$                                 |
|                                                          | $A = ₹ 4.00$                                                         |
|                                                          | $B = \frac{1}{4} A$                                                  |
|                                                          | $B = ₹ 1.00$                                                         |

| Dividend per share:    |                      |                      |
|------------------------|----------------------|----------------------|
|                        | Preference shares    | Ordinary shares      |
| Distributed earnings   | ₹ 5.50               | ₹ 2.10               |
| Undistributed earnings | <u>₹ 1.00</u>        | <u>₹ 4.00</u>        |
| <b>Totals</b>          | <b><u>₹ 6.50</u></b> | <b><u>₹ 6.10</u></b> |

\*\*\*\*\*

### 2.11.2 Partly paid shares

- Where ordinary shares are issued but not fully paid, they are treated in the calculation of basic earnings per share as a fraction of an ordinary share to the extent that they were entitled to participate in dividend during the period relative to a fully paid ordinary share.
- To the extent that partly paid shares are not entitled to participate in dividend during the period they are treated as the equivalent of warrants or options in the calculation of diluted earnings per share. The unpaid balance is assumed to represent proceeds used to purchase ordinary shares. The number of shares included in diluted earnings per share is the difference between the number of shares subscribed and the number of shares assumed to be purchased.

#### Illustration 17

An entity issues 100,000 ordinary shares of Re 1 each for a consideration of ₹ 2.50 per share. Cash of ₹ 1.75 per share was received by the balance sheet date. The partly paid shares are entitled to participate in dividends for the period in proportion to the amount paid.

Calculate number of shares for calculation of Basic EPS.

**Solution**

The number of ordinary share equivalents that would be included in the basic EPS calculation on a weighted basis is as follows:

$$(100,000 \times ₹ 1.75) / ₹ 2.50 = 70,000 \text{ shares.}$$

\*\*\*\*\*

## 2.12 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

*Extracts from Annual reports of Hindustan Unilever Ltd.*

(All amounts in ₹ crores, unless otherwise stated)

| Particulars                                                                                      | Note | Year ended<br>31st March, 2022 | Year ended<br>31st March, 2021 |
|--------------------------------------------------------------------------------------------------|------|--------------------------------|--------------------------------|
| <b>OTHER COMPREHENSIVE INCOME</b>                                                                |      |                                |                                |
| <b>Items that will not be reclassified subsequently to profit or loss</b>                        |      |                                |                                |
| Remeasurements of the net defined benefit plans                                                  | 39C  | 41                             | (3)                            |
| <b>Income tax relating to items that will not be reclassified subsequently to profit or loss</b> |      |                                |                                |
| Remeasurements of the net defined benefit plans                                                  | 9A   | (10)                           | 1                              |
| <b>Items that will be reclassified subsequently to profit or loss</b>                            |      |                                |                                |
| Fair value of debt instruments through other comprehensive income                                | 18C  | (1)                            | (0)                            |
| Fair value of cash flow hedges through other comprehensive income                                | 18C  | 85                             | 70                             |
| <b>Income tax relating to items that will be reclassified subsequently to profit or loss</b>     |      |                                |                                |
| Fair value of debt instruments through other comprehensive income                                | 9A   | 0                              | 0                              |
| Fair value of cash flow hedges through other comprehensive income                                | 9A   | (0)                            | (47)                           |
| <b>OTHER COMPREHENSIVE INCOME FOR THE YEAR (B)</b>                                               |      | <b>115</b>                     | <b>21</b>                      |
| <b>TOTAL COMPREHENSIVE INCOME FOR THE YEAR (A+B)</b>                                             |      | <b>8,933</b>                   | <b>7,975</b>                   |
| <b>Earnings per equity share</b>                                                                 |      |                                |                                |
| Basic (Face value of ₹1 each)                                                                    | 35   | ₹37.53                         | ₹33.85                         |
| Diluted (Face value of ₹1 each)                                                                  | 35   | ₹37.53                         | ₹33.85                         |
| Basis of preparation, measurement and significant accounting policies                            | 2    |                                |                                |

**NOTE 35 EARNINGS PER EQUITY SHARE**

Basic earnings per share is computed by dividing the net profit for the period attributable to the equity shareholders of the Company by the weighted average number of equity shares outstanding during the period. The weighted average number of equity shares outstanding during the period and for all periods presented is adjusted for events, such as bonus shares, other than the conversion of potential equity shares that have changed the number of equity shares outstanding, without a corresponding change in resources.

For the purpose of calculating diluted earnings per share, the net profit for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period is adjusted for the effects of all dilutive potential equity shares.

|                                                                                                                          | Year ended<br>31st March, 2022 | Year ended<br>31st March, 2021 |
|--------------------------------------------------------------------------------------------------------------------------|--------------------------------|--------------------------------|
| <b>Earnings Per Share has been computed as under:</b>                                                                    |                                |                                |
| Profit for the year                                                                                                      | 8,818                          | 7,954                          |
| Weighted average number of equity shares outstanding during the year                                                     | 2,34,95,87,637                 | 2,34,95,42,101                 |
| Earnings Per Share (₹) - Basic (Face value of ₹1 per share)                                                              | ₹37.53                         | ₹33.85                         |
| Add: Weighted average number of potential equity shares on account of employee stock options/performance share schemes * | 3,625                          | 50,297                         |
| Weighted average number of Equity shares (including dilutive shares) outstanding during the year                         | 2,34,95,91,262                 | 2,34,95,92,398                 |
| Earnings Per Share (₹) - Diluted (Face value of ₹1 per share)                                                            | ₹37.53                         | ₹33.85                         |

\* Pertains to ESOP shares vested during the year, no outstanding share options as at 31st March, 2022

(Source: Annual Report for 2021-2022 of Hindustan Unilever Ltd.)

## Larsen and Toubro Ltd. (Extract of Statement of Profit and Loss)

## Statement of Profit and Loss for the year ended March 31, 2022 (contd.)

|                                                                                                                    | Note    | 2021-22        | 2020-21         |
|--------------------------------------------------------------------------------------------------------------------|---------|----------------|-----------------|
|                                                                                                                    |         | ₹ crore        |                 |
| Brought forward - other comprehensive income                                                                       |         | 58.02          | 39.36           |
| <b>B Items that will be reclassified to Profit or Loss:</b>                                                        |         |                |                 |
| Debt instruments through other comprehensive income                                                                |         | (177.90)       | 239.46          |
| Income tax (expenses)/income on debt instruments through other comprehensive income                                |         | 40.70          | (54.79)         |
|                                                                                                                    |         | (137.20)       | 184.67          |
| Exchange differences in translating the financial statements of foreign operations                                 |         | (26.59)        | 17.56           |
| Income tax (expenses)/income on exchange differences in translating the financial statements of foreign operations |         | 6.69           | (4.42)          |
|                                                                                                                    |         | (19.90)        | 13.14           |
| Effective portion of gains/(losses) on hedging instruments in a cash flow hedge                                    |         | 69.17          | 218.43          |
| Income tax (expenses)/income on effective portion of gains/(losses) on hedging instruments in a cash flow hedge    |         | (8.59)         | (69.74)         |
|                                                                                                                    |         | 60.58          | 148.69          |
| Cost of hedging reserve                                                                                            |         | 3.06           | 11.80           |
| Income tax (expenses)/income on cost of hedging reserve                                                            |         | (0.77)         | (2.97)          |
|                                                                                                                    |         | 2.29           | 8.83            |
| Other comprehensive income for the year (net of tax)                                                               |         | (36.21)        | 394.69          |
| <b>Total comprehensive income for the year</b>                                                                     |         | <b>7843.24</b> | <b>12192.48</b> |
| <b>Earnings per share (EPS) of ₹ 2 each from continuing operations:</b>                                            |         |                |                 |
| Basic earnings per equity share (₹)                                                                                | 49      | 56.09          | 22.41           |
| Diluted earnings per equity share (₹)                                                                              | 49      | 56.03          | 22.39           |
| <b>Earnings per share (EPS) of ₹ 2 each from discontinued operations:</b>                                          |         |                |                 |
| Basic earnings per equity share (₹)                                                                                | 49      | —              | 61.61           |
| Diluted earnings per equity share (₹)                                                                              | 49      | —              | 61.54           |
| <b>Earnings per share (EPS) of ₹ 2 each from continuing operations &amp; discontinued operations:</b>              |         |                |                 |
| Basic earnings per equity share (₹)                                                                                | 49      | 56.09          | 84.02           |
| Diluted earnings per equity share (₹)                                                                              | 49      | 56.03          | 83.93           |
| <b>Face value per equity share (₹)</b>                                                                             |         | <b>2.00</b>    | <b>2.00</b>     |
| <b>NOTES FORMING PART OF THE FINANCIAL STATEMENTS</b>                                                              | 1 to 65 |                |                 |

## NOTE [49]

Basic and diluted Earnings per Share [EPS] computed in accordance with Ind AS 33 "Earnings per Share":

| Particulars                                                                                  |       | 2021-22        | 2020-21        |
|----------------------------------------------------------------------------------------------|-------|----------------|----------------|
| <b>Basic earnings per share</b>                                                              |       |                |                |
| Profit after tax from continuing operations as per accounts (₹ crore)                        | A     | 7879.45        | 3147.31        |
| Profit after tax from discontinued operations as per accounts (₹ crore)                      | B     | —              | 8650.48        |
| Profit after tax from continuing and discontinued operations as per accounts (₹ crore)       | C=A+B | 7879.45        | 11797.79       |
| Weighted average number of equity shares outstanding                                         | D     | 1,40,47,47,700 | 1,40,41,46,937 |
| Basic EPS from continuing operations(₹)                                                      | A/D   | 56.09          | 22.41          |
| Basic EPS from discontinued operations(₹)                                                    | B/D   | —              | 61.61          |
| Basic EPS from continuing discontinued operations(₹)                                         | C/D   | 56.09          | 84.02          |
| <b>Diluted earnings per share</b>                                                            |       |                |                |
| Profit after tax from continuing operations as per accounts (₹ crore)                        | A     | 7879.45        | 3147.31        |
| Profit after tax from discontinued operations as per accounts (₹ crore)                      | B     | —              | 8650.48        |
| Profit after tax from continuing and discontinued operations as per accounts (₹ crore)       | C=A+B | 7879.45        | 11797.79       |
| Weighted average number of equity shares outstanding                                         | D     | 1,40,47,47,700 | 1,40,41,46,937 |
| Add: Weighted average number of potential equity shares on account of employee stock options | E     | 15,40,580      | 14,20,264      |
| Weighted average number of equity shares outstanding for diluted EPS                         | F=D+E | 1,40,62,88,280 | 1,40,55,67,202 |
| Diluted EPS from continuing operations(₹)                                                    | A/F   | 56.03          | 22.39          |
| Diluted EPS from discontinued operations(₹)                                                  | B/F   | —              | 61.54          |
| Diluted EPS from continuing discontinued operations(₹)                                       | C/F   | 56.03          | 83.93          |
| Face value per share (₹)                                                                     |       | 2              | 2              |

(Source: Annual Report for 2021-2022 of Larsen and Toubro Ltd.)



## Reliance Industries Ltd. (Statement of Profit and Loss)

**Statement of Profit and Loss**For the year ended 31<sup>st</sup> March, 2022

|                                                                                  |         | (₹ in crore)    |                 |
|----------------------------------------------------------------------------------|---------|-----------------|-----------------|
|                                                                                  | Notes   | 2021-22         | 2020-21         |
| <b>Income</b>                                                                    |         |                 |                 |
| Value of Sales                                                                   |         | 4,63,067        | 2,76,181        |
| Income from Services                                                             |         | 3,358           | 2,759           |
| <b>Value of Sales &amp; Services (Revenue)</b>                                   |         | <b>4,66,425</b> | <b>2,78,940</b> |
| Less: GST Recovered                                                              |         | 21,050          | 13,871          |
| <b>Revenue from Operations</b>                                                   | 26      | <b>4,45,375</b> | <b>2,65,069</b> |
| Other Income                                                                     | 27      | 13,872          | 14,818          |
| <b>Total Income</b>                                                              |         | <b>4,59,247</b> | <b>2,79,887</b> |
| <b>Expenses</b>                                                                  |         |                 |                 |
| Cost of Material Consumed                                                        |         | 3,20,852        | 1,68,262        |
| Purchase of Stock-in-Trade                                                       |         | 10,691          | 7,301           |
| Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade    | 28      | (7,962)         | 610             |
| Excise Duty                                                                      |         | 21,672          | 19,402          |
| Employee Benefits Expense                                                        | 29      | 5,426           | 5,024           |
| Finance Costs                                                                    | 30      | 9,123           | 16,211          |
| Depreciation / Amortisation and Depletion Expense                                | 1       | 10,276          | 9,199           |
| Other Expenses                                                                   | 31      | 42,383          | 30,970          |
| <b>Total Expenses</b>                                                            |         | <b>4,12,461</b> | <b>2,56,979</b> |
| <b>Profit Before Exceptional Item and Tax</b>                                    |         | <b>46,786</b>   | <b>22,908</b>   |
| Exceptional Item (Net of Tax)                                                    | 32      | -               | 4,304           |
| <b>Profit Before Tax *</b>                                                       |         | <b>46,786</b>   | <b>27,212</b>   |
| <b>Tax Expenses *</b>                                                            |         |                 |                 |
| Current Tax                                                                      | 12      | 787             | -               |
| Deferred Tax                                                                     | 19      | 6,915           | (4,732)         |
| <b>Profit for the Year</b>                                                       |         | <b>39,084</b>   | <b>31,944</b>   |
| <b>Other Comprehensive Income</b>                                                |         |                 |                 |
| i. Items that will not be reclassified to Profit or Loss                         | 27.1    | 241             | 350             |
| ii. Income tax relating to items that will not be reclassified to Profit or Loss |         | (58)            | (79)            |
| iii. Items that will be reclassified to Profit or Loss                           | 27.2    | (2,705)         | 2,755           |
| iv. Income tax relating to items that will be reclassified to Profit or Loss     |         | 543             | (456)           |
| <b>Total Other Comprehensive Income/ (Loss) for the Year (Net of Tax)</b>        |         | <b>(1,979)</b>  | <b>2,570</b>    |
| <b>Total Comprehensive Income for the Year</b>                                   |         | <b>37,105</b>   | <b>34,514</b>   |
| <b>Earnings per Equity Share of Face Value of ₹ 10 Each</b>                      |         |                 |                 |
| Basic (in ₹) - After Exceptional Item                                            | 33      | 59.24           | 49.66           |
| Basic (in ₹) - Before Exceptional Item                                           | 33      | 59.24           | 42.97           |
| Diluted (in ₹) - After Exceptional Item                                          | 33      | 58.49           | 48.90           |
| Diluted (in ₹) - Before Exceptional Item                                         | 33      | 58.49           | 42.31           |
| Significant Accounting Policies                                                  | 1 to 47 |                 |                 |
| See accompanying Notes to the Financial Statements                               |         |                 |                 |

|                                                                                                                                     | (₹ in crore)   |                |
|-------------------------------------------------------------------------------------------------------------------------------------|----------------|----------------|
|                                                                                                                                     | 2021-22        | 2020-21        |
| <b>33. Earnings Per Share (EPS)</b>                                                                                                 |                |                |
| Face Value per Equity Share (₹)                                                                                                     | 10             | 10             |
| Basic Earnings per Share (₹) - After Exceptional Item                                                                               | 59.24          | 49.66          |
| Basic Earnings per Share (₹) - Before Exceptional Item                                                                              | 59.24          | 42.97          |
| Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - After Exceptional Item  | 39,084         | 31,944         |
| Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - Before Exceptional Item | 39,084         | 27,640         |
| Weighted Average number of Equity Shares used as denominator for calculating Basic EPS                                              | 6,59,81,11,978 | 6,43,28,74,848 |
| Diluted Earnings per Share (₹) - After Exceptional Item                                                                             | 58.49          | 48.90          |
| Diluted Earnings per Share (₹) - Before Exceptional Item                                                                            | 58.49          | 42.31          |
| Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - After Exceptional Item  | 39,084         | 31,944         |
| Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - Before Exceptional Item | 39,084         | 27,640         |
| Weighted Average number of Equity Shares used as denominator for calculating Diluted EPS                                            | 6,68,16,52,444 | 6,53,21,38,901 |
| <b>Reconciliation of Weighted Average Number of Shares Outstanding</b>                                                              |                |                |
| Weighted Average number of Equity Shares used as denominator for calculating Basic EPS *                                            | 6,59,81,11,978 | 6,43,28,74,848 |
| Total Weighted Average Potential Equity Shares *                                                                                    | 8,35,40,466    | 9,92,64,053    |
| Weighted Average number of Equity Shares used as denominator for calculating Diluted EPS                                            | 6,68,16,52,444 | 6,53,21,38,901 |

\* Dilutive impact of Employee Stock Option Scheme and Partly paid Rights Issue Shares

\* Refer Note 14.9

(Source: Annual Report for 2021-2022 of Reliance Industries Ltd.)

## 2.13 SIGNIFICANT DIFFERENCES BETWEEN IND AS 33 AND AS 20

| S. No. | Particulars            | Ind AS 33                                                                                                                                                                                                                           | AS 20                                                                   |
|--------|------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| 1.     | Additional disclosures | Disclosure is required for instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future but were not included in the calculation of diluted earnings per share because | Certain additional disclosures required under Ind AS not required here. |

|    |                                                |                                                                                                                                                                                               |                                                |
|----|------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------|
|    |                                                | they are anti-dilutive for the periods presented.                                                                                                                                             |                                                |
| 2. | <i>Mandatorily convertible instrument</i>      | Ordinary shares to be issued upon conversion of a mandatorily convertible instrument are included in the calculation of basic EPS from the date the contract is entered into.                 | No specific requirement as in Ind AS.          |
| 3. | <i>Shares issuable after a passage of time</i> | Ordinary shares that are issuable solely after a passage of time are not treated as contingently issuable shares because passage of time is a certainty.                                      | No specific guidance.                          |
| 4. | <i>Contingently returnable shares</i>          | Outstanding ordinary shares that are contingently returnable are not treated as outstanding and are ignored in the calculation of basic EPS until the shares are no longer subject to recall. | No guidance on contingently returnable shares. |





4. Calculate Basic EPS for period ending 20X0, 20X1 and 20X2, when

|                                                                     | 20X0    | 20X1    | 20X2    |
|---------------------------------------------------------------------|---------|---------|---------|
| Profit attributable to ordinary equity holders of the parent entity | ₹ 1,100 | ₹ 1,500 | ₹ 1,800 |

|                                                                                               |                                                |
|-----------------------------------------------------------------------------------------------|------------------------------------------------|
| Shares outstanding before rights issue                                                        | 500 shares                                     |
| Rights issue                                                                                  | One new share for each five outstanding shares |
| Exercise price                                                                                | ₹ 5.00                                         |
| Date of rights issue                                                                          | 1 January 20X1                                 |
| Last date to exercise rights                                                                  | 1 March 20X1                                   |
| Market price of one ordinary share immediately before exercise on 1 <sup>st</sup> March 20X1: | ₹ 11.00                                        |
| Reporting date                                                                                | 31 December                                    |

5. Calculate Subsidiary's and Group's Basic EPS and Diluted EPS, when

| Parent:                                                                           |                                                                            |
|-----------------------------------------------------------------------------------|----------------------------------------------------------------------------|
| Profit attributable to ordinary equity holders of the parent entity               | ₹ 12,000 (excluding any earnings of, or dividends paid by, the subsidiary) |
| Ordinary shares outstanding                                                       | 10,000                                                                     |
| Instruments of subsidiary owned by the parent                                     | 800 ordinary shares                                                        |
|                                                                                   | 30 warrants exercisable to purchase ordinary shares of subsidiary          |
|                                                                                   | 300 convertible preference shares                                          |
| Subsidiary:                                                                       |                                                                            |
| Profit                                                                            | ₹ 5,400                                                                    |
| Ordinary shares outstanding                                                       | 1,000                                                                      |
| Warrants                                                                          | 150, exercisable to purchase ordinary shares of the subsidiary             |
| Exercise price                                                                    | ₹ 10                                                                       |
| Average market price of one ordinary share                                        | ₹ 20                                                                       |
| Convertible preference shares                                                     | 400, each convertible into one ordinary share                              |
| Dividends on preference shares                                                    | ₹ 1 per share                                                              |
| No inter-company eliminations or adjustments were necessary except for dividends. |                                                                            |

Ignore income taxes. Also, ignore classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by Ind AS 32.

6. CAB Limited is in the process of preparation of the consolidated financial statements of the group for the year ending 31<sup>st</sup> March, 20X3 and the extract of the same is as follows:

| Particulars                | Attributable to CAB Limited | Non-controlling interest | Total<br>(₹ in '000) |
|----------------------------|-----------------------------|--------------------------|----------------------|
| Profit for the year        | 39,000                      | 3,000                    | 42,000               |
| Other Comprehensive Income | 5,000                       | Nil                      | 5,000                |
| Total Comprehensive Income | 44,000                      | 3,000                    | 47,000               |

The long-term finance of the company comprises of the following:

- (i) 20,00,00,000 equity shares at the beginning of the year and the company has issued 5,00,00,000 shares on 1st July, 20X2 at full market value.
- (ii) 8,00,00,000 irredeemable preference shares. These shares were in issue for the whole of the year ended 31st March, 20X3. The dividend on these preference shares is discretionary.
- (iii) ₹ 18 crores of 6% convertible debentures issued on 1st April, 20X1 and repayable on 31<sup>st</sup> March, 20X5 at par. Interest is payable annually. As an alternative to repayment at par, the holder on maturity can elect to exchange their convertible debentures for 10 crores ordinary shares in the company. On 1st April, 20X1, the prevailing market interest rate for four-year convertible debentures which had no right of conversion was 8%. Using an annual discount rate of 8%, the present value of ₹ 1 payable in four years is 0.74 and the cumulative present value of ₹ 1 payable at the end of years one to four is 3.31.

In the year ended 31<sup>st</sup> March, 20X3, CAB Limited declared an ordinary dividend of 0.10 paise per share and a dividend of 0.05 paise per share on the irredeemable preference shares.

Compute the following:

- the finance cost of convertible debentures and its closing balance as on 31<sup>st</sup> March, 20X3 to be presented in the consolidated financial statements.
- the basic and diluted earnings per share for the year ended 31<sup>st</sup> March, 20X3.

Assume that income tax is applicable to CAB Limited and its subsidiaries at 25%.

## Answers

### 1. Rights issue bonus fraction

|            | Shares   | ₹ per share | ₹          |
|------------|----------|-------------|------------|
| Cum-rights | 5        | 1           | 5.0        |
| Rights     | <u>1</u> | 0.9         | <u>0.9</u> |
| Ex-rights  | <u>6</u> |             | <u>5.9</u> |

Theoretical ex-rights price  $(5.9 / 6) = 0.9833$

Bonus fraction = Cum-rights price / Theoretical ex-rights price  
 $= 1/0.9833$

#### Number of shares

1 January - 31 March  $(1,000,000 \times 3/12 \times 1/0.9833)$  254,237

1 April - 31 December  $(1,200,000 \times 9/12)$  900,000

1,154,237

### 2.

#### Number of shares

#### Profit ₹

Profit 200,000

Ordinary shares 1,000,000

New shares on conversion (weighted average)

$9/12 \times ₹ 25,000 / 100 \times 120$  22,500 -

Figures for basic EPS 1,022,500 200,000

**Basic EPS is  $(₹ 200,000 / 1,022,500) = 0.196$  per share**

#### Dilution adjustments

Unconverted shares  $₹ 75,000 / 100 \times 120$  90,000

Interest:  $₹ 75,000 \times 5\% \times 0.7$  (net of tax) 2,625

Converted shares pre conversion adjustment

$3/12 \times ₹ 25,000 / 100 \times 120$  7,500

Interest:  $[3/12 \times ₹ 25,000 \times 5\% \times 0.7]$  219

1,120,000 202,844

**Diluted EPS is  $(₹ 202,844 / 1,120,000) = 0.181$**

**3. Diluted EPS**

|                       | Number of Shares | Profit (₹)     | EPS          |
|-----------------------|------------------|----------------|--------------|
| Basic                 | 1,000,000        | 100,000        | 0.10         |
| Dilution (Refer W.N.) | 50,000           | –              | –            |
|                       | <u>1,050,000</u> | <u>100,000</u> | <u>0.095</u> |

**Working Notes:**

|                                                                     |                 |   |                |
|---------------------------------------------------------------------|-----------------|---|----------------|
| Proceeds of issue                                                   | (200,000 × ₹ 6) | = | 1,200,000      |
| Number that would have been issued at Fair value (1,200,000 / ₹ 8)= |                 |   | 150,000        |
| Number actually issued                                              |                 |   | <u>200,000</u> |
| Number for “free” (200,000 – 150,000)                               |                 |   | <u>50,000</u>  |

**4. Calculation of theoretical ex-rights value per share**

Fair value of all outstanding shares before the exercise of rights + total amount received from exercise of rights

---

Number of shares outstanding before exercise + number of shares issued in the exercise

$$(\text{₹}11.00 \times 500 \text{ shares}) + (\text{₹}5.00 \times 100 \text{ shares})$$


---

$$500 \text{ shares} + 100 \text{ shares}$$

Theoretical ex-rights value per share = ₹10.00

**Calculation of adjustment factor**

|                                                |         |        |
|------------------------------------------------|---------|--------|
| Fair value per share before exercise of rights | ₹ 11.00 |        |
|                                                |         | = 1.10 |
| Theoretical ex-rights value per share          | ₹ 10.00 |        |

**Calculation of basic earnings per share**

|                                                                 | 20X0                                          | 20X1   | 20X2 |
|-----------------------------------------------------------------|-----------------------------------------------|--------|------|
| 20X0 Basic EPS as originally reported: ₹1,100 / 500 shares      | ₹ 2.20                                        |        |      |
| 20X0 Basic EPS restated for rights: ₹1,100 / (500 shares x 1.1) | ₹ 2.00                                        |        |      |
| 20X1 Basic EPS including effects of rights issue:               |                                               | ₹ 2.54 |      |
|                                                                 | {₹1,500 / [(500 x 1.1 x 2/12) + (600x10/12)]} |        |      |
| 20X2 Basic EPS: ₹ 1,800 / 600 shares                            |                                               | ₹ 3.00 |      |

### 5. Subsidiary's earnings per share

|           |                    |                                                                   |
|-----------|--------------------|-------------------------------------------------------------------|
| Basic EPS | ₹ 5.00 calculated: | $\frac{\text{₹ 5,400 (a)} - \text{₹ 400 (b)}}{1,000 \text{ (c)}}$ |
|-----------|--------------------|-------------------------------------------------------------------|

|             |                    |                                                                         |
|-------------|--------------------|-------------------------------------------------------------------------|
| Diluted EPS | ₹ 3.66 calculated: | $\frac{\text{₹ 5,400 (d)}}{(1,000 + 75 \text{ (e)} + 400 \text{ (f)})}$ |
|-------------|--------------------|-------------------------------------------------------------------------|

#### Notes:

- (a) Subsidiary's profit attributable to ordinary equity holders.
- (b) Dividends paid by subsidiary on convertible preference shares.
- (c) Subsidiary's ordinary shares outstanding.
- (d) Subsidiary's profit attributable to ordinary equity holders (₹ 5,000) increased by ₹ 400 preference dividends for the purpose of calculating diluted earnings per share.
- (e) Incremental shares from warrants, calculated:  $[(\text{₹ } 20 - \text{₹ } 10) \div \text{₹ } 20] \times 150$ .
- (f) Subsidiary's ordinary shares assumed outstanding from conversion of convertible preference shares, calculated: 400 convertible preference shares  $\times$  conversion factor of 1.

### Consolidated earnings per share

|           |                    |                                                                     |
|-----------|--------------------|---------------------------------------------------------------------|
| Basic EPS | ₹ 1.63 calculated: | $\frac{\text{₹ 12,000(a)} + \text{₹ 4,300(b)}}{10,000 \text{ (c)}}$ |
|-----------|--------------------|---------------------------------------------------------------------|

|             |                    |                                                                                           |
|-------------|--------------------|-------------------------------------------------------------------------------------------|
| Diluted EPS | ₹ 1.61 calculated: | $\frac{\text{₹ 12,000} + \text{₹ 2,928(d)} + \text{₹ 55(e)} + \text{₹ 1,098(f)}}{10,000}$ |
|-------------|--------------------|-------------------------------------------------------------------------------------------|

- (a) Parent's profit attributable to ordinary equity holders of the parent entity.
- (b) Portion of subsidiary's profit to be included in consolidated basic earnings per share, calculated:  $(800 \times \text{₹ } 5.00) + (300 \times \text{Re } 1.00)$ .
- (c) Parent's ordinary shares outstanding.
- (d) Parent's proportionate interest in subsidiary's earnings attributable to ordinary shares, calculated:  $(800 \div 1,000) \times (1,000 \text{ shares} \times \text{₹ } 3.66 \text{ per share})$ .
- (e) Parent's proportionate interest in subsidiary's earnings attributable to warrants, calculated:  $(30 \div 150) \times (75 \text{ incremental shares} \times \text{₹ } 3.66 \text{ per share})$ .

- (f) Parent's proportionate interest in subsidiary's earnings attributable to convertible preference shares, calculated:  $(300 \div 400) \times (400 \text{ shares from conversion} \times ₹ 3.66 \text{ per share})$ .

**6. Calculation of the liability and equity components on 6% Convertible debentures:**

Present value of principal payable at the end of 4<sup>th</sup> year ( $₹ 1,80,000 \text{ thousand} \times 0.74$ )

= ₹ 1,33,200 thousand

Present value of interest payable annually for 4 years ( $₹ 1,80,000 \text{ thousand} \times 6\% \times 3.31$ )

= ₹ 35,748 thousand

Total liability component = ₹ 1,68,948 thousand

Therefore, equity component = ₹ 1,80,000 thousand – ₹ 1,68,948 thousand = ₹ 11,052 thousand

**Calculation of finance cost and closing balance of 6% convertible debentures**

| Year      | Opening balance<br>₹ in '000 | Finance cost<br>@ 8%<br>₹ in '000 | Interest paid<br>@ 6%<br>₹ in '000 | Closing balance<br>₹ in '000 |
|-----------|------------------------------|-----------------------------------|------------------------------------|------------------------------|
|           | a                            | b = a x 8%                        | c                                  | d = a + b - c                |
| 31.3.20X2 | 1,68,948                     | 13,515.84                         | 10,800                             | 1,71,663.84                  |
| 31.3.20X3 | 1,71,663.84                  | 13,733.11                         | 10,800                             | 1,74,596.95                  |

Finance cost of convertible debentures for the year ended 31.3. 20X3 is ₹ **13,733.11 thousand** and closing balance as on 31.3. 20X3 is ₹ **1,74,596.95 thousand**.

**Calculation of Basic EPS**

₹ in '000

|                                                                   |                |
|-------------------------------------------------------------------|----------------|
| Profit for the year                                               | 39,000         |
| Less: Dividend on preference shares<br>(80,000 thousand x ₹ 0.05) | <u>(4,000)</u> |
| Profit attributable to equity shareholders                        | <u>35,000</u>  |

Weighted average number of shares =  $20,00,00,000 + \{5,00,00,000 \times (9/12)\}$

= 23,75,00,000 shares or 2,37,500 thousand shares

Basic EPS = ₹ 35,000 thousand / 2,37,500 thousand shares

= ₹ 0.147

**Calculation of Diluted EPS****₹ in '000**

|                                                     |                   |                  |
|-----------------------------------------------------|-------------------|------------------|
| Profit for the year                                 |                   | 39,000           |
| Less: Dividend on preference shares (80,000 x 0.05) |                   | <u>(4,000)</u>   |
|                                                     |                   | 35,000           |
| Add: Finance cost (as given in the above table)     | 13,733.11         |                  |
| Less: Tax @ 25%                                     | <u>(3,433.28)</u> | <u>10,299.83</u> |
|                                                     |                   | <u>45,299.83</u> |

Weighted average number of shares

$$= 20,00,00,000 + \{5,00,00,000 \times (9/12)\} + 10,00,00,000$$

$$= 33,75,00,000 \text{ shares or } 3,37,500 \text{ thousand shares}$$

$$\text{Diluted EPS} = ₹ 45,299.83 \text{ thousand} / 3,37,500 \text{ thousand shares}$$

$$= ₹ 0.134$$



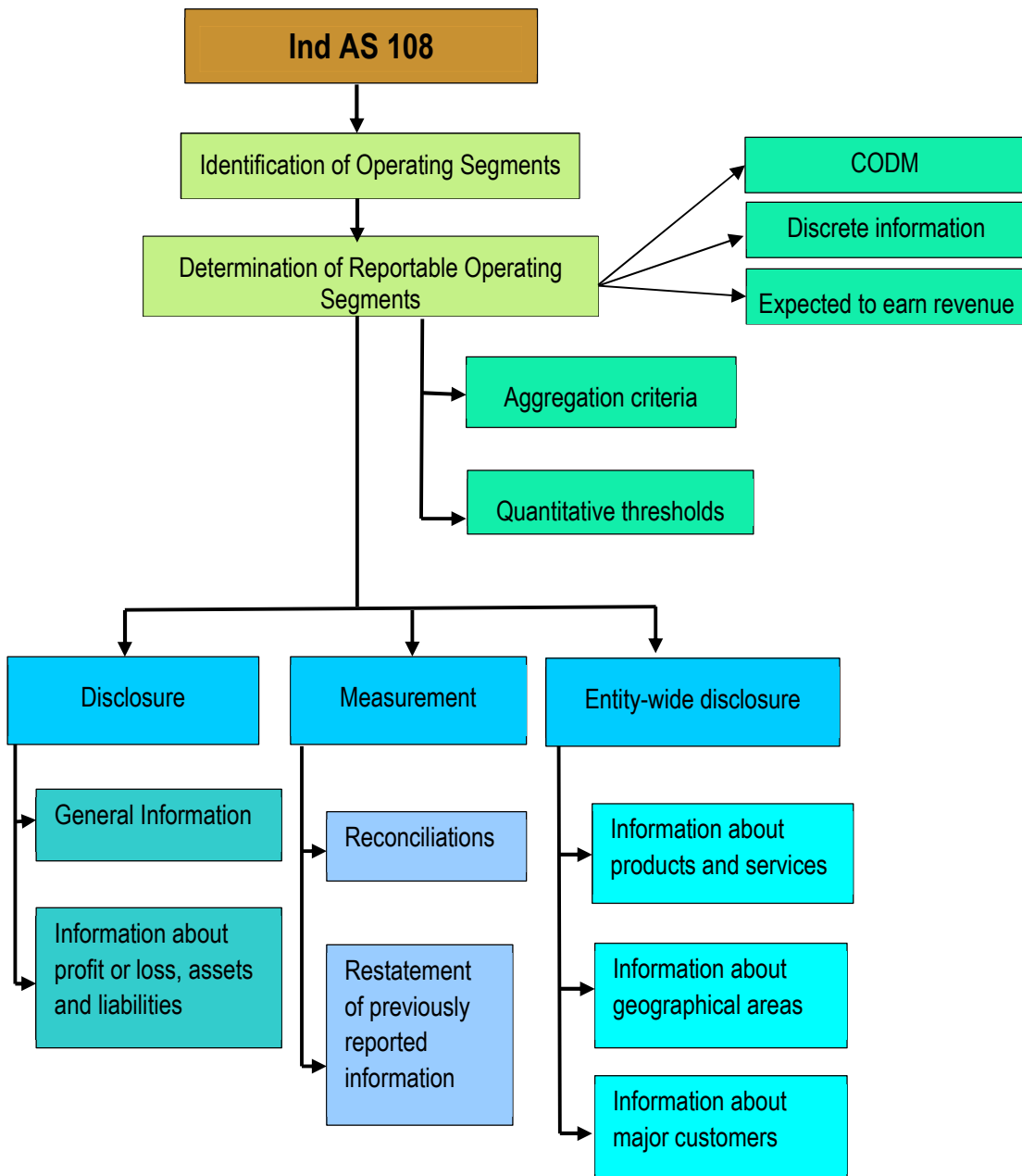
## UNIT 3

### INDIAN ACCOUNTING STANDARD 108 : OPERATING SEGMENTS

#### LEARNING OUTCOMES

**After studying this unit, you will be able to:**

- ☐ Explain the meaning of 'operating segments'
- ☐ Define the 'chief operating decision maker' (CODM)
- ☐ Identify the reportable segments and the application of aggregation criteria
- ☐ Comply with the disclosure requirement under Ind AS 108 with regard to operating segments
- ☐ Differentiate between Ind AS 108 and AS 17

**UNIT OVERVIEW**



### 3.1 CORE PRINCIPLE

An entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Ind AS 108 requires an entity to disclose information to enable the stakeholders to have insight into the entity's operations from the same perspective as that of its management. For instance, in case of an entity engaged in multiple lines of business / business activities (e.g., engineering, financial services and IT), the users of financial statements must have the information about the performance of each of its 'business activities' as perceived by management in order to make better and more informed decisions about their investments in the entity as a whole.

Similarly, an entity may be operating across multiple economic environments. 'Economic Environments' in general, are those factors which have an impact on the working of any business. These factors could include political and economic macro-systems, trade cycles, economic resources, statutory environment, income levels, industrial growth rates and many other such factors. These are dynamic in nature and are in a continuous state of change.

In view of these complexities, Ind AS 108 requires disclosure of information in a manner which enables users to make informed decisions based on their assessment of the economic environments in which the different businesses of an entity operate.



### 3.2 SCOPE

Ind AS 108 should apply to companies to which Indian Accounting Standards notified under the Companies Act, 2013 apply.

If an entity that is not required to apply Ind AS 108 but chooses to disclose information about segments that does not comply with Ind AS 108, it should not describe the information as segment information.

If a financial report contains both the consolidated financial statements of a parent that is within the scope of Ind AS 108 as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

*Extract from: Hindustan Unilever Limited's Annual Report for 2021-2022*

#### NOTE 46

The Company has presented segment information in the consolidated financial statements which are presented in the same annual report. Accordingly, in terms of Paragraph 4 of Ind AS 108 'Operating Segments', no disclosures related to segments are presented in these standalone financial statements.



### 3.3 OPERATING SEGMENTS

An operating segment is a component of an entity:

- (a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);
- (b) whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance; and
- (c) for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

A perusal of the above requirements for identifying an operating segment differs with requirements contained in Accounting Standard (AS) 17, *Segment Reporting*. According to AS 17, identification of business segment is determined by considering risk and returns derived from an identical product or service or group of related products and services. Similarly, identification of geographical segment is determined by considering the risk and returns from products and services within a particular economic environment.

Ind AS 108, however, requires the consideration of earning of revenues and incurring of expenses from a business activity, the operating results of which are regularly reviewed by entity's CODM and discrete financial information is available. It may be noted that AS 17 follows the approach of risk and return for determination of a business and geographical segment. Ind AS 108, however, follows the management approach meaning thereby that whichever business activity is considered by the management as a separate source of revenue will be considered as an operating segment, the operating results of which are regularly reviewed by CODM to make decision about resources allocation and performance measurement.

Under this approach, not only would enterprises be likely to report more detailed information but the knowledge obtained of the structure of an enterprise's internal organisation is valuable in itself because it highlights segments based on such structure. This approach results in the following significant advantages:

- An ability to see an enterprise "through the eyes of management" enhances a user's ability to predict actions or reactions of management that can significantly affect the enterprise's prospects for future cash flows.
- Information about those segments is generated for management's use and hence the incremental cost of providing information for external reporting would be relatively low.

**Illustration 1**

ABC Ltd. manufactures and sells healthcare products, and food and grocery products. Three products namely A, B & C are manufactured. Product A is classified as healthcare product and product B & C are classified as food and grocery products. Products B & C are similar products. Discrete financial information is available for each manufacturing locations and for the selling activity of each product. There are two-line managers responsible for manufacturing activities of products A, B & C. Manager X manages product A and Manager B manages products B & C. The operating results of health care products (product A) and food and grocery products (products B & C) are regularly reviewed by the CODM.

Identify reportable segments of ABC Ltd.

**Solution**

In this situation both the healthcare, and food and grocery product line meet the criteria for operating segments set out above. Therefore, it is likely that ABC Ltd.'s operating segments would be classified as being (i) healthcare and (ii) food and grocery segments.

Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments. For the purposes of Ind AS 108, an entity's post-employment benefit plans are not operating segments.

\*\*\*\*\*

### 3.3.1 Functions that are integral to business

---

In case of a company, where the activities of a function are an integral part of company's business (for example, research and development function for a pharmaceuticals or software company), this can be considered as an operating function provided that there is discrete information available that is regularly reviewed by the CODM.

### 3.3.2 Discontinued operations – whether an operating segment

---

If the discontinued operation

- continues to engage in business activities;
- whose operating results are reviewed by the CODM; and
- there is discrete information available to support the review

Then, it would meet the definition of an operating segment.

The term 'chief operating decision maker' (CODM) identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the

performance of the operating segments of an entity. Often the CODM of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.

For many entities, the three characteristics of operating segments clearly identify its operating segments. However, an entity may produce reports in which its business activities are presented in a variety of ways. If the CODM uses more than one set of segment information, other factors may identify a single set of components as constituting an entity's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

### Illustration 2

*The CEO along with other Board members do a review of financial information about various business segments and take decisions on the basis of discrete information available for these segments and are correctly identified as **Chief Operating Decision Maker (CODM)**. Review of only revenue information is done for decision making about those segments by the CODM. As per CODM, many segments require minimal costs due to centralization of costs.*

*Analyse whether the review of only the revenue related information is sufficient for these segments to be considered as operating segments for the purposes of Ind AS 108 'Operating Segments'.*

### Solution

Many entities would be considering the decision making for segments on the basis of revenue growth – especially the ones aggressively trying to build a market share. Common examples would be businesses in the technology sector or those creating or launching new products from time to time. For them, the decision making for different regional segments would need revenue growth and related information for further investment decisions.

Merely examining revenue data by CODM without taking into account the corresponding expenses involved in generating that revenue may not provide adequate insights for determining how to allocate resources and measure the performance of a segment.

However, in the instant case, the logic given by the CODM is that since many segments require minimal costs (due to centralization of costs), therefore, revenue-only data is a fair representation of the operating results.

In the above case, review of the information that is based only on revenue data may be appropriate to consider that the segment meets the definition of an operating segment.

\*\*\*\*\*

### Whether a committee of non-executive directors (NEDs) is likely to be the CODM.

NEDs are not usually involved in resource allocation decisions, other than at a very high level. Their role is primarily related to governance than a management role. Accordingly, it may be difficult to establish if they would meet the definition of the CODM.

However, a function (Board of directors), might include non-executive directors whose sole responsibility is governance. Such a function would be a CODM if the most significant operating, as well as strategic, decisions are made by that function, even if those non-executive directors do not participate in implementing such decisions.

### Overlapping sets of components

Generally, an operating segment has a segment manager who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment. The term 'segment manager' identifies a function, not necessarily a manager with a specific title. The chief operating decision maker also may be the segment manager for some operating segments. A single manager may be the segment manager for more than one operating segment. If the characteristics apply to more than one set of components of an organisation but there is only one set for which segment managers are held responsible, that set of components constitutes the operating segments.

The characteristics may apply to two or more overlapping sets of components for which managers are held responsible. That structure is sometimes referred to as a matrix form of organisation. For example, in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. The CODM regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity should determine which set of components constitutes the operating segments by reference to the core principle.

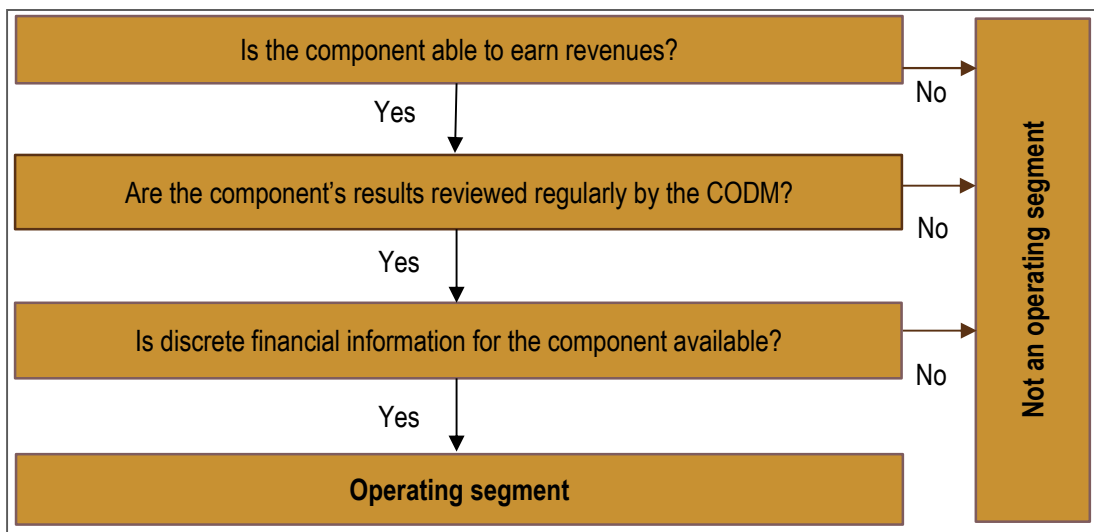


**Illustration 3**

*X Ltd. is engaged in the manufacture and sale of two distinct type of products A & B. X Ltd. supplies the product in the domestic market in India as well as in Singapore. There are two regional managers responsible for manufacturing activities of product A & B worldwide and also two other managers responsible for different geographical areas. For internal reporting purposes, X Ltd. provides information product-wise and as per the geographical location of the company. The CODM regularly reviews the operating results of both sets of components.*

*Comment, how should X Ltd. identify its operating segments.*

**Solution**

In this situation, both the geographical sales areas and product areas may meet the criteria for operating segment. However, in such situation, it is more difficult to determine clearly which set of components should be identified as the entity's operating segments. In such situation the entity should determine which set of components constitutes the operating segments by reference to the core principle. The core principle is that the entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. The entity should also assess whether the identified operating segments could realistically represent the level at which the CODM is assessing performance and allocating resources.

Therefore, X Ltd. should consider all the above factors and apply judgement to determine which component should be disclosed as operating segment.

\*\*\*\*\*

**Illustration 4**

*CODM of XY Ltd. receives and reviews multiple sets of information when assessing the businesses' overall performance to take a decision on resources allocation. It receives the information as under:*

- Level 1 Report: Summary report for all 4 regions
- Level 2 Report: Summary report for 20 Sub-regions within those regions
- Level 3 Report: Detailed report for 50 Branches within the sub-regions

*State what factors and level should be considered for determining an operating segment.*

**Solution**

We need to consider multiple factors (including but not limited to below):

- The process that CODM may use to assess the performance (Key Financial Matrix, KPIs, Ratio etc.);
- Identify the segment managers and their responsibility areas;
- The process of budgeting for resource allocations.

\*\*\*\*\*



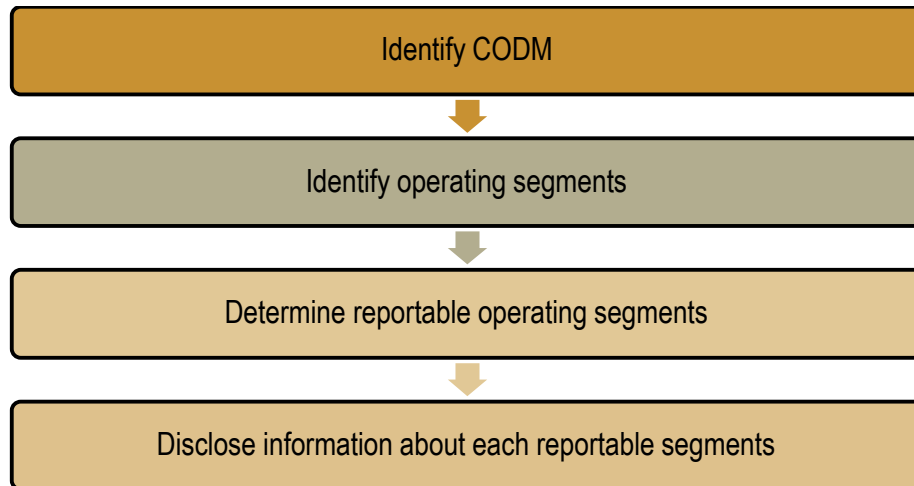


### 3.4 REPORTABLE SEGMENTS

An entity should report separately information about each operating segment that:

- (a) has been identified or results from aggregating two or more of those segments; and
- (b) exceeds the quantitative thresholds.

Standard specifies other situations in which separate information about an operating segment should be reported.



### 3.5 AGGREGATION CRITERIA

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of Ind AS 108, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

- (a) the nature of the products and services;
- (b) the nature of the production processes;
- (c) the type or class of customer for their products and services;
- (d) the methods used to distribute their products or provide their services; and
- (e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

### Illustration 5

*XY Ltd. has operations in France, Italy, Germany, UK and India. It wishes to apply aggregation criteria on geographical basis.*

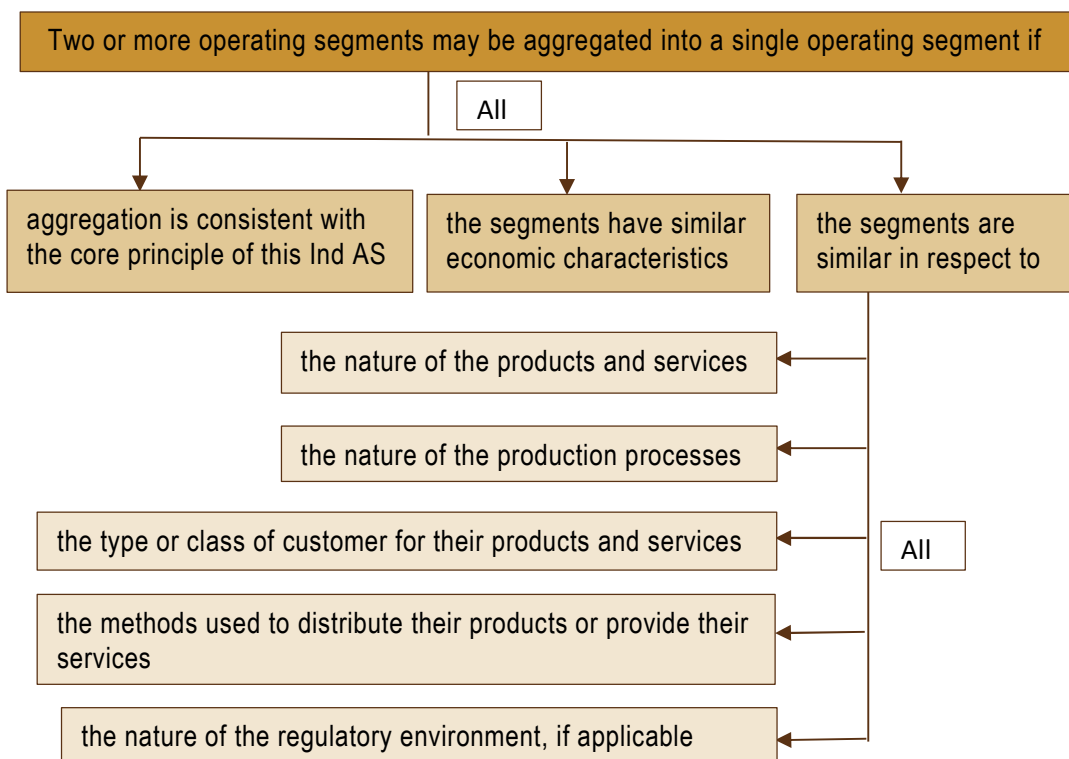
*State, how will the aggregation criteria apply for reporting segments in the given scenario.*

### Solution

XY Ltd. needs to assess and prove that each country possesses the same economic characteristics. Factors including exchange control regulations, currency risks and economic conditions are required to be considered.

Considering above factors, it may be possible to aggregate the results of France, Italy and Germany (falling within EU region) and results of UK and India may be separately reported (no aggregation is permitted).

\*\*\*\*\*



### Illustration 6

*X Ltd. is engaged in the business of manufacturing and selling papers. Varieties of paper like adhesive paper, anti-rust paper, antique paper, art paper etc., are manufactured and sold by X Ltd.*

*State whether X Ltd. should classify these papers into different segments.*

**Solution**

Two or more operating segments may be aggregated into a single operating segment if the segments have similar economic characteristics, and the segments are similar with respect to various factors like nature of the product and production process, type of customers, method of distribution and regulatory requirement.

In case of X Ltd., so far as varieties of paper concerned, if all factors such as nature of the product and production process, type of customers, method of distribution and regulatory requirement are common, there is no need to create different segments for each type of paper.

\*\*\*\*\*

**Illustration 7**

*T Ltd is engaged in transport sector, running a fleet of buses at different routes. T Ltd has identified 3 operating segments:*

- *Segment 1: Local Route*
- *Segment 2: Inter-city Route*
- *Segment 3: Contract Hiring*

*The characteristics of each segment are as under:*

**Segment 1:** *The local transport authority awards the contract to ply the buses at different routes for passengers. These contracts are awarded following a competitive tender process; the ticket price paid by passengers are controlled by the local transport authority. T Ltd would charge the local transport authority on a per kilometer basis.*

**Segment 2:** *T Ltd operates buses from one city to another, prices are set by T Ltd on the basis of services provided (Deluxe, Luxury or Superior).*

**Segment 3:** *T Ltd also leases buses to schools under a long-term arrangement.*

*While Segment 1 has been showing significant decline in profitability, Segment 2 is performing well in respect of higher revenues and improved margins. The management of the company is not sure why is the segment information relevant for users when they should only be concerned about the returns from overall business. They would like to aggregate the Segment 1 and Segment 2 for reporting under 'Operating Segment'*

**Required:**

*State whether it is appropriate to aggregate Segments 1 and 2 with reference to Ind AS 108 'Operating Segments'; and also discuss, in the above context, whether disclosure of segment information is relevant to an investor's appraisal of financial statements.*

**Solution**

Ind AS 108 '**Operating Segments**' requires operating segments to be aggregated to present a reportable segment if the segments have similar economic characteristics, and the segments are similar in each of the following aggregation criteria:

- (a) The nature of the products and services
- (b) The nature of the production process
- (c) The type or class of customer for their products and services
- (d) The methods used to distribute their products or provide their services
- (e) If applicable, the nature of the regulatory environment

While the products and services are similar, the customers for those products and services are different.

In Segment 1, the decision to award the contract is in the hands of the local authority, which also sets prices and pays for the services. The company is not exposed to passenger revenue risk, since a contract is awarded by competitive tender.

On the other hand, in the inter-city segment, the customer determines whether a bus route is economically viable by choosing whether or not to buy tickets. T Ltd sets the ticket prices but will be affected by customer behavior or feedback. T Ltd is exposed to passenger revenue-risk, as it sets prices which customers may or may not choose to pay.

Operating Segment provides information that makes the financial statements more useful to investors. In making the investment decisions, investors and creditors consider the returns they are likely to make on their investment. This requires assessment of the amount, timing and uncertainty of the future cash flows of T Ltd as well as of management's stewardship of T Ltd's resources. How management derives profit is therefore relevant information to an investor.

Inappropriately aggregating segments reduces the usefulness of segment disclosures to investors. Ind AS 108 requires information to be disclosed that is not readily available elsewhere in the financial statements, therefore it provides additional information which aids an investor's understanding of how the business operates and is managed.

In T Ltd.'s case, if the segments are aggregated, then the increased profits in segment 2 will hide the decreased profits in segment 1. However, the fact that profits have sharply declined in segment 1 would be of interest to investors as it may suggest that future cash flows from this segment are at risk.

It is not mandatory to aggregate segments. An entity, if desires, can disclose separately information about segments that meet all the criteria. However, with regard to upper limit on number of segments to be reported, the entity should consider whether a practical limit has been reached.

\*\*\*\*\*



### 3.6 QUANTITATIVE THRESHOLDS

An entity should report separately information about an operating segment that meets any of the following quantitative thresholds:

- (a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.
- (b) Its reported profit or loss is 10% or more, in absolute amount, of the greater, in absolute amount, of
  - (i) the combined reported profit of all operating segments that did not report a loss and
  - (ii) the combined reported loss of all operating segments that reported a loss.
- (c) Its assets are 10% or more of the combined assets of all operating segments. Operating segments that do not meet any of the quantitative thresholds may be considered reportable and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

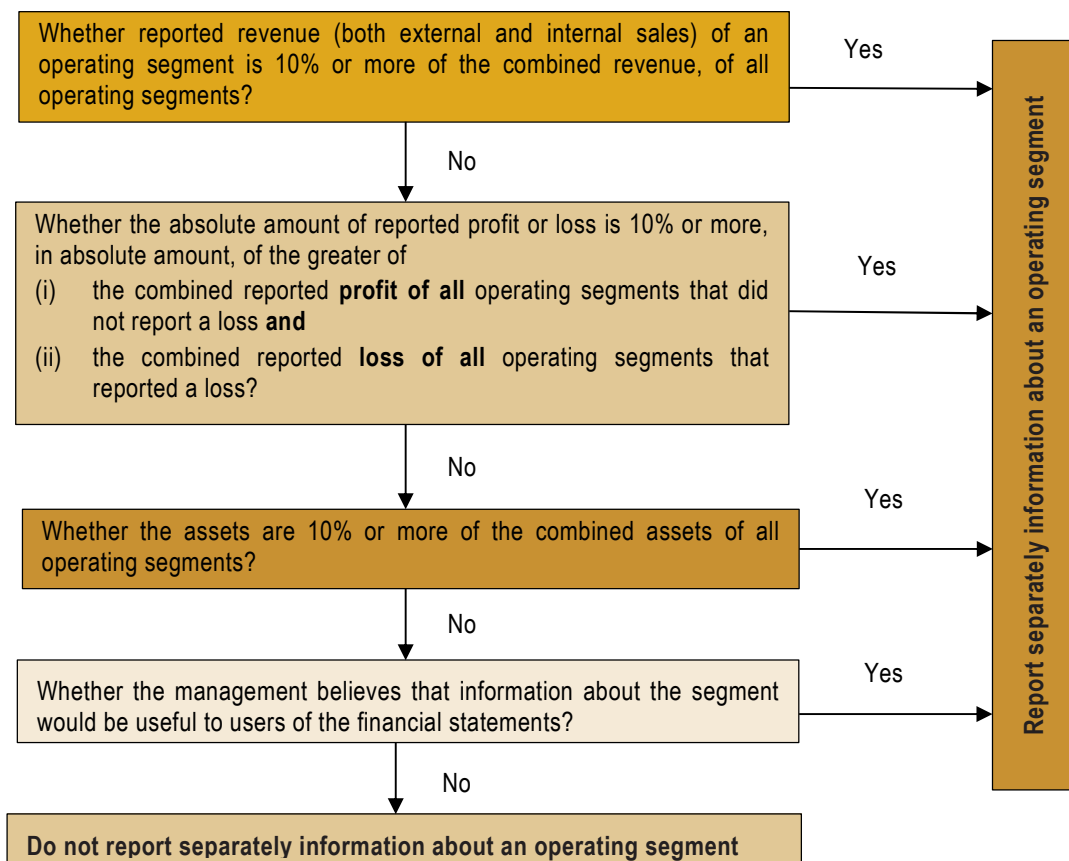


**Illustration 8**

*X Ltd. has identified the following business components.*

| Segment              | Revenue (₹) |           | Profit (₹) | Assets (₹) |
|----------------------|-------------|-----------|------------|------------|
|                      | External    | Internal  |            |            |
| Pharma               | 97,00,000   | Nil       | 20,00,000  | 55,00,000  |
| FMCG                 | Nil         | 4,00,000  | 2,50,000   | 25,00,000  |
| Ayurveda             | 3,00,000    | Nil       | 2,00,000   | 4,00,000   |
| Others               | 8,00,000    | 41,00,000 | 5,50,000   | 6,00,000   |
| Total for the entity | 1,08,00,000 | 45,00,000 | 30,00,000  | 90,00,000  |

*Which of the segments would be reportable as per the criteria prescribed in Ind AS108?*

**Solution**

Quantitative thresholds are calculated below:

| Segments                          | Pharma | FMCG  | Ayurveda | Others |
|-----------------------------------|--------|-------|----------|--------|
| % segment sales to total sales    | 63.40  | 2.61  | 1.96     | 32.03  |
| % segment profit to total profits | 66.67  | 8.33  | 6.67     | 18.33  |
| % segment assets to total assets  | 61.11  | 27.78 | 4.44     | 6.67   |

Segment Pharma would separately reportable since they meet all three size criteria, though any one criteria is required. FMCG segment does not satisfy the revenue and profit test but does satisfy the asset test. So it would be separately reportable. Ayurveda segment does not meet any threshold. It may not be classified as reportable segment.

\*\*\*\*\*

An entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments should be identified as reportable segments (even if they do not meet the criteria) until at least 75% of the entity's revenue is included in reportable segments.

**Note**

- External revenue of reportable segments must be  $\geq 75\%$  of total revenue of the entity.
- Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if information about the segment is useful to users.

Non-reportable segments – After the appropriate aggregation and requisite tests are done (i.e. 10% tests done and 75% test met), information about other business activities and operating segments that are not reportable should be combined and disclosed in an 'all other segments' category separately from other reconciling items in the reconciliations. The sources of the revenue included in the 'all other segments' category should be described.

If management judges that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment should continue to be reported separately in the current period even if it no longer meets the criteria for reportability.

If an operating segment is identified as a reportable segment in the current period in accordance with the quantitative thresholds, segment data for a prior period presented for comparative purposes should be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the criteria for reportability in the prior period, unless the necessary information is not available and the cost to develop it would be excessive.

There may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed. Although no precise limit has been determined, as the number of segments that are reportable increases above ten, the entity should consider whether a practical limit has been reached.

#### Illustration 9

*An entity has branches in different parts of the country – catering to different customers and selling local made products (a product of one region is not sold in any other region). No region or product contributes more than 5% to total revenue of the entity.*

*Discuss how many segments are reportable.*

#### Solution

Under the quantitative threshold, external revenue of reportable segments must be  $\geq 75\%$  of total revenue of the entity. Considering above case, minimum 15 operating segments need to be reportable ( $75\% \text{ [threshold]} / 5\% \text{ {revenue}}$ ).

\*\*\*\*\*



### 3.7 DISCLOSURE

An entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

An entity should disclose the following for each period for which a statement of profit and loss is presented:

- (a) general information;
- (b) information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement; and
- (c) reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts.

Reconciliations of the amounts in the balance sheet for reportable segments to the amounts in the entity's balance sheet are required for each date at which a balance sheet is presented. Information for prior periods should be restated.

### **3.7.1 General Information**

---

An entity should disclose the following general information:

- (a) factors used to identify the entity's reportable segments, including the basis of organisation (for example, whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated); and
- (b) the judgements made by management in applying the aggregation criteria. This includes a brief description of the operating segments that have been aggregated in this way and the economic indicators that have been assessed in determining that the aggregated operating segments share similar economic characteristics; and
- (c) types of products and services from which each reportable segment derives its revenues.

#### **3.7.1.1 Factors that management used to identify the entity's reportable segments**

Diversified Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. Most of the businesses were acquired as individual units, and the management at the time of the acquisition was retained.

#### **3.7.1.2 Description of the types of products and services from which each reportable segment derives its revenues**

Diversified Company has five reportable segments: car parts, motor vessels, software, electronics and finance. The car parts segment produces replacement parts for sale to car parts retailers. The motor vessels segment produces small motor vessels to serve the offshore oil industry and similar businesses. The software segment produces application software for sale to computer manufacturers and retailers. The electronics segment produces integrated circuits and related products for sale to computer manufacturers. The finance segment is responsible for portions of the company's financial operations including financing customer purchases of



products from other segments and property lending operations.

*Extract from Annual Report for 2021-2022 of Hindustan Unilever Limited*

#### **NOTE 46 SEGMENT INFORMATION**

The Operating Segment is the level at which discrete financial information is available. Business segments are identified considering:

- a) the nature of products and services
- b) the differing risks and returns
- c) the internal organisation and management structure, and
- d) the internal financial reporting systems.

### **3.7.2 Information about profit or loss, assets and liabilities**

An entity should report a measure of profit or loss for each reportable segment. An entity should report a measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to CODM. An entity should also disclose the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the CODM, or are otherwise regularly provided to the CODM, even if not included in that measure of segment profit or loss:

- (a) revenues from external customers;
- (b) revenues from transactions with other operating segments of the same entity;
- (c) interest revenue;
- (d) interest expense;
- (e) depreciation and amortisation;
- (f) material items of income and expense disclosed in accordance with Ind AS 1, *Presentation of Financial Statements*;
- (g) the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;
- (h) income tax expense or income; and
- (i) material non-cash items other than depreciation and amortisation.

An entity should report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the CODM relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, an entity may report that segment's interest revenue net of its interest expense and disclose that it has done so.

An entity should disclose the following about each reportable segment if the specified amounts are included in the measure of segment assets reviewed by the CODM or are otherwise regularly provided to the CODM, even if not included in the measure of segment assets:

- (a) the amount of investment in associates and joint ventures accounted for by the equity method; and
- (b) the amounts of additions to non-current assets (For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the reporting period) other than financial instruments, deferred tax assets, net defined benefit assets (in accordance with Ind AS 19, *Employee Benefits*) and rights arising under insurance contracts.

The following table illustrates a suggested format for disclosing information about segment profit or loss, assets and liabilities. The same type of information is required for each year for which a statement of profit and loss is presented. Diversified Company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration are assumed to be the amounts in reports used by the CODM.

#### Information about reportable segment profit or loss, assets and liabilities

|                                      | Car<br>parts<br>₹ | Motor<br>vessels<br>₹ | Software<br>₹ | Electronics<br>₹ | Finance<br>₹ | All<br>others<br>₹   | Total<br>₹ |
|--------------------------------------|-------------------|-----------------------|---------------|------------------|--------------|----------------------|------------|
| Revenue from external customers      | 3,000             | 5,000                 | 9,500         | 12,000           | 5,000        | 1,000 <sup>(a)</sup> | 35,500     |
| Inter-segment revenues               | -                 | -                     | 3,000         | 1,500            | -            | -                    | 4,500      |
| Interest revenue                     | 450               | 800                   | 1,000         | 1,500            | -            | -                    | 3,750      |
| Interest expense                     | 350               | 600                   | 700           | 1,100            | -            | -                    | 2,750      |
| Net interest revenue <sup>(b)</sup>  | -                 | -                     | -             |                  |              |                      | 1,000      |
| Depreciation and amortisation        | 200               | 100                   | 50            | 1,500            | 1,100        | -                    | 2,950      |
| Reportable Segment profit            | 200               | 70                    | 900           | 2,300            | 500          | 100                  | 4,070      |
| <i>Other material Non-cash item:</i> |                   |                       |               |                  |              |                      |            |
| Impairment of assets                 | -                 | 200                   | -             | -                | -            | -                    | 200        |
| Reportable segment assets            | 2,000             | 5,000                 | 3,000         | 12,000           | 57,000       | 2,000                | 81,000     |

|                                                         |       |       |       |       |        |   |        |
|---------------------------------------------------------|-------|-------|-------|-------|--------|---|--------|
| Expenditures for reportable segment non- current assets | 300   | 700   | 500   | 800   | 600    | - | 2,900  |
| Reportable segment liabilities                          | 1,050 | 3,000 | 1,800 | 8,000 | 30,000 |   | 43,850 |

(a) Revenues from segments below the quantitative thresholds are attributable to four operating segments of Diversified Company. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.

(b) The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, only the net amount is disclosed.

*Extract from Annual Report for 2021-2022 of Hindustan Unilever Limited*

Segment revenue relating to each of the above domestic business segments includes Income from Services provided to group companies, where applicable. Segment results relate to profit from continuing operations before other income, finance costs, exceptional items and tax

|                                              | Year ended 31st March, 2022 |              |               | Year ended 31st March, 2021 |              |               |
|----------------------------------------------|-----------------------------|--------------|---------------|-----------------------------|--------------|---------------|
|                                              | External                    | Intersegment | Total         | External                    | Intersegment | Total         |
| <b>Revenue</b>                               |                             |              |               |                             |              |               |
| Home care                                    | 16,570                      | -            | 16,570        | 13,957                      | -            | 13,957        |
| Beauty & Personal care                       | 19,567                      | -            | 19,567        | 18,038                      | -            | 18,038        |
| Foods & Refreshment                          | 14,105                      | -            | 14,105        | 13,204                      | -            | 13,204        |
| Others (includes Exports, Consignment, etc.) | 2,204                       | -            | 2,204         | 1,829                       | -            | 1,829         |
| <b>Total Revenue</b>                         | <b>52,446</b>               | <b>-</b>     | <b>52,446</b> | <b>47,028</b>               | <b>-</b>     | <b>47,028</b> |

|                                                                           | Year ended 31st March, 2022 |              |               | Year ended 31st March, 2021 |              |               |
|---------------------------------------------------------------------------|-----------------------------|--------------|---------------|-----------------------------|--------------|---------------|
|                                                                           | External                    | Intersegment | Total         | External                    | Intersegment | Total         |
| <b>Result</b>                                                             |                             |              |               |                             |              |               |
| Home care                                                                 | 3,183                       | -            | 3,183         | 2,773                       | -            | 2,773         |
| Beauty & Personal care                                                    | 5,392                       | -            | 5,392         | 5,134                       | -            | 5,134         |
| Foods & Refreshment                                                       | 2,623                       | -            | 2,623         | 2,189                       | -            | 2,189         |
| Others (includes Exports, Consignment, etc.)                              | 568                         | -            | 568           | 456                         | -            | 456           |
| <b>Total Segment Results</b>                                              | <b>11,766</b>               | <b>-</b>     | <b>11,766</b> | <b>10,552</b>               | <b>-</b>     | <b>10,552</b> |
| Finance costs                                                             |                             |              | (106)         |                             |              | (117)         |
| Other Income                                                              |                             |              | 258           |                             |              | 410           |
| <b>Profit from continuing operations before exceptional items and tax</b> |                             |              | <b>11,918</b> |                             |              | <b>10,845</b> |
| Exceptional items - income/ (expenditure)                                 |                             |              | (44)          |                             |              | (239)         |
| <b>Profit before tax from continuing operations</b>                       |                             |              | <b>11,874</b> |                             |              | <b>10,606</b> |
| Tax expense                                                               |                             |              |               |                             |              |               |
| Current tax                                                               |                             |              | (2,840)       |                             |              | (2,520)       |
| Deferred tax charge/ (credit)                                             |                             |              | (147)         |                             |              | (86)          |
| <b>Profit for the year from Continuing Operations (A)</b>                 |                             |              | <b>8,887</b>  |                             |              | <b>8,000</b>  |
| <b>Profit for the year from Discontinued Operations (B)</b>               |                             |              | <b>5</b>      |                             |              | <b>(1)</b>    |
| <b>Profit For the Year (A+B)</b>                                          |                             |              | <b>8,892</b>  |                             |              | <b>7,999</b>  |
| Less: Non Controlling Interest                                            |                             |              | (13)          |                             |              | (4)           |
| <b>Profit for the Year</b>                                                |                             |              | <b>8,879</b>  |                             |              | <b>7,995</b>  |

## Other Information

|                                              | Segment Assets         |                        | Segment Liabilities    |                        |
|----------------------------------------------|------------------------|------------------------|------------------------|------------------------|
|                                              | As at 31st March, 2022 | As at 31st March, 2021 | As at 31st March, 2022 | As at 31st March, 2021 |
| Home care                                    | 3,999                  | 3,175                  | 3,755                  | 3,404                  |
| Beauty & Personal care                       | 6,239                  | 5,910                  | 5,670                  | 5,636                  |
| Foods and Refreshment                        | 49,669                 | 49,510                 | 3,140                  | 3,358                  |
| Others (includes Exports, Consignment, etc.) | 1,413                  | 1,068                  | 682                    | 608                    |
| <b>Total</b>                                 | <b>61,320</b>          | <b>59,663</b>          | <b>13,247</b>          | <b>13,006</b>          |
| Unallocated Corporate Assets / (Liabilities) | 9,197                  | 9,094                  | 8,183                  | 8,057                  |
| <b>Total Assets / (Liabilities)</b>          | <b>70,517</b>          | <b>68,757</b>          | <b>21,430</b>          | <b>21,063</b>          |

|                                              | Year ended 31st March, 2022 |                           |                                           | Year ended 31st March, 2021 |                            |                                           |
|----------------------------------------------|-----------------------------|---------------------------|-------------------------------------------|-----------------------------|----------------------------|-------------------------------------------|
|                                              | Capital expenditure         | Depreciation/Amortisation | Non-cash expenses other than depreciation | Capital expenditure         | Depreciation/Amortisation* | Non-cash expenses other than depreciation |
| Home care                                    | 280                         | 213                       | 38                                        | 366                         | 245                        | 89                                        |
| Beauty & Personal care                       | 512                         | 544                       | 44                                        | 407                         | 472                        | 105                                       |
| Foods & Refreshment                          | 361                         | 300                       | 34                                        | 1,684                       | 324                        | 73                                        |
| Others (includes Exports, Consignment, etc.) | 59                          | 34                        | 12                                        | 48                          | 33                         | 3                                         |

\*In addition to the above, ₹15 crores (2020-21: ₹60 crores) of accelerated depreciation has been charged to exceptional items under a restructuring project.

### 3.8 MEASUREMENT

The amount of each segment item reported should be the measure reported to the CODM for the purposes of making decisions about allocating resources to the segment and assessing its performance. Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses should be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Similarly, only those assets and liabilities that are included in the measures of the segment's assets and segment's liabilities that are used by the chief operating decision maker should be reported for that segment. If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts should be allocated on a reasonable basis.

If the CODM uses only one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities in assessing segment performance and deciding how to allocate resources, segment profit or loss, assets and liabilities should be reported at those measures. If the CODM uses more than one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities, the reported measures should be those that management believes are determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements.

An entity should provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity should disclose the following:

- (a) the basis of accounting for any transactions between reportable segments;

- (b) the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income and discontinued operations (if not apparent from the reconciliations). Those differences could include accounting policies and policies or allocation of centrally incurred costs that are necessary for an understanding of the reported segment information;
- (c) the nature of any differences between the measurements of the reportable segments' assets and the entity's assets (if not apparent from the reconciliations). Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information;
- (d) the nature of any differences between the measurements of the reportable segments' liabilities and the entity's liabilities (if not apparent from the reconciliations). Those differences could include accounting policies and policies for allocation of jointly utilised liabilities that are necessary for an understanding of the reported segment information;
- (e) the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss; and
- (f) the nature and effect of any asymmetrical allocations to reportable segments. For example, an entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.

#### Illustration 10

*GH Ltd. has four distinct operating segments. The management of GH is concerned as it is unsure on how common costs be reasonably allocated to different operating segments. They intend to allocate management charges, interest costs of internal funding, cost of management of properties and pension costs.*

*Analyse, whether such costs need to conform to the accounting policies as used to prepare the financial statements.*

#### Solution

Ind AS 108 does not prescribe any specific basis but suggests that a reasonable basis to be used in allocation of common costs. Here, it may not be reasonable to allocate management charges to most profitable segment. However, it may be reasonable to charge interest costs of internal funding on the basis of actual usage over time, even if majority of funds are used for running a loss-making segment.

A reasonable manner of allocation of above costs could be:

**Management Charges:** These may be allocated based on Net Assets invested or Revenue earned by the segments. It needs to be understood if there is an operating segment which is yet



to earn revenue, it would fail to have any costs being allocated.

**Interest costs:** As mentioned above, these may be allocated on the basis of actual usage and time.

**Cost of management of properties:** Based on value of property used at each segment.

**Pension costs:** Based on salary expenses of each segment.

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### Measurement of operating segment profit or loss, assets and liabilities

The accounting policies of the operating segments are the same as those described in the significant accounting policies except that pension expense for each operating segment is recognised and measured based on cash payments to the pension plan. Diversified Company evaluates performance based on profit or loss from operations before tax expense not including non-recurring gains and losses and foreign exchange gains and losses.

Diversified Company accounts for inter-segment sales and transfers as if the sales or transfers were to third parties, i.e., at current market prices.

### 3.8.1 Reconciliations

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An entity should provide reconciliations of all of the following:

- (a) the total of the reportable segments' revenues to the entity's revenue;
- (b) the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to the entity's profit or loss after those items;
- (c) the total of the reportable segments' assets to the entity's assets if the segment assets are reported;
- (d) the total of the reportable segments' liabilities to the entity's liabilities if segment liabilities are reported; and
- (e) the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.

All material reconciling items should be separately identified and described. For example, the amount of each material adjustment needed to reconcile reportable segment profit or loss to the entity's profit or loss arising from different accounting policies should be separately identified and described.

The following illustrate reconciliations of reportable segment revenues, profit or loss, assets and liabilities to the entity's corresponding amounts. Reconciliations also are required to be shown for every other material item of information disclosed. The entity's financial statements are assumed not to include discontinued operations. The entity recognises and measures pension expense of its reportable segments on the basis of cash payments to the pension plan, and it does not allocate certain items to its reportable segments.

### Reconciliation of reportable segment revenues, profit or loss, assets and liabilities

|                                                       |               |
|-------------------------------------------------------|---------------|
| <b>Revenues</b>                                       | ₹             |
| Total revenues for reportable segments                | 39,000        |
| Other revenues                                        | 1,000         |
| Elimination of intersegment revenues                  | (4,500)       |
| Entity's revenues                                     | 35,500        |
| <b>Profit or Loss</b>                                 | ₹             |
| Total profit or loss for reportable segments          | 3,970         |
| Other profit or loss                                  | 100           |
| Elimination of intersegment profits                   | (500)         |
| Unallocated amounts:                                  |               |
| Litigation settlement received                        | 500           |
| Other corporate expenses                              | (750)         |
| Adjustment to pension expense in consolidation        | (250)         |
| Income before income tax expense                      | 3,070         |
| <b>Assets</b>                                         | ₹             |
| Total assets for reportable segments                  | 79,000        |
| Other assets                                          | 2,000         |
| Elimination of receivable from corporate headquarters | (1,000)       |
| Other unallocated amounts                             | 1,500         |
| Entity's assets                                       | 81,500        |
| <b>Liabilities</b>                                    | ₹             |
| Total liabilities for reportable segments             | 43,850        |
| Unallocated defined benefit pension liabilities       | 25,000        |
| Entity's liabilities                                  | <u>68,850</u> |



| Other material items                           | Reportable<br>Segment totals<br>₹ | Adjustments<br>₹ | Entity totals<br>₹ |
|------------------------------------------------|-----------------------------------|------------------|--------------------|
| Interest revenue                               | 3,750                             | 75               | 3,825              |
| Interest expenses                              | 2,750                             | (50)             | 2,700              |
| Net interest revenue<br>(finance segment only) | 1,000                             | -                | 1,000              |
| Expenditure for assets                         | 2,900                             | 1,000            | 3,900              |
| Depreciation and amortisation                  | 2,950                             | -                | 2,950              |
| Impairment of assets                           | 200                               | -                | 200                |

The reconciling item to adjust expenditures for assets is the amount incurred for the corporate headquarters building, which is not included in segment information. None of the other adjustments are material.

### 3.9 RESTATEMENT OF PREVIOUSLY REPORTED INFORMATION

If an entity changes the structure of its internal organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, should be restated unless the information is not available and the cost to develop it would be excessive. The determination of whether the information is not available and the cost to develop it would be excessive should be made for each individual item of disclosure. Following a change in the composition of its reportable segments, an entity should disclose whether it has restated the corresponding items of segment information for earlier periods.

If an entity has changed the structure of its internal organisation in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is not restated to reflect the change, the entity should disclose in the year in which the change occurs segment information for the current period on both the old basis and the new basis of segmentation, unless the necessary information is not available and the cost to develop it would be excessive.

### 3.10 ENTITY-WIDE DISCLOSURES

Some entities' business activities are not organised on the basis of differences in related products and services or differences in geographical areas of operations. Such an entity's reportable segments may report revenues from a broad range of essentially different products

and services, or more than one of its reportable segments may provide essentially the same products and services. Similarly, an entity's reportable segments may hold assets in different geographical areas and report revenues from customers in different geographical areas, or more than one of its reportable segments may operate in the same geographical area. Certain information required should be provided only if it is not provided as part of the reportable segment information required by Ind AS 108.

### 3.10.1 Information about products and services

An entity should report the revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact should be disclosed. The amounts of revenues reported should be based on the financial information used to produce the entity's financial statements.

*Extract from Annual Report for 2021-2022 of Hindustan Unilever Limited*

#### Segment-wise Revenue from operations

The Company has following major segments:-

- (a) Home Care include Fabric Solutions, Home and Hygiene, etc
- (b) Beauty & Personal Care include Skin Cleansing, Skin Care, Hair Care, etc
- (c) Foods & Refreshment include Tea, Health Food Drinks and Coffee, etc
- (d) Others include Exports, Consignment, etc.

|                                              | Year ended<br>31st March, 2022 | Year ended<br>31st March, 2021 |
|----------------------------------------------|--------------------------------|--------------------------------|
| Home Care                                    | 16,578                         | 13,959                         |
| Beauty & Personal Care                       | 19,460                         | 17,964                         |
| Foods & Refreshment                          | 14,105                         | 13,204                         |
| Others (includes Exports, Consignment, etc.) | 1,050                          | 869                            |
| <b>Total</b>                                 | <b>51,193</b>                  | <b>45,996</b>                  |

### 3.10.2 Information about geographical areas

An entity should report the following geographical information, unless the necessary information is not available and the cost to develop it would be excessive:

- (a) revenues from external customers
  - (i) attributed to the entity's country of domicile and
  - (ii) attributed to all foreign countries in total from which the entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues should be disclosed separately. An entity should disclose the basis for attributing revenues from external customers to individual countries; and

- (b) non-current assets (For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the reporting period) other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts (i) located in the entity's country of domicile and (ii) located in all foreign countries in total in which the entity holds assets. If assets in an individual foreign country are material, those assets should be disclosed separately.

The amounts reported should be based on the financial information that is used to produce the entity's financial statements. If the necessary information is not available and the cost to develop it would be excessive, that fact should be disclosed. An entity may provide, in addition to the information required by this paragraph, subtotals of geographical information about groups of countries.

The following illustrates the geographical information required (Because Diversified Company's reportable segments are based on differences in products and services, no additional disclosures of revenue information about products and services are required.)

| Geographical Information | Revenue <sup>(a)</sup><br>₹ | Non-Current Assets<br>₹ |
|--------------------------|-----------------------------|-------------------------|
| United States            | 19,000                      | 11,000                  |
| Canada                   | 4,200                       | -                       |
| China                    | 3,400                       | 6,500                   |
| Japan                    | 2,900                       | 3,500                   |
| Other countries          | <u>6,000</u>                | <u>3,000</u>            |
| Total                    | <u>35,500</u>               | <u>24,000</u>           |

Revenue are attributed to countries on the basis of the customer's location.

*Extract from Annual Report for 2021-2022 of Hindustan Unilever Limited*

#### Additional Information by Geographies

Although the Group's operations are managed by product area, we provide additional information based on geographies.

|                                          | Year ended<br>31st March, 2022 | Year ended<br>31st March, 2021 |
|------------------------------------------|--------------------------------|--------------------------------|
| <b>Revenue by Geographical Market</b>    |                                |                                |
| India                                    | 50,327                         | 45,283                         |
| Outside India                            | 2,119                          | 1,745                          |
|                                          | <b>52,446</b>                  | <b>47,028</b>                  |
| <b>Carrying Amount of Segment Assets</b> |                                |                                |
| India                                    | 60,771                         | 59,256                         |
| Outside India                            | 549                            | 407                            |
|                                          | <b>61,320</b>                  | <b>59,663</b>                  |

### 3.10.3 Information about major customers

An entity should provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10% or more of an entity's revenues, the entity should disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer. For the purposes of Ind AS 108, a group of entities known to a reporting entity to be under common control should be considered a single customer. However, judgement is required to assess whether a government (including government agencies and similar bodies whether local, national or international) and entities known to the reporting entity to be under the control of that government are considered a single customer. In assessing this, the reporting entity should consider the extent of economic integration between those entities.

The following illustrates the information about major customers. Neither the identity of the customer nor the amount of revenues for each operating segment is required.

Revenues from one customer of Diversified Company's software and electronics segments represent approximately ₹ 5,000 of the Company's total revenues.

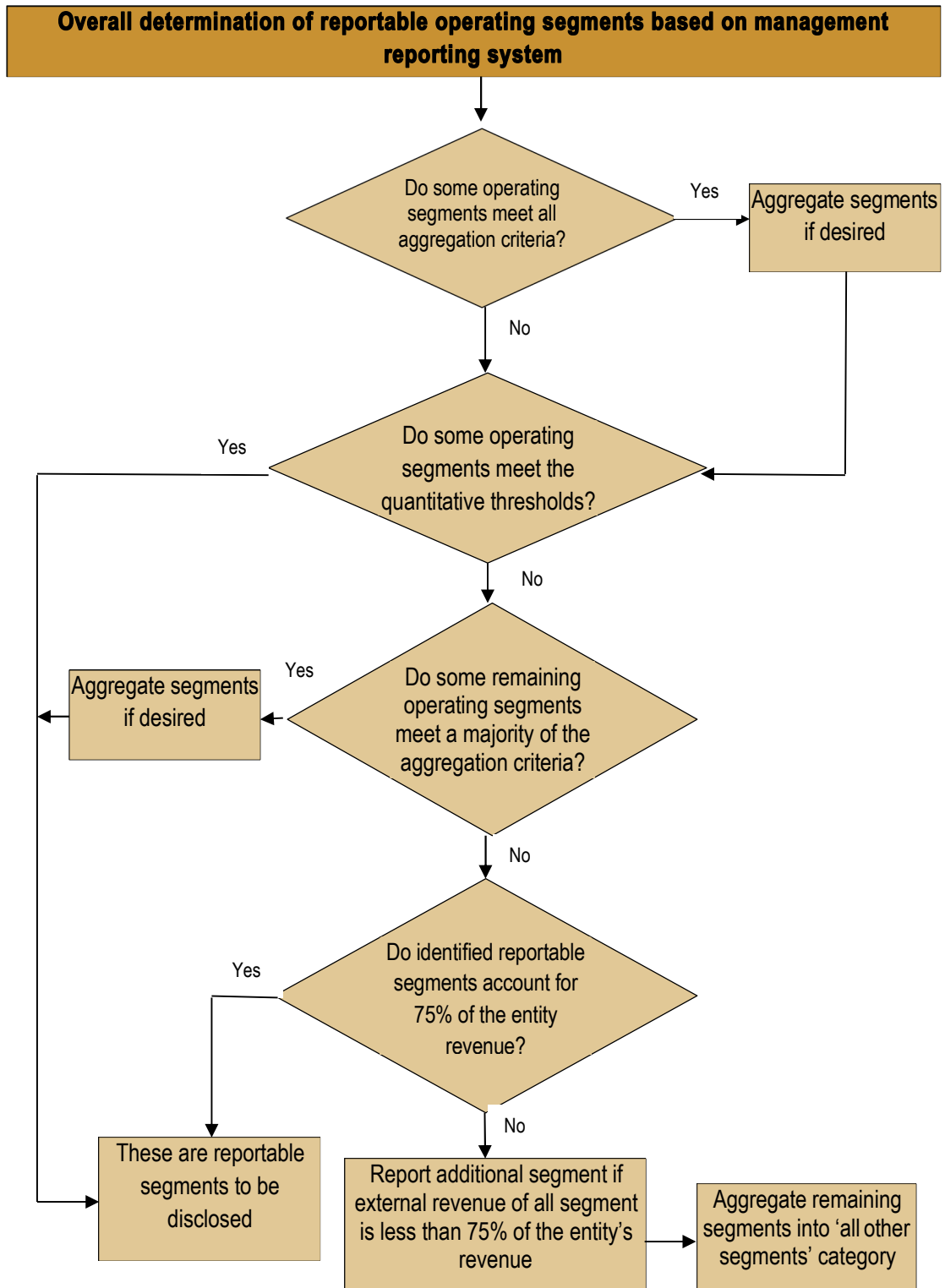
*Extract from Annual Report for 2021-22 of Hindustan Unilever Limited*

#### **Revenue from major customers**

The Group is not reliant on revenues from transactions with any single external customer and does not receive 10% or more of its revenues from transactions with any single external customer.

### **Diagram to assist in identifying reportable segments**

The following diagram illustrates how to apply the main provisions for identifying reportable segments as defined in Ind AS 108.





### 3.11 SIGNIFICANT DIFFERENCES IN IND AS 108 *VIS-A-VIS* AS 17

| S. No. | Particulars                                           | Ind AS 108                                                                                                                                                                                                                                                                                                                                                                      | AS 17                                                                                                                                                                                                                                                                                   |
|--------|-------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.     | <i>Approach for identification of segments</i>        | Identification of segments under Ind AS 108 is based on 'management approach' i.e., operating segments are identified based on the internal reports regularly reviewed by the entity's chief operating decision maker.                                                                                                                                                          | AS 17 requires identification of two sets of segments; one based on related products and services, and the other on geographical areas based on the risks and returns approach. One set is regarded as primary segments and the other as secondary segments.                            |
| 2.     | <i>Basis for reporting the segments</i>               | Ind AS 108 requires that the amounts reported for each operating segment should be measured on the same basis as that used by the chief operating decision maker for the purposes of allocating resources to the segments and assessing its performance. It does not define the terms segment revenue, segment expense, segment result, segment assets and segment liabilities. | AS 17 requires segment information to be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements.<br><br>Accordingly, AS 17 defines segment revenue, segment expense, segment result, segment assets and segment liabilities. |
| 3.     | <i>Aggregation criteria</i>                           | Ind AS 108 specifies aggregation criteria for aggregation of two or more segments and also requires the related disclosures in this regard.                                                                                                                                                                                                                                     | AS 17 does not deal specifically with this aspect.                                                                                                                                                                                                                                      |
| 4.     | <i>Disclosure in case of single reporting segment</i> | Ind AS 108 requires certain disclosures even in case of entities having single reportable segment.                                                                                                                                                                                                                                                                              | AS 17 states that in case there is neither more than one business segment nor more than one geographical segment,                                                                                                                                                                       |

|    |                               |                                                                                                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
|----|-------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|    |                               |                                                                                                                                                                                                                                                                                                                                                                                                 | segment information as per this standard is not required to be disclosed. However, this fact shall be disclosed by way of footnote.                                                                                                                                                                                                                                                                                                                                                                                                               |
| 5. | <i>Disclosure of Interest</i> | Ind AS 108 requires separate disclosures about interest revenue and interest expense of each reportable segment, therefore, these aspects have not been specifically dealt with.                                                                                                                                                                                                                | As per AS 17, interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense. It also provides that in case interest is included as a part of the cost of inventories and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. These aspects are specifically dealt with keeping in view that the definition of 'segment expense' given in AS 17 excludes interest. |
| 6. | <i>Disclosure basis</i>       | Ind AS 108 requires disclosures of revenues from external customers for each product and service. Regarding geographical information, it requires the disclosure of revenues from customers in the country of domicile and in all foreign countries, non-current assets in the country of domicile and all foreign countries. It also requires disclosure of information about major customers. | Disclosures in AS 17 are based on the classification of the segments as primary or secondary segments. Disclosure requirements for primary segments are more detailed as compared to secondary segments.                                                                                                                                                                                                                                                                                                                                          |

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



## TEST YOUR KNOWLEDGE

### Questions

1. X Ltd. has identified 4 operating segments for which revenue data is given below:

|                      | External Revenue (₹)    | Internal Revenue (₹)    | Total (₹)                 |
|----------------------|-------------------------|-------------------------|---------------------------|
| Segment A            | 30,00,000               | Nil                     | 30,00,000                 |
| Segment B            | 6,50,000                | Nil                     | 6,50,000                  |
| Segment C            | 8,50,000                | 1,00,000                | 9,50,000                  |
| Segment D            | <u>5,00,000</u>         | <u>49,00,000</u>        | <u>54,00,000</u>          |
| <b>Total Revenue</b> | <b><u>50,00,000</u></b> | <b><u>50,00,000</u></b> | <b><u>1,00,00,000</u></b> |

Additional information:

Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years.

Which of the segments would be reportable under the criteria identified in Ind AS 108?

2. X Ltd. operates in coating industry. Its business segments comprise **Coating** (consisting of decorative, automotive, industrial paints and related activities) and **Others** (consisting of chemicals, polymers and related activities). Certain information for financial year 20X1-20X2 is given below: (₹ in lakhs)

| Segments | External Revenue (including GST) | GST   | Other operating income | Result | Asset  | Liabilities |
|----------|----------------------------------|-------|------------------------|--------|--------|-------------|
| Coating  | 2,00,000                         | 5,000 | 40,000                 | 10,000 | 50,000 | 30,000      |
| Others   | 70,000                           | 3,000 | 15,000                 | 4,000  | 30,000 | 10,000      |



Additional information:

1. Unallocated income net of expenses is ₹ 30,00,00,000
2. Interest and bank charges is ₹ 20,00,00,000
3. Income tax expenses is ₹ 20,00,00,000 (current tax ₹ 19,50,00,000 and deferred tax ₹ 50,00,000)
4. Unallocated Investments are ₹ 1,00,00,00,000 and other assets are ₹ 1,00,00,00,000.
5. Unallocated liabilities, Reserves & surplus and share capital are ₹ 2,00,00,00,000, ₹ 3,00,00,00,000 & ₹ 1,00,00,00,000 respectively.
6. Depreciation amounts for coating & others are ₹ 10,00,00,000 and ₹ 3,00,00,000 respectively.
7. Capital expenditure for coating and others are ₹ 50,00,00,000 and ₹ 20,00,00,000 respectively.
8. Revenue from outside India is ₹ 6,20,00,00,000 and segment asset outside India ₹ 1,00,00,00,000.

Based on the above information, comment how X Ltd. would disclose information about reportable segment revenue, profit or loss, assets and liabilities for financial year 20X1-20X2.

3. An entity uses the weighted average cost formula to assign costs to inventories and cost of goods sold for financial reporting purposes, but the reports provided to the chief operating decision maker use the First-In, First-Out (FIFO) method for evaluating the performance of segment operations.

State the cost formula to be used for Ind AS 108 disclosure purposes.

4. ABC Limited has 5 operating segments namely A, B, C, D and E. The profit / loss of respective segments for the year ended 31<sup>st</sup> March, 20X1 are as follows:

| Segment      | Profit/(Loss)<br>(₹ in crore) |
|--------------|-------------------------------|
| A            | 780                           |
| B            | 1,500                         |
| C            | (2,300)                       |
| D            | (4,500)                       |
| E            | 6,000                         |
| <b>Total</b> | <b>1,480</b>                  |

Based on the quantitative thresholds, state which of the above segments A to E would be considered as reportable segments for the year ending 31<sup>st</sup> March, 20X1.

## Answers

1. Threshold amount is ₹ 10,00,000 ( $₹ 1,00,00,000 \times 10\%$ ).

Segment A exceeds the quantitative threshold ( $₹ 30,00,000 > ₹ 10,00,000$ ) and hence reportable segment.

Segment D exceeds the quantitative threshold ( $₹ 54,00,000 > ₹ 10,00,000$ ) and hence reportable segment.

Segment B & C do not meet the quantitative threshold amount and may not be classified as reportable segment.

However, the total external revenue generated by these two segments A & D represent only 70% [ $(₹ 35,00,000 / 50,00,000) \times 100$ ] of the entity's total external revenue. If the total external revenue reported by operating segments constitutes less than 75% of the entity total revenue, additional operating segments should be identified as reportable segments until at least 75% of the revenue is included in reportable segments.

In case of X Ltd., it is given that Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years. In accordance with the requirement of Ind AS 108, X Ltd. designates this start-up segment C as a reportable segment, making the total external revenue attributable to reportable segments 87% [ $(₹ 43,50,000 / 50,00,000) \times 100$ ] of total entity revenues.

In this situation, Segments A, C and D will be reportable segments and Segment B will be shown as other segment.

**Alternatively**, segment B can be considered as a reportable segment as well as it meets the definition of operating segment. If Segment B is considered as reportable segment:

External revenue reported:  $₹ 30,00,000 + ₹ 6,50,000 + ₹ 5,00,000 = ₹ 41,50,000$

% of Total External Revenue =  $₹ 41,50,000 / ₹ 50,00,000 = 83\%$

Accordingly, Segments A, B and D will be reportable segments and Segment C will be shown as other segment.

## 2. Segment information

(A) Information about operating segment

(1) the company's operating segments comprise:

**Coatings:** consisting of decorative, automotive, industrial paints and related activities.

**Others:** consisting of chemicals, polymers and related activities.

(2) Segment revenues, results and other information.

(₹ in Lakhs)

|     | Revenue                                                               | Coating  | Others  | Total    |
|-----|-----------------------------------------------------------------------|----------|---------|----------|
| 1.  | External Revenue (gross)                                              | 2,00,000 | 70,000  | 2,70,000 |
|     | GST                                                                   | (5,000)  | (3,000) | (8,000)  |
|     | Total Revenue (net)                                                   | 1,95,000 | 67,000  | 2,62,000 |
|     | Other Operating Income                                                | 40,000   | 15,000  | 55,000   |
|     | Total Revenue                                                         | 2,35,000 | 82,000  | 3,17,000 |
| 2.  | Results                                                               |          |         |          |
|     | Segment results                                                       | 10,000   | 4,000   | 14,000   |
|     | Unallocated income (net of unallocated expenses)                      |          |         | 3,000    |
|     | Profit from operation before interest, taxation and exceptional items |          |         | 17,000   |
|     | Interest and bank charges                                             |          |         | (2,000)  |
|     | Profit before exceptional items                                       |          |         | 15,000   |
|     | Exceptional items                                                     |          |         | Nil      |
|     | Profit before taxation                                                |          |         | 15,000   |
|     | Income Taxes                                                          |          |         |          |
|     | -Current taxes                                                        |          |         | (1,950)  |
|     | -Deferred taxes                                                       |          |         | (50)     |
|     | Profit after taxation                                                 |          |         | 13,000   |
| 3.  | Other Information                                                     |          |         |          |
| (a) | Assets                                                                |          |         |          |
|     | Segment Assets                                                        | 50,000   | 30,000  | 80,000   |
|     | Investments                                                           |          |         | 10,000   |
|     | Unallocated assets                                                    |          |         | 10,000   |
|     | Total Assets                                                          |          |         | 1,00,000 |
| (b) | Liabilities and Shareholder's funds                                   |          |         |          |
|     | Segment liabilities                                                   | 30,000   | 10,000  | 40,000   |
|     | Unallocated liabilities                                               |          |         | 20,000   |
|     | Share capital                                                         |          |         | 10,000   |

|                                 |                                                  |                      |                                  |                        |
|---------------------------------|--------------------------------------------------|----------------------|----------------------------------|------------------------|
|                                 | Reserves and surplus                             |                      |                                  | <u>30,000</u>          |
|                                 | <b>Total liabilities and shareholder's funds</b> |                      |                                  | <b><u>1,00,000</u></b> |
| <b>(c)</b>                      | <b>Others</b>                                    |                      |                                  |                        |
|                                 | Capital Expenditure                              | (5,000)              | (2,000)                          | (7,000)                |
|                                 | Depreciation                                     | (1,000)              | (300)                            | (1,300)                |
| <b>Geographical Information</b> |                                                  |                      |                                  | <b>(₹ in lakhs)</b>    |
|                                 |                                                  | <b>India<br/>(₹)</b> | <b>Outside<br/>India<br/>(₹)</b> | <b>Total<br/>(₹)</b>   |
|                                 | Revenue                                          | 2,55,000             | 62,000                           | 3,17,000               |
|                                 | Segment assets                                   | 90,000               | 10,000                           | 1,00,000               |
|                                 | Capital expenditure                              | 7,000                |                                  | 7,000                  |

**Notes:**

- (i) The operating segments have been identified in line with the Ind AS 108, taking into account the nature of product, organisation structure, economic environment and internal reporting system.
  - (ii) Segment revenue, results, assets and liabilities include the respective amounts identifiable to each of the segments. Unallocable assets include unallocable non-current assets and other current assets. Unallocable liabilities include unallocable current liabilities and net deferred tax liability.
  - (iii) Corresponding figures for previous year have not been provided. However, in a practical scenario the corresponding figures would need to be given.
3. The entity should use First-in-first-out (FIFO) method for its Ind AS 108 disclosures, even though it uses the weighted average cost formula for measuring inventories for inclusion in its financial statements. Where chief operating decision maker uses only one measure of segment asset, same measure should be used to report segment information. Accordingly, in the given case, the method used in preparing the financial information for the chief operating decision maker should be used for reporting under Ind AS 108.
- However, reconciliation between the segment results and results as per financial statements needs to be given by the entity in its segment report.
4. With regard to quantitative thresholds to determine reportable segment relevant in context of instant case, paragraph 13(b) of Ind AS 108 may be noted which provides as follows:

"The absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not

report a loss and (ii) the combined reported loss of all operating segments that reported a loss.”

In compliance with Ind AS 108, the segment profit/loss of respective segment will be compared with the greater of the following:

- (i) All segments in profit, i.e., A, B and E – Total profit ₹ 8,280 crores.
- (ii) All segments in loss, i.e., C and D – Total loss ₹ 6,800 crores.

Greater of the above – ₹ 8,280 crores.

Based on the above, reportable segments will be determined as follows:

| Segment      | Profit/(Loss)<br>(₹ in crore) | As absolute % of<br>₹ 8,280 crore | Reportable<br>segment |
|--------------|-------------------------------|-----------------------------------|-----------------------|
| A            | 780                           | 9%                                | No                    |
| B            | 1,500                         | 18%                               | Yes                   |
| C            | (2,300)                       | 28%                               | Yes                   |
| D            | (4,500)                       | 54%                               | Yes                   |
| E            | <u>6,000</u>                  | 72%                               | Yes                   |
| <b>Total</b> | <b><u>1,480</u></b>           |                                   |                       |

Hence B, C, D, E are reportable segments.

[illegible]



# ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS



## LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Define financial asset, financial liability and equity
- ❑ Examine the scope of financial instruments and items excluded from scope of financial instruments
- ❑ Understand the application of these definitions and scope to different forms of instruments
- ❑ Determine whether the financial instruments such as preference shares, debentures and bonds will be classified under “equity” or “financial liabilities” or components thereof will be classified under both
- ❑ Apply necessary accounting principles for determining when a financial liability can be offset with a financial asset
- ❑ Apply accounting principles for recognition of financial assets and financial liabilities
- ❑ Classify financial asset and financial liability
- ❑ Determine the accounting treatment for regular way purchase or sale of financial assets



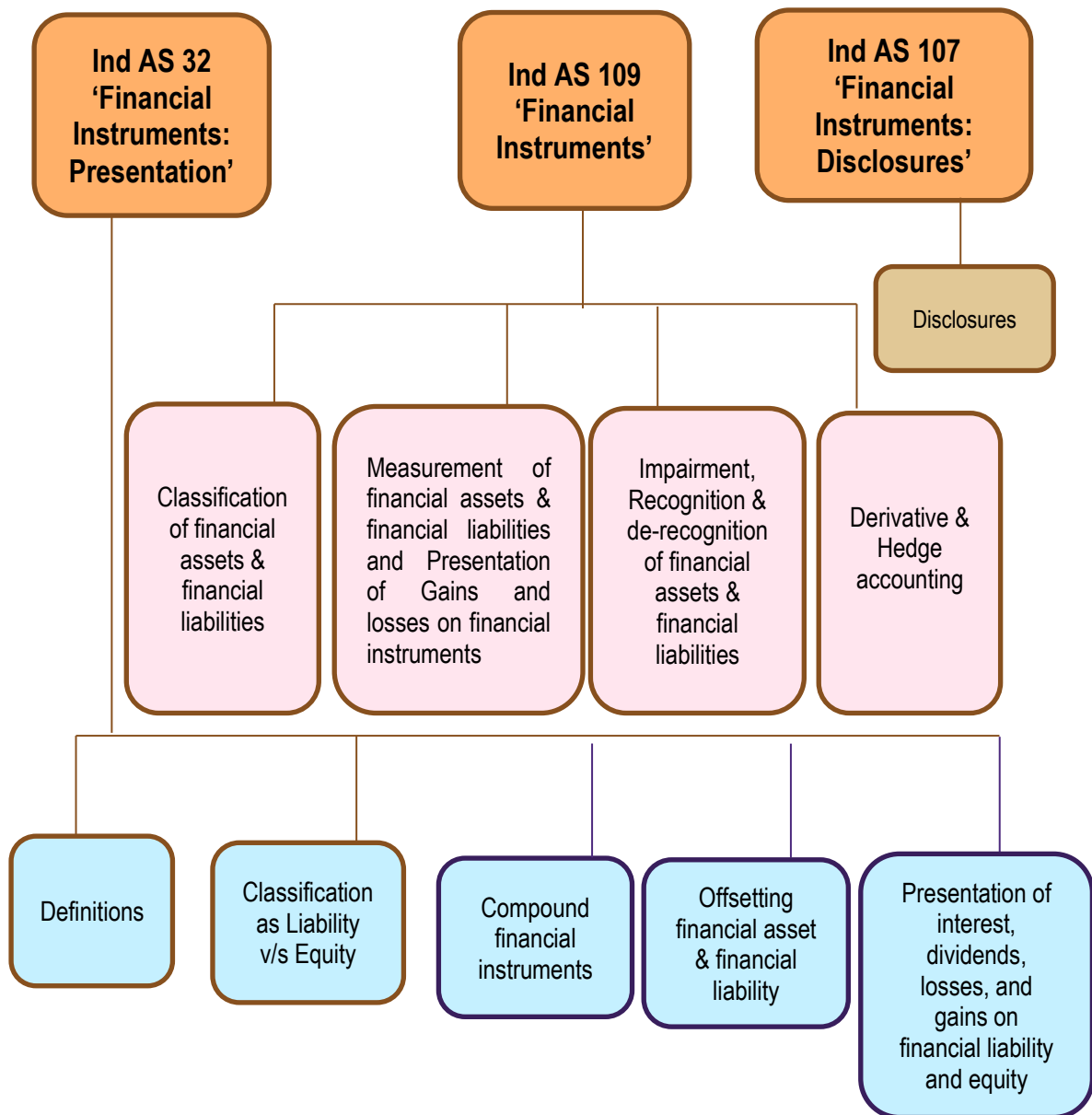
- ❑ Measure financial assets initially and subsequently
- ❑ Measure financial liability initially and subsequently
- ❑ Reclassify the financial instrument and deal with the accounting aspect upon reclassification
- ❑ Acquire the conceptual understanding of “derivatives” and “embedded derivatives”,
- ❑ Identify the situations in which embedded derivatives need to be separated and
- ❑ Deal with the Accounting principles in the situations in which embedded derivatives are so separated
- ❑ Identify the hedged items
- ❑ Designate the items as hedged items/instruments
- ❑ Qualify instruments for hedge accounting
- ❑ Determine the criteria for qualifying the items as hedge items and its accounting.
- ❑ Determine whether or not a transfer qualifies for derecognition and accounting treatment in various situations
- ❑ Apply accounting principles for derecognition of financial liabilities, including evaluating practical complexities involved in exchange of financial instruments or parts thereof
- ❑ Disclose necessary details regarding financial instruments as per the standards

## CHAPTER OVERVIEW



The chapter is divided into 7 units-

- a) **Unit 1 'Financial Instruments: Scope and Definitions'** deals with a brief introduction of financial instruments, definitions of financial instrument, financial asset, financial liability and equity instrument. It also discusses the contracts which are included and excluded from the scope of the standards on Financial Instruments.
- b) **Unit 2 'Classification and Measurement of Financial Assets and Financial Liabilities'**, deals with criterias for classification, measurement (initially and subsequently), reclassification of financial assets and financial liabilities. It further discusses impairment of financial assets.
- c) **Unit 3 'Financial Instruments: Equity and Financial Liabilities'** covers the analysis of the definition of financial liabilities and equity. It also deliberates critical features in differentiating a financial liability from an equity instrument and delves into various aspects which help in determining the liability as financial liability. The unit also explains when an instrument is a compound financial instrument. It also analyses treasury shares, interest, dividends, losses and gains. Finally, it elucidates offsetting a financial asset and financial liability.
- d) **Unit 4 'Derivatives and Embedded Derivatives'** defines the two derivatives with examples and the manner of separating the embedded derivatives from the host contract alongwith the characteristics differences and deals with the accounting thereof.
- e) **Unit 5 'Recognition and Derecognition of Financial Instruments'** covers guidance prescribed in the standard on initial recognition of financial instruments. It also takes into account, the timings of recognition and accounting treatment under various situations. Later on, it discusses the derecognition of financial instruments and situations under which derecognition will be considered or not. The unit also covers the extinguishment and modification of financial liabilities and accounting of debt for equity swaps.
- f) **Unit 6 'Hedge Accounting'** covers identification and designation of hedge items, criteria qualifying an item as hedge item and accounting thereof.
- g) **Unit 7 'Disclosures'** covers disclosure requirements as stated in the standard.



## UNIT 1: FINANCIAL INSTRUMENTS: SCOPE AND DEFINITIONS



### 1.1 INTRODUCTION

With the changing landscape of Indian economy and more liberalisation, raising funds in national and international markets through different forms of instruments has gathered momentum. As companies expand their horizon, investors at the same time are getting cautious to invest through different means to achieve their intended objective, which could have fixed return like a debt instrument or a residual share in net assets like equity or both. Several type of instruments are issued like convertible preference shares, FCCBs, foreign currency loans, debt syndication arrangements, loans from group companies, etc. by borrowing entities for raising funds. Accounting treatment of these instruments in the books, with introduction of Indian Accounting Standards (Ind AS) is important for us to understand to reflect proper financial reporting for users of financial statements that provides relevant and faithful representation of the financial performance, financial position, and cash flows of the reporting entity.

**MCA notified following Ind AS to deal with accounting of financial instruments:**

- Ind AS 109 – Financial instruments
- Ind AS 32 – Financial instruments: Presentation
- Ind AS 107 – Financial Instruments: Disclosures

These Ind AS are largely aligned with the prevailing guidance in IFRS which require classification of a financial instrument based on substance of the arrangement between the parties rather than their legal form and the definition of financial asset, financial liability and equity. Further, recognition and measurement criteria are also driven based on classification of such instruments.



### 1.2 WHAT ARE FINANCIAL INSTRUMENTS?

A **financial instrument** is any **contract** that gives rise to a **financial asset** of one entity and a **financial liability** or **equity instrument** of another entity.

- Here, a **contract** refers to an agreement between two or more parties that has clear economic consequences and which parties usually are bound to adhere, usually because the agreement is enforceable by law.
- Contracts need not be in writing and may take a variety of forms.
- An important point to note is any assets or liabilities that are not contractual are not financial liabilities or financial assets. For eg.: income taxes are a statutory obligation and not arising from contract, constructive obligations as defined in Ind AS 37 – Provisions,

Contingent Liabilities and Contingent Assets do not arise from contracts and hence, are not financial liabilities, etc.

- Financial instruments include:
  - (a) Primary instruments (such as receivables, payables and equity instruments) and
  - (b) Derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps).

While the examples above provide an indication of what financial instruments comprise, let's understand the definition of each of these type of financial instruments in greater detail.



### 1.3 WHAT IS A FINANCIAL ASSET?

A **'financial asset'** is any asset that is:

- (a) **Cash**;
- (b) An equity instrument of another entity;
- (c) A **contractual right**:
  - (i) to receive cash or another financial asset from another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or
- (d) a contract that will or may be settled in **entity's own equity instruments** and is:
  - (i) a non-derivative for which the entity is or may be obliged to receive a variable number of entity's own equity instruments; or
  - (ii) a derivative that will or may be settled other than by exchange of fixed amount of cash or another financial asset for a fixed number of entity's own equity instruments. For this purpose, entity's own equity instruments do not include puttable financial instruments classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a pro-rata share of net assets of the entity on liquidation and are classified as equity instruments, or instruments that are themselves contracts for future receipt or delivery of entity's own equity instruments.

On the basis of the above definition, a financial asset can be either of the following –

#### Financial asset

Common examples

- ❖ Cash
- ❖ Trade receivables
- ❖ Investments in bonds and deposits
- ❖ Investment in equity instruments
- ❖ Loans receivable, etc.

- On the basis of the above definition, some of the key elements to understand:

|                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|-------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Cash</b>                                                       | <ul style="list-style-type: none"> <li>❖ Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements.</li> <li>❖ A deposit of cash with bank or other financial institution represents a contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| <b>Contractual right to receive cash or other financial asset</b> | <ul style="list-style-type: none"> <li>❖ A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument.<br/>Common examples of contractual right to receive cash and corresponding financial liability representing other party's contractual obligation to deliver cash in future are:             <ol style="list-style-type: none"> <li>1. Trade receivables;</li> <li>2. Loans and Notes receivable</li> <li>3. Deposits made;</li> <li>4. Investment in bonds, etc.</li> </ol> </li> <li>❖ The ability to exercise a contractual right or to satisfy a contractual obligation may be absolute or it may be contingent on occurrence of one or more future events, not wholly within the control of either party to the contractual arrangement.</li> <li>❖ A contingent right and obligation meets the definition of financial asset and financial liability, even though such assets and liabilities are not always recognized in the financial statements. For eg.: A lender may be provided with a financial guarantee by a party ('guarantor') on behalf of borrower, entitling to recover the outstanding dues from the guarantor if the borrower were to default, etc. It may be noted that paragraph 2 of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' excludes from its scope financial instruments within the scope of Ind AS 109. Therefore, financial guarantee contracts cannot be disclosed as contingent liability.</li> </ul> |

- **Physical assets, right-of-use assets and intangible assets**

- ◆ Physical assets (such as inventories, property, plant and equipment), right-of-use assets and intangible assets (such as patents and trademarks) are not financial assets.
- ◆ Control of such physical assets, right-of-use assets and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

- **Prepaid expenses**

- ◆ Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
- ◆ Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

- **'Perpetual' debt instruments**

Perpetual debt instruments such as 'perpetual' bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future.

### Example 1

*Evaluate the financial assets.*

| S. No. | Particulars                    | Whether FA or not | Remarks                                   |
|--------|--------------------------------|-------------------|-------------------------------------------|
| 1      | Investment in bonds debentures | FA                | • Contractual right to receive cash.      |
| 2      | Loans and receivables          | FA                | • Contractual right to receive cash.      |
| 3      | Deposits given                 | FA                | • Contractual right to receive cash.      |
| 4      | Trade & other receivables      | FA                | • Contractual right to receive cash.      |
| 5      | Cash and cash equivalents      | FA                | • Specifically covered in the definition. |
| 6      | Bank balance                   | FA                | • Contractual right to receive cash.      |

| S. No. | Particulars                                                                      | Whether FA or not | Remarks                                                                                                                                                                                                                                        |
|--------|----------------------------------------------------------------------------------|-------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 7      | Investments in equity shares                                                     | FA                | <ul style="list-style-type: none"> <li>Equity instrument of another entity.</li> </ul>                                                                                                                                                         |
| 8      | Perpetual debt instruments<br>Eg. perpetual bonds, debentures and capital notes. | FA                | <ul style="list-style-type: none"> <li>Such instruments provide the contractual right to receive interest for indefinite future or a right to return of principal under terms that make it very unlikely or very far in the future.</li> </ul> |
| 9      | Physical assets<br>Eg. inventories, property, plant and equipment etc.           | No                | <ul style="list-style-type: none"> <li>Control of such assets does not create a present right to receive cash or another financial asset.</li> </ul>                                                                                           |
| 10     | Right to use assets<br>Eg. Lease vehicle etc.                                    | No                | <ul style="list-style-type: none"> <li>Control of such assets does not create a present right to receive cash or another financial asset.</li> </ul>                                                                                           |
| 11     | Intangibles<br>Eg. Patents, trademark etc.                                       | No                | <ul style="list-style-type: none"> <li>Control of such assets does not create a present right to receive cash or another financial asset.</li> </ul>                                                                                           |
| 12     | Prepaid expenses<br>Eg. Prepaid insurance, prepaid rent etc.                     | No                | <ul style="list-style-type: none"> <li>These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.</li> </ul>                                                                   |
| 13     | Advance given for goods and services                                             | No                | <ul style="list-style-type: none"> <li>These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.</li> </ul>                                                                   |

### Illustration 1: Trade receivables

*A Ltd. makes sale of goods to customers on credit of 45 days. The customers are entitled to earn a cash discount @ 2% per annum if payment is made before 45 days and an interest @ 10% per annum is charged for any payments made after 45 days.*

*Evaluate whether such trade receivable are financial assets or not.*

### Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.



In the above case, A Ltd. has the contractual right to receive cash /bank from its trade receivable recorded in its books of accounts, after the expiry of credit period of 45 days or earlier after passing discounts of 2 % per annum.

Hence, trade receivables would meet the definition of financial assets.

It may be noted that contractual right to receive cash includes contractual right to receipt of money in bank account or any wallet account.

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### Illustration 2: Deposits

*Z Ltd. (the 'Company') makes sale of goods to customers on credit. Goods are carried in large containers for delivery to the dealers' destinations. All dealers are required to deposit a fixed amount of ₹ 10,000 as security for the containers, which is returned only when the contract with Company terminates. The deposits carry 8% per annum which is payable only when the contract terminates.*

*If the containers are returned by the dealers in broken condition or any damage caused, then appropriate adjustments shall be made from the deposits at the time of settlement.*

*How would such deposits be treated in books of the dealers?*

### Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

In the above case, such security deposits are receivable in cash at the end of contract period between the dealer and the Company.

Hence, they meet the definition of financial assets.

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## 1.4 WHAT IS A FINANCIAL LIABILITY?

- A **financial liability** is any liability that is:
  - (a) A **contractual obligation**:
    - (i) To deliver cash or other 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 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 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. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments, 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, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, following type of instruments that meets the definition of a financial liability may still be classified as an equity instrument if they have certain features and meets specific conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32. The definition of financial liability includes a carve-out from IAS 32 that the variability due to foreign currency shall be ignored while classifying a foreign currency convertible bond as equity or liability or compound financial instrument.

For details, refer Unit 3 – Equity and Financial Liabilities.

### Financial liability

#### Common examples

- ❖ Loans and borrowings
- ❖ Payables for purchase of goods & services
- ❖ Finance lease liabilities
- ❖ Redeemable instruments like preference shares, debentures, etc.
- ❖ Guarantee given for repayment of debt upon borrower's default

**Example 2**

*Evaluate the financial Liability.*

| S. No. | Particulars                                                                                                                                  | Whether FL or not | Remarks                                                                                                                        |
|--------|----------------------------------------------------------------------------------------------------------------------------------------------|-------------------|--------------------------------------------------------------------------------------------------------------------------------|
| 1      | Loans payable or bank loan                                                                                                                   | FL                | <ul style="list-style-type: none"> <li>Contractual obligation to pay cash.</li> </ul>                                          |
| 2      | Trade and other payables                                                                                                                     | FL                | <ul style="list-style-type: none"> <li>Contractual obligation to pay cash</li> </ul>                                           |
| 3      | Bills payable / acceptance                                                                                                                   | FL                | <ul style="list-style-type: none"> <li>Contractual obligation to pay cash.</li> </ul>                                          |
| 4      | Deposits received                                                                                                                            | FL                | <ul style="list-style-type: none"> <li>Contractual obligation to pay cash.</li> </ul>                                          |
| 5      | Mandatory redeemable preferences shares                                                                                                      | FL                | Contractual obligation to pay cash.                                                                                            |
| 6      | Financial guarantee given (Also see the scope section to understand when financial guarantee contract can be regarded as insurance contract) | FL                | <ul style="list-style-type: none"> <li>Contractual obligation to pay cash, due to the occurrence of certain events.</li> </ul> |

**Illustration 3: Perpetual debt instruments**

*A Ltd. issues a bond at principal amount of CU 1000 per bond. The terms of bond require annual payments in perpetuity at a stated interest rate of 8 per cent applied to the principal amount of CU 1,000. Assuming 8 per cent to be the market rate of interest for the instrument when it was issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition.*

*Evaluate the financial instrument in the hands of both the holder and the issuer.*

**Solution**

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

- For the Holder – There is right to receive cash in future. Hence, it will be classified as a financial asset
- For the Issuer – There is contractual obligation to pay cash in future. However, the instrument is redeemed at the option of A Ltd. or on liquidation of A Ltd. Therefore, the instrument has characteristics of both equity and financial liability. Such an

instrument is regarded as compound financial instrument (Ref. para 28 of Ind AS 32). See Unit 3 to understand accounting for compound financial instrument.

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**Illustration 4: Creditors for sale of goods**

*A Ltd. (the 'Company') makes purchase of steel for its consumption in normal course of business. The purchase terms provide for payment of goods at 30 days credit and interest payable @ 12% per annum for any delays beyond the credit period.*

*Analyse whether the transaction leads to any financial instruments and if yes, then what is the nature of that financial instrument?*

**Solution**

A financial liability is any liability where there is a contractual obligation to deliver cash or other financial asset to another entity.

In the above case, A Ltd. has entered into a contractual arrangement for purchase of goods at a fixed consideration payable to the creditor. A contractual arrangement that provides for payment in fixed amount of cash to another entity meets the definition of financial liability.

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**Illustration 5: Contract for exchange on unfavorable conditions**

*A Ltd. (the 'Company') makes a borrowing for INR 10 lacs from RBC Bank, with bullet repayment of INR 10 lacs and an annual interest rate of 12% per annum. Now, Company defaults at the end of 5<sup>th</sup> year and consequently, a rescheduling of the payment schedule is made beginning 6<sup>th</sup> year onwards. The Company is required to pay INR 1,300,000 at the end of 6<sup>th</sup> year for one time settlement, in lieu of defaults in payments made earlier.*

- (a) *Does the above instrument meet definition of financial liability? Please explain.*  
(b) *Analyse the differential amount to be exchanged for one-time settlement.*

**Solution**

- (a) A Ltd. has entered into an arrangement wherein against the borrowing, A Ltd. has contractual obligation to make stream of payments (including interest and principal). This meets definition of financial liability.
- (b) Let's compute the amount required to be settled and any differential arising upon one time settlement at the end of 6<sup>th</sup> year –
- ◆ Loan principal amount = ₹ 10,00,000
  - ◆ Amount payable at the end of 6<sup>th</sup> year = ₹ 12,54,400 [10,00,000 x 1.12 x 1.12 (Interest for 5<sup>th</sup> & 6<sup>th</sup> year in default plus principal amount)]
  - ◆ One time settlement = INR 13,00,000
  - ◆ Additional amount payable = ₹ 45,600

The above represents a contractual obligation to pay cash against settlement of a financial liability under conditions that are unfavorable to A Ltd. (owing to additional amount payable in comparison to amount that would have been paid without one time settlement). Hence the rescheduled arrangement meets definition of 'financial liability'.

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## 1.5 WHAT IS AN EQUITY INSTRUMENT?

- As per Ind AS 32.11 – An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
  - As per Ind AS 32.16 – An instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:
    - (a) The instrument includes **no 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 issuer.
    - (b) If the instrument will or may be settled in the **issuer's own equity instruments**, it is:
      - (i) a **non-derivative** that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
      - (ii) a **derivative** that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its 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. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.
- A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

## Equity

- ❖ Equity instruments issued
- ❖ Warrants to issue fixed number of shares at fixed price against each warrant
- ❖ Other instruments convertible into fixed number of equity shares for fixed amount per share, etc.

- The **key characteristics** of an equity instrument have been further explained as follows:

|                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|----------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>No contractual obligation</b></p>            | <ul style="list-style-type: none"> <li>❖ A key characteristic of equity instruments is that they carry no contractual obligation throughout for any payment or distribution towards the holders of such instruments.</li> <li>❖ However, following type of instruments as an exception are 'equity' classified even if they contain an obligation to deliver cash or other financial asset, provided certain requisite criteria are met –             <ol style="list-style-type: none"> <li>1. puttable financial instruments that meet certain conditions</li> <li>2. an instrument, or a component of an instrument, that contains an obligation for the issuing entity to deliver to the holder a pro rata share of the net assets of the issuing entity only on its liquidation.</li> </ol> </li> </ul> <p>The nature of these instruments and the criteria to be met for equity classification are explained in greater detail in Unit 3 – Financial Instruments : Equity and Financial Liabilities.</p>                                                                                                                                                                                 |
| <p><b>Settlement in own equity instruments</b></p> | <ul style="list-style-type: none"> <li>❖ Settlement in own equity instruments is equity classified only if it's a fixed-for-fixed transaction, ie, issue of fixed number of shares and involves a fixed amount of cash or other financial asset.</li> <li>❖ Where an entity enters into a non-derivative contract to issue a fixed number of its own equity instruments in exchange for a fixed amount of cash (or another financial asset), it is an equity instrument of the entity. But this does not apply for instruments that are equity classified being a puttable instrument or other instrument entitling the holder to pro-rata share in net assets that meet specified criteria (refer Unit 3 – Equity and Financial Liabilities).</li> <li>❖ However, if such a contract contains an obligation for the entity to pay cash (or another financial asset), it also gives rise to a liability for the present value of the redemption amount. For example: a forward contract entered into by an entity to repurchase fixed number of its own shares for a fixed amount of cash gives rise to a financial liability to be recorded at present value of redemption amount.</li> </ul> |

- An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obliged to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

**Example 3**

When a Company proposes dividend in its board meeting, no obligation arises because it becomes payable only post approval by shareholders in the annual general meeting. However, when the dividend is approved by shareholders in annual general meeting, the Company has taken an obligation to distribute dividend to its shareholders and hence it's a contractual obligation meeting the definition of financial liability.

- **Examples** of equity instruments include:
  - ◆ Non-puttable ordinary shares, for eg.: equity shares issued by companies
  - ◆ Some puttable instruments (if they meet requisite criteria and are not classified as financial liabilities);
  - ◆ Some 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 (if they meet requisite criteria and are not classified as financial liabilities);
  - ◆ Some types of preference shares (where repayment and distribution is at the discretion of the Issuer);
  - ◆ Warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.
- Basis the above definition of equity and characteristics of such instruments, let's evaluate some typical form of instruments that may be issued and how are they classified –

- ◆ **Preference shares**

Preference shares is a class of shares issued by Indian companies, whose terms may provide for redemption at a pre-determined amount with a fixed return which may be cumulative or discretionary. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attached to the share to determine whether it exhibits the fundamental characteristic of a financial liability or an equity instrument, as explained below:

**(A) Redeemable preference shares:**

| Redemption terms               | Evaluation under Ind AS 32                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
|--------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Redemption at a specified date | This contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. <b>Hence, classified as 'financial liability'.</b>                                                                                            |
| Redemption at option of Holder |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| Redemption at option of Issuer | An option of the issuer to redeem shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. <b>Hence, classified as 'equity instrument'.</b><br><br>An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares, at which time this instrument shall be reclassified from 'equity' to 'financial liability'. |

**(B) Non-redeemable preference shares**

Non-redeemable preference shares may be issued by foreign subsidiaries or foreign branches or foreign associates or foreign joint operations or foreign joint ventures. In this case, appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

- When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments.
- The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
  - (a) a history of making distributions;
  - (b) an intention to make distributions in the future
  - (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends)



on the ordinary shares if dividends are not paid on the preference shares)

- (d) the amount of the issuer's reserves
- (e) an issuer's expectation of a profit or loss for a period; or
- (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Hence, the contractual terms determine the nature of instrument. Any historical trend or ability of the Issuer does not affect the classification of an instrument as 'equity' or 'financial liability'.

### (C) Distributions on preference shares

Other than the terms for redemption of financial instrument, another important point for consideration is whether the Company has an obligation to make payments of dividend ie, whether dividend on such preference shares are cumulative or non-cumulative.

- **Where dividends are at the discretion of the issuer** –this is akin to an equity instrument. However, where the instrument itself is redeemable, the obligation to pay still exists but only to the extent of the redemption value and not dividends on such shares unless they are declared.
- **Where dividends are cumulative but payable only on liquidation**—One needs to assess the key terms of the instrument to check if the entity has a contractual obligation:
  - (a) **Where no contractual obligation exists to pay**– such preference shares may themselves be irredeemable and the dividend on such shares even if cumulative, the entity may be under no obligation to pay unless upon liquidation – then such preference shares may be classified as equity.
  - (b) **Where contractual obligation exists** – In cases where the preference shares are not redeemable, it is like an equity instrument. But if they are entitled to dividend which is payable such that entity does not have an unconditional right to defer payment, then this provides the shareholders with a lender's return on the amount invested. This obligation is also not negated if the entity is unable to pay such dividend for lack of funds or insufficient distributable profits. Therefore, the obligation to pay dividend meets the definition of financial liability. The instrument in such cases shall have two components – financial

liability represented by dividend and equity component represented by the issue price, such instruments are overall classified as 'compound financial instruments' and each of the components as mentioned above are accounted separately.

#### Illustration 6: Preference shares with non-cumulative dividend

*Silver Ltd. issued irredeemable preference shares with face value of ₹ 10 each and premium of ₹ 90. These shares carry dividend @ 8% per annum, however dividend is paid only when Silver Ltd declares dividend on equity shares. Analyse the nature of this instrument.*

#### Solution

In the above case, two main characteristics of the preference shares are:

- (i) Preference shares carry dividend, which is payable only when Company declares dividend on equity shares
- (ii) Preference share are irredeemable.

Analysing the definition of equity, an instrument meets definition of equity if:

- (a) It contains no contractual obligation to pay cash; and
- (b) Where an instrument shall be settled in own equity instruments, it's a non-derivative contract that will be settled only by issue of fixed number of shares or a derivative contract that will be settled by issue of fixed number of shares for a fixed amount of cash.

In the above instrument, there is no contractual obligation on the Company to pay cash since –

- (i) Face value is not redeemable (except in case of liquidation); and
- (ii) Dividend is payable only if Company declares dividend on equity shares. Since dividend on equity shares is discretionary and the Company can choose not to pay, Company has an unconditional right to avoid payment of cash on preference shares also.

Hence preference shares meet definition of equity instrument.

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- **Contracts settled in own equity instruments but classified as 'financial liability' (where equity instrument is treated as currency) –**

| Terms                          | Evaluation under Ind AS 32                                                                                                                                                                                                                                                                                                                   |
|--------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Non derivative contract</b> | <ul style="list-style-type: none"> <li>• A contract that will be settled in a variable number of entity's own shares whose value equals a fixed amount is a financial liability, because the entity is under an obligation to pay a fixed amount, that is settled through equity instruments (similar to settlement in currency).</li> </ul> |

|                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|----------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                            | <ul style="list-style-type: none"> <li>Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.</li> </ul>                                                                                                                                                  |
| <b>Derivative contract</b> | <ul style="list-style-type: none"> <li>A contract that will be settled in a variable number of the entity's own shares whose value equals an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability.</li> <li>An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract.</li> </ul> |

#### Illustration 7: Non-derivative contract to be settled in own equity instruments

*A Ltd. invests in compulsorily convertible preference shares (CCPS) issued by its subsidiary – B Ltd. at ₹ 1,000 each (₹ 10 face value + ₹ 990 premium). Under the terms of the instrument, each CCPS is compulsorily convertible into one equity share of B Ltd at the end of 5 years. Such CCPS carry dividend @ 12% per annum, payable only when declared at the discretion of B Ltd. Evaluate this under definition of financial instrument.*

#### Solution

B Ltd. has issued CCPS which provide for –

- Conversion into fixed number of equity shares, ie, one equity share for every CCPS
- Non-cumulative dividends.

Applying the definition of 'equity' under Ind AS 32 –

- There is no contractual obligation to deliver cash or other financial asset. Dividends are payable only when declared and hence, at the discretion of the Issuer – B Ltd., thereby resulting in no contractual obligation over B Ltd.
- Conversion is into a fixed number of equity shares.

Hence it meets definition of equity instrument and shall be classified as such in books of B Ltd.

\*\*\*\*\*

#### Illustration 8: Settlement in variable number of shares

*Target Ltd. took a borrowing from Z Ltd. for ₹ 10,00,000. Z Ltd. enters into an arrangement with Target Ltd. for settlement of the loan against issue of a certain number of equity shares of Target Ltd. whose value equals ₹ 10,00,000. For this purpose, fair value per share (to determine*

*total number of equity shares to be issued) shall be determined based on the market price of the shares of Target Ltd. at a future date, upon settlement of the contract. Evaluate this under definition of financial instrument.*

### Solution

In the above scenario, Target Ltd. is under an obligation to issue variable number of equity shares equal to a total consideration of ₹ 10,00,000. Hence equity shares are used as currency for purpose of settlement of an amount payable by Target Ltd.

Since this is variable number of shares to be issued in a non-derivative contract for fixed amount of cash, it tantamounts to use of equity shares as 'currency' and hence this contract meets the definition of financial liability in books of Target Ltd.

\*\*\*\*\*



## 1.6 COMPARISON OF FINANCIAL ASSETS, FINANCIAL LIABILITIES AND EQUITY

| Sl. No. | Financial Assets                                                                                                                                 | Financial liabilities                                                                                                                                                                           | Equity                                                                                                                 |
|---------|--------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|
| 1       | Cash                                                                                                                                             | -                                                                                                                                                                                               | -                                                                                                                      |
| 2       | An equity instrument of another entity.                                                                                                          | -                                                                                                                                                                                               | -                                                                                                                      |
| 3.      | <b>A contractual right</b><br>To receive cash or another financial asset from another entity<br>Or                                               | <b>A contractual obligation</b><br>To deliver cash or another financial asset to another entity<br>Or                                                                                           | <b>No contractual obligation</b><br>To deliver cash or another financial asset to another entity.<br>Or                |
| 3       | To exchange financial assets or financial liabilities with another entity under conditions that are <b>potentially favourable</b> to the entity. | To exchange financial assets or financial liabilities with another entity under conditions that are <b>potentially unfavourable</b> to the entity.                                              | To exchange financial assets or financial liabilities with another entity.                                             |
| 4       | A contract that will or may be settled in the entity's own equity instruments.                                                                   | A contract that will or may be settled in the entity's own equity instruments including derivative and non-derivative ( <b>Variable no. of shares. and Fixed for Fixed criterion not met</b> ). | A contract that will or may be settled in the entity's own equity <b>instruments (Fixed for Fixed criterion met)</b> . |



## 1.7 SCOPE OF FINANCIAL INSTRUMENTS

Scope of financial instruments excludes the following:

- (a) Interests in subsidiaries, associates and joint ventures that are accounted for in accordance with Ind AS 110 *Consolidated Financial Statements*, Ind AS 27 *Separate Financial Statements* or Ind AS 28 *Investments in Associates and Joint Ventures*. However, in some cases, Ind AS 110, Ind AS 27 or Ind AS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in Ind AS 32 *Financial Instruments: Presentation*.
- (b) Rights and obligations under leases to which Ind AS 116 *Leases* applies. However,
  - (i) finance lease receivables (i.e. net investments in finance leases) and operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of Ind AS 109;
  - (ii) lease liabilities recognised by a lessee are subject to the derecognition requirements in paragraph 3.3.1 of Ind AS 109; and
  - (iii) derivatives that are embedded in leases are subject to the embedded derivatives requirements of Ind AS 109.
- (c) employers' rights and obligations under employee benefit plans, to which Ind AS 19 *Employee Benefits* applies.
- (d) rights and obligations arising under (i) an insurance contract as defined in Ind AS 104 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, or (ii) a contract that is within the scope of Ind AS 104 because it contains a discretionary participation feature.
  - However, this Standard applies to a derivative that is embedded in a contract within the scope of Ind AS 104 if the derivative is not itself a contract within the scope of Ind AS 104.
  - Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 104 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

- (e) Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of Ind AS 103 *Business Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.
- (f) Loan commitments other than those loan commitments described below –
  - loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.
  - loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).
  - commitments to provide a loan at a below-market interest rate

However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan commitments are subject to the derecognition requirements of this Standard.

- (g) Financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 102 *Share-based Payment* applies, except for contracts to buy non-financial items as described below.
- (h) Rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it recognised a provision in accordance with Ind AS 37.
- (i) Rights and obligations within the scope of Ind AS 115 *Revenue from Contracts with Customers* that are financial instruments, except for those that Ind AS 115 specifies are accounted for in accordance with this Standard.

**Summary of the transaction outside the scope Financial Instruments:**

| Sl. No. | Particulars                                                       | Covered under Ind AS 109 | Covered under Ind AS 32 | Under Ind AS 107 | Applicable Ind AS         |
|---------|-------------------------------------------------------------------|--------------------------|-------------------------|------------------|---------------------------|
| 1       | Interest in subsidiaries (At Costs)                               | No                       | No                      | No               | Ind AS 27                 |
| 2       | Interests in associates (At Costs)                                | No                       | No                      | No               | Ind AS 27                 |
| 3       | Interest in joint ventures (At Costs)                             | No                       | No                      | No               | Ind AS 27                 |
| 4       | Rights and obligations under leases                               | No                       | No                      | Yes              | Ind AS 116                |
| 5       | Employers' rights and obligations under employee benefit plans    | No                       | No                      | No               | Ind AS 19                 |
| 6       | Rights and obligations under an insurance contract                | No                       | No                      | No               | Ind AS 104                |
| 7       | Forward contract arising within the scope of business combination | No                       | No                      | Yes              | Ind AS 107                |
| 8       | Loan commitment other than covered under Ind AS 109 and Ind AS 32 | No                       | No                      | Yes              | Ind AS 107                |
| 9       | Shared based payments                                             | No                       | No                      | No               | Ind AS 102                |
| 10      | Reimbursement right in respect of provision                       | No                       | No                      | Yes              | Ind AS 37 and Ind AS 107  |
| 11      | Rights and obligations under revenue for contracts with customers | No                       | No                      | Yes              | Ind AS 115 and Ind AS 107 |



## 1.8 CONTRACTS TO BUY OR SELL NON-FINANCIAL ITEMS ('OWN USE EXEMPTION')

- Contracts to buy or sell non-financial items are outside the scope of 'financial instruments', except for the following:
  - Contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

- (b) A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments that are irrevocably designated as measured at fair value through profit or loss (even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements). This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard applying the scope exclusion in (a) above.
- (c) A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, where such a contract was not entered into for the purpose of receipt or delivery of the non-financial item in accordance with entity's expected purchase, sale or usage requirements.
- There are various ways in which a contract to buy or sell non-financial items can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:
  - (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
  - (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
  - (c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
  - (d) when the non-financial item that is the subject of the contract is readily convertible to cash.

**Example 4**

ABC Ltd. enters into a contract to buy 100 tonnes of cocoa beans at 1,000 per tonne for delivery in 12 months. On the settlement date, the market price for cocoa beans is 1,500 per tonne. If the contract cannot be settled net in cash and this contract is entered for delivery of cocoa beans in line with ABC Ltd.'s expected purchase/ usage requirements, then own-use exemption applies.

In such case, the contract is considered to be an executory contract outside the scope of Ind AS 109 and hence shall not be accounted as a derivative.



## UNIT 2: CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES



### 2.1 RECOGNITION AND SUBSEQUENT MEASUREMENT

All financial assets and financial liabilities are measured at their fair values upon initial recognition. Classification of the financial assets and financial liabilities drives their initial and subsequent measurement.



### 2.2 FINANCIAL ASSETS: KEY ELEMENTS TO DETERMINE CLASSIFICATION

**Key essential elements that determine classification of financial assets are:**

**(A) Business model (BM) test:**

- An entity's business model refers to how an entity manages its financial assets in order to generate cash flows.

#### Factors determining BM

- ❖ An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model and an entity will need to use judgement when it assesses its business model for managing financial assets.
- ❖ This assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available. Such relevant evidence includes, but is not limited to:
  - (a) how the performance of business model and the financial assets held within that business model are evaluated & reported to the entity's key management personnel;
  - (b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
  - (c) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

|                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|-------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Level of aggregation of assets for determining BM</b>          | <ul style="list-style-type: none"><li>❖ An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective and not based on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined at a higher level of aggregation.</li><li>❖ However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.</li></ul> |
| <b>Determining basis of realisation of contractual cash flows</b> | <ul style="list-style-type: none"><li>❖ Entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios.</li><li>❖ For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur.</li></ul>                                                                                                                                                                            |
| <b>Difference in actual realisation from BM</b>                   | <p>If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements nor does it change the classification of the remaining financial assets held in that business model (ie those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment.</p>                                                                                                                                                                                              |

- **Financial assets held for trading:**

Financial assets held for trading are defined as those that:

- (a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;
- (b) on initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- (c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin.

#### **Illustration 1**

*An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs.*

*The entity performs credit risk management activities with the objective of minimising credit losses. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.*

*Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.*

*Evaluate the business model.*

#### **Solution**

- Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows.

- Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy. Infrequent sales resulting from unanticipated funding needs (eg in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.

Hence the business model of the company is to collect contractual cash flows and not realisation from sale of financial assets.

\*\*\*\*\*

### Illustration 2

*An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired.*

*If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them.*

*In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.*

*Evaluate the business model.*

### Solution

The objective of the entity's business model is to hold the financial assets in order to collect the contractual cash flows. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets are credit impaired at initial recognition).

Moreover, the fact that the entity enters into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model.

\*\*\*\*\*

### Illustration 3

*Entity B sells goods to customers on credit. Entity B typically offers customers up to 60 days following the delivery of goods to make payment in full. Entity B collects cash in*

*accordance with the contractual cash flows of trade receivables and has no intention to dispose of the receivables.*

*Evaluate the business model.*

### **Solution**

Entity's B objective is to collect contractual cash flows from trade receivables and therefore, trade receivables meet the business model test for the purpose of classifying the financial assets at amortised cost.

\*\*\*\*\*

### **Illustration 4**

*An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period.*

*The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.*

*Evaluate the business model.*

### **Solution**

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk). The objective of this contrasting business model is to hold financial assets to collect contractual cash flows.

\*\*\*\*\*

**Illustration 5**

*An entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it.*

*The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. In the consolidated balance sheet, loans continue to be recognised because they are not derecognised by the securitisation vehicle.*

*Evaluate the business model.*

**Solution**

The entity originating loans to customers has the objective of realising contractual cash flows on the loan portfolio only through sale to securitisation vehicle. However, the consolidated group originates loans with the objective of holding them to collect the contractual cash flows.

- Hence, the consolidated financial statements provide for a business model with the objective of collecting contractual cash flows by holding to maturity.
- And in separate financial statements of the entity originating loans to customers, business model is to collect cash flows through sale only.

\*\*\*\*\*

**Illustration 6**

*A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (eg, a run on the bank's deposits). The entity does not anticipate selling these assets except in such scenarios. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised.*

*However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.*

*Evaluate the business model.*

**Solution**

The objective of the entity's business model is to hold the financial assets to collect contractual cash flows. The analysis would not change –

- If during a previous stress case scenario the entity had sales that were significant in value in order to meet its liquidity needs; or
- Recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows.

If the entity is required by its regulator to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's business model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.

In contrast, if an entity holds financial assets to meet its everyday liquidity needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows.

\*\*\*\*\*

**(B) Contractual cash flows characteristics test:**

Ind AS 109 requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held –

- i. within a business model whose objective is to hold assets to collect contractual cash flows; or
- ii. within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

To do so, an entity is required to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

- The key characteristics of cash flows to test if they are solely payments of principal and interest are as follows:

|                           |                                                                                                                                                                                                                                                                               |
|---------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>What is principal?</b> | <ul style="list-style-type: none"> <li>❖ Principal is the fair value of the financial asset at initial recognition.</li> <li>❖ However, that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).</li> </ul> |
|---------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

**Components  
of 'interest  
element'**

**Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement.** An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

- ❖ In a basic lending arrangement, consideration for the time value of money 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);
- ❖ costs (for example, administrative costs) associated with holding the financial asset for a particular period of time; and
- ❖ 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 & interest.
- ❖ Leverage is a contractual cash flow characteristic of some financial assets, that increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts cannot be said to have contractual cash flows that are only payments of principal & interest and hence, cannot be subsequently measured at amortised cost or fair value through other comprehensive income.



- Following are **examples** of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:
  - (a) a variable interest rate on a financial instrument, where this rate consists of consideration for –
    - time value of money,
    - credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed); and
    - other basic lending risks and costs, as well as a profit margin.

This is because this variable interest rate is only to provide the lender with a return through 'interest' based on present market factors and no other form of return on the principal amount of the financial instrument. So, it has characteristics of return similar to one on a basic lending arrangement and thus, meets definition of contractual cash flows that are solely payments of principal and interest.

- (b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract;

Reasonable additional compensation' implies that the party choosing to exercise its option to terminate the contract compensates the other party.

### **Exception**

Some prepayment options could result in other party being forced to accept negative compensation – e.g. the lender receives an amount less than the unpaid amounts of principal and interest if the borrower chooses to prepay.

Earlier, these instruments were measured at FVTPL. However, now after amendment, such financial assets could be measured at amortised cost or at FVOCI if they meet the other relevant requirements of Ind AS 109.

To be eligible for the exception, the fair value of the prepayment feature would have to be insignificant on initial recognition of the asset. If this is impracticable to assess based on the facts and circumstances that existed on initial recognition of the asset, then the exception would not be available. Also, financial assets prepayable at current fair value would be measured at FVTPL. The same would apply if the prepayment amount includes the fair value cost to terminate a

hedging instrument if the amount is inconsistent with the current Ind AS 109 prepayment rules. (The measurement principles given here have been explained in detail in the subsequent sections).

- (c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (ie an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

#### Illustration 7

*Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.*

*Evaluate the Contractual cash flows characteristics test*

#### Solution

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

However, if the interest payments were indexed to another variable such as the debtor's performance (eg the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement.

\*\*\*\*\*

#### Illustration 8

*Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer. Analyse the nature of cash flows.*

**Solution**

The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement; ie the return is linked to the value of the equity of the issuer.

\*\*\*\*\*

**Illustration 9**

*Instrument H is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.*

*Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest. Analyse the nature of cash flows.*

**Solution**

The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.

If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.

\*\*\*\*\*

**Illustration 10**

*Instrument D is loan with recourse and is secured by collateral. Does the collateral affect the nature of contractual cash flows?*

**Solution**

The fact that a loan is collateralised (since with recourse) does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The collateral is only a security to recover dues.

\*\*\*\*\*

**Illustration 11**

*Instrument G is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates). Analyse the nature of cash flows.*

**Solution**

Here, interest on the instrument has an inverse relationship to the market rate of interest. Hence, it is unlike a basic lending arrangement which normally comprises of interest payable on any funds lent, as a consideration for the time value of money, credit risk and profit margin normally existing in such arrangements. This arrangement with an inverse floating interest rate provides the lender with a return which may be higher or lower to the market rate of interest and hence, is not necessarily a consideration for the time value of money on the principal amount outstanding.

Thus, these do not represent contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

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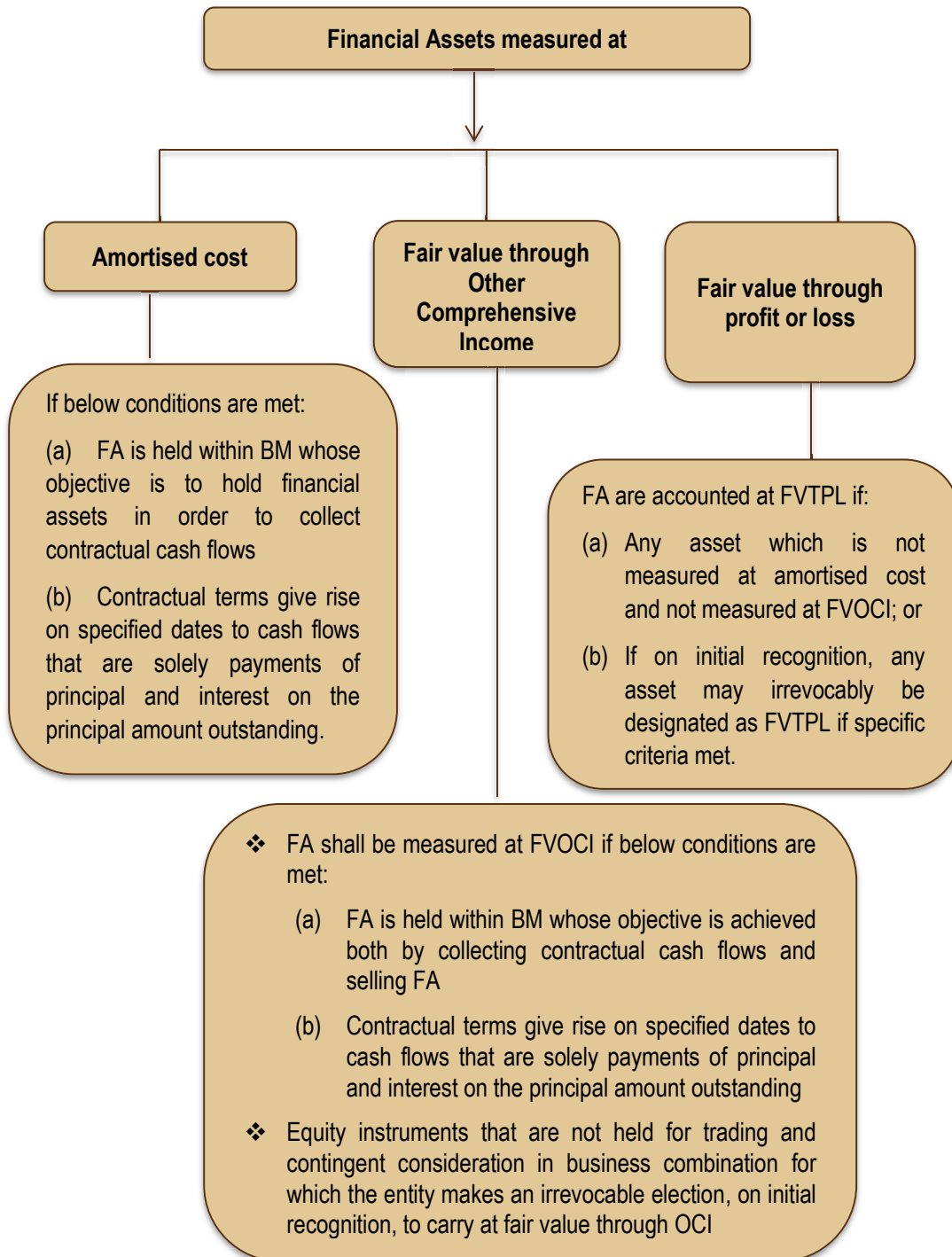


## 2.3 FINANCIAL ASSETS: CLASSIFICATION – OVERALL CONCEPT

Categorisation of financial assets (FA) is determined based on the business model that determines how cash flows of the financial asset are collected and the contractual cash flow characteristics; and can be:

- (a) Measured at **Amortised cost**
- (b) Measured at fair value through comprehensive income (**FVOCI**)
- (c) Measured at fair value through profit or loss (**FVTPL**).
- As per Ind AS 109.4.1.1 – Except for financial assets designated as fair value through profit or loss (refer Ind AS 109.4.1.5), an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:
  - (a) Entity's **business model** (BM) for managing the financial assets and
  - (b) **Contractual cash flow** characteristics of the financial asset.

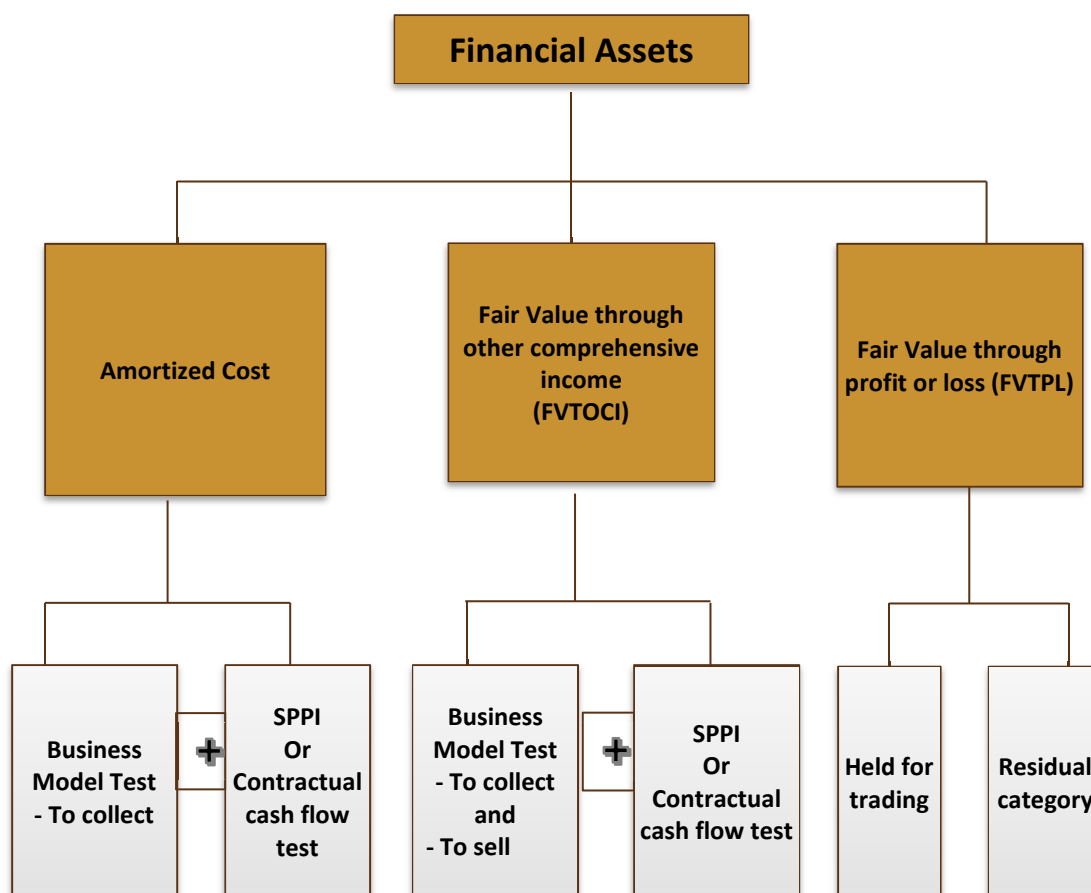
- Categorisation of financial assets has been broadly laid out in the below flow chart:



- **Exception to classification based on above criteria mentioned in para 109.4.1.1 – Option to designate at fair value through profit or loss:**

An entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an '**accounting mismatch**') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases

**The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice** (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows.



## 1. Financial Assets at Amortised cost

- **What is Amortised cost**

- ◆ **Amortised cost** is the amount at which the financial asset is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

- ◆ **In applying effective interest method –**

- (a) Entity identifies fees that are an integral part of the effective interest rate of a financial instrument. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

- (b) Such fees adjusted in effective interest rate are then amortised over then expected life of the instrument. However, a shorter period may be used if such fee adjusted in effective interest rate pertains to such shorter period.

- **Financial asset (FA) shall be classified at amortised cost if it meets both of following criteria:**

- 1. **'Hold-to-collect' business model test** - Objective is to hold the financial asset in order to collect contractual cash flows;

**AND**

- 2. **'SPPI' contractual cash flow characteristics test** - Contractual terms give rise to cash flows that are **Solely Payments of Principal and Interest (SPPI)** on the principal amount outstanding.

- **Examples of Financial assets classified and accounted for at amortised cost:**

- ◆ Trade receivables
- ◆ Investments in government bonds (not held for trading)
- ◆ Investments in term deposits (at standard interest rates)
- ◆ Loan receivables with 'basic' features

Investment in Equity instrument can never be classified at amortized cost.

**Illustration 12 : Hold-to-collect' business model test**

*An entity purchased a debt instrument for 1,00,000.*

*The instrument pays interest of 6,000 annually and has 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows.*

*Evaluate the business model test.*

**Solution**

Entity's objective is to hold the asset to collect the contractual cash flows and not to sell the assets before the maturity period.

Thus, the debt instrument would meet the 'hold-to-collect' business model test.

\*\*\*\*\*

**Illustration 13 : Hold-to-collect' business model test**

*An entity purchased a debt instrument for 1,00,000.*

*The instrument pays interest of 6,000 annually and has 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows.*

*Six years have passed and the entity is suffering a liquidity crisis and needs to sell the asset to raise funds.*

*Evaluate the business model test.*

**Solution**

Since the sale of financial assets was not expected on initial classification and therefore, does not affect the classification (i.e. there is no retrospective reclassification).

Thus, the debt instrument would still meet the 'hold-to-collect' business model test.

\*\*\*\*\*

**Illustration 14 : SPPI or contractual cash flow test**

*SPPI test for loan with zero interest and no fixed repayment terms*

*Parent H Ltd. provides a loan to its Subsidiary S Ltd. The loan is classified as a current liability in Subsidiary S's financial statements and has the following terms:*

- Interest free loan.*
- No fixed repayment terms*
- Repayable on demand of Parent H Ltd.*

*Does the loan meet the 'SPPI' or contractual cash flows characteristic test?*



**Solution**

Yes. The terms for the repayment of the principal amount of the loan on demand satisfies the criterion of SPPI.

\*\*\*\*\*

**Illustration 15 : SPPI Test for loan with zero interest repayable in ten years**

*Parent H Ltd. provides a loan of INR 100 million to Subsidiary B. The loan has the following terms:*

- No interest
- Repayable in ten years.

*Does the loan meet the 'SPPI' or contractual cash flows characteristic test?*

**Solution**

Yes. The terms for the repayment of the principal amount of the loan in 10 years satisfies the criterion of SPPI.

\*\*\*\*\*

**Illustration 16 : SPPI Test for loan with interest rate**

*Entity A Ltd. lends Entity B Ltd. INR 5 million for ten years, subject to the following terms:*

- Interest is based on the prevailing variable market interest rate.
- Variable interest rate is capped at 10%.
- Repayable in ten years.

*Does the loan meet the 'SPPI' or contractual cash flows characteristic test?*

**Solution**

Contractual cash flows of both a fixed rate instrument and a floating rate instrument are payments of principal and interest as long as the interest reflects consideration for the time value of money and credit risk.

Therefore, a loan that contains a combination of a fixed and variable interest rate meets the contractual cash flow characteristics test.

\*\*\*\*\*

**Illustration 17: Trade receivables – Amortised cost**

*H Ltd. makes sale of goods to customers on credit of 60 days. The customers are entitled to earn a cash discount @ 5% per annum if payment is made before 60 days and an interest @ 12% per annum is charged for any payments made after 60 days. Company does not have a policy of selling its debtors and holds them to collect contractual cash flows.*

*Evaluate the financial instrument.*

**Solution**

In the above case, since H Ltd. has a contractual right to receive cash flows from its customers and therefore such trade receivable are financial assets for H Ltd.

Further, H Ltd. business model test to collect will satisfy as the objective is to hold its trade receivable to collect contractual cash flows till the end of maturity period and such trade receivable recorded in books represents contractual cash flows that are solely payments of principal and interest if paid beyond credit period.

Hence such trade receivables are classified at amortised cost.

\*\*\*\*\*

#### **Illustration 18: Security Deposits – Amortized Costs**

*A Ltd. (the 'Company') has obtained the premises from B Ltd. on lease to carry on its business. The lease contract period is 5 years. As per the lease agreement, A Ltd. has paid security deposits to B Ltd. amounting to ₹ 10 Lac which is refundable after the expiry of lease agreement.*

*How would such deposits be treated in books of the A Ltd. ?*

#### **Solution**

In the above case, since A Ltd. has a contractual right to receive cash flows from its Lessor, B Ltd. and therefore such security deposits receivable are financial assets for A Ltd.

Further, A Ltd. business model test to collect will be satisfied as the objective is to hold its security deposits receivable to collect contractual cash flows till the end of maturity period. And such trade receivable recorded in books represents contractual cash flows that are solely payments of principal and interest.

Hence such security deposits receivables are classified at amortised cost.

\*\*\*\*\*

## **2. Financial Assets at Fair Value at Other Comprehensive Income**

### **A. Accounting for debt instruments when it is classified as FVOCI**

- **Financial asset (FA) is measured at fair value through OCI (FVOCI) if it meets both of following criteria:**

1. **'Hold-to-collect and sell' business model test** - Objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset i.e. Intention of the entity is to sell the instrument before the investment matures.

**AND**

2. **'SPPI' contractual cash flow characteristics test** - Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.

- **Examples of FA classified and accounted for at FVOCI:**

- ◆ Investments in government bonds where the investment period is likely to be shorter than its maturity period.
- ◆ Investments in corporate bonds where the investment period is likely to be shorter than its maturity period.

**Illustration 19 : 'Hold-to-collect' or 'hold-to-collect & sell' business model test**

*Entity A has surplus funds – INR 50 million*

*A has not yet found suitable investment opportunity so it buys medium dated (5 year maturity) high quality government bonds in order to generate interest income.*

*If a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. It is likely that a suitable business opportunity will be found before maturity date.*

*Whether the investment opportunity will meet the 'hold-to-collect' or 'hold-to-collect & sell' business model test?*

**Solution**

Government bonds would not meet the 'hold-to-collect' business model test because it is considered likely that the bonds will be sold well before their contractual maturity.

However, it is likely that such investment would meet the 'hold-to-collect and sell' business model test.

\*\*\*\*\*

**B. Equity instrument when it is classified as FVOCI**

- ◆ Ind AS 109 requires all equity investments to be measured at fair value. The default approach is that all changes in fair value of instruments to be recognised in profit or loss.
- ◆ However, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI, with all subsequent changes in fair value being recognised in other comprehensive income.
- ◆ Under FVOCI category, fair value changes are recognised in OCI while dividends are recognised in profit or loss.
- ◆ On disposal of the investment the cumulative change in fair value is required to remain in OCI and is not reclassified to profit or loss. However, entities have the ability to transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings).

**3. Financial Assets at profit and loss**

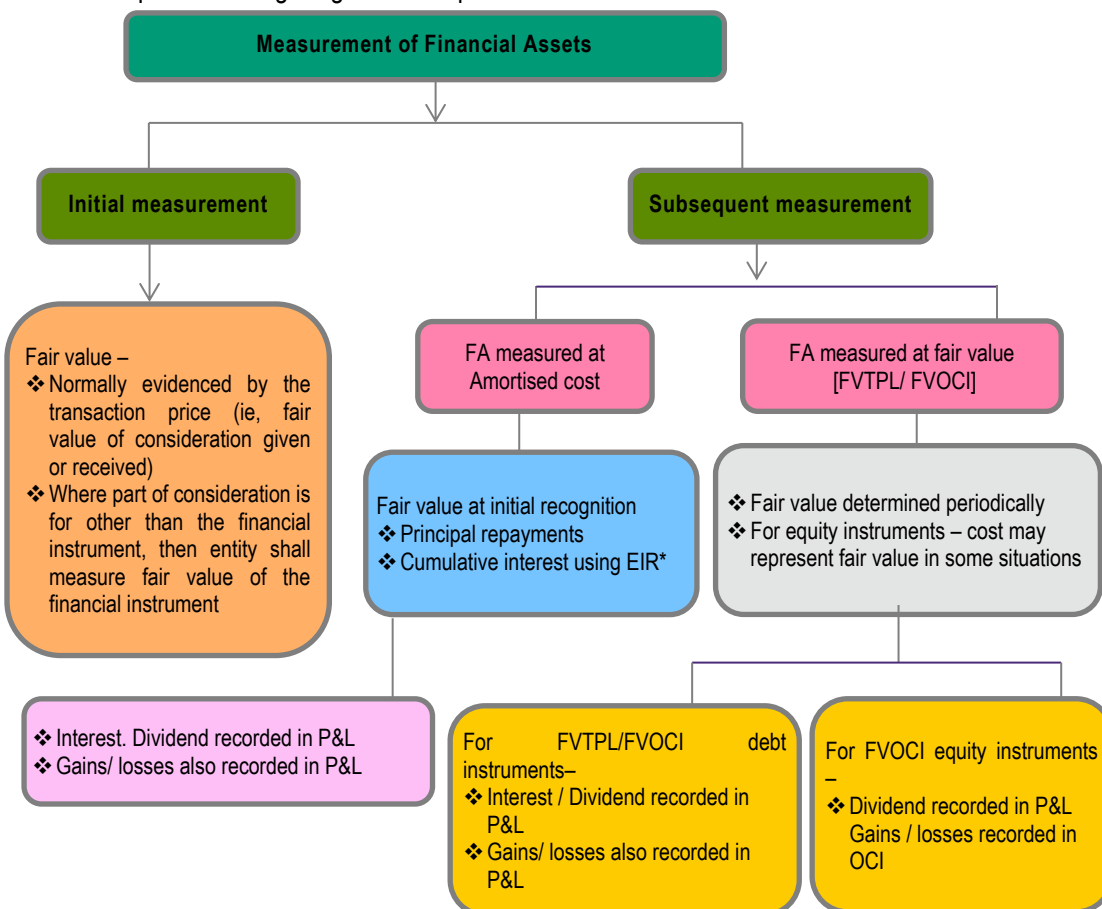
- **Fair value through profit or loss (FVTPL) is the residual category in Ind AS 109.**
- **Financial asset (FA) classified and measured at FVTPL if FA is:**
  - ◆ A held-for-trading financial asset
  - ◆ A debt instrument that does not qualify to be measured at amortised cost or FVOCI
  - ◆ An equity investment which the entity has not elected to classify as at FVOCI

- **Examples of Financial assets classified and accounted for at fair value through profit or loss (FVTPL):**
  - ◆ Derivatives that have not been designated in a hedging relationship, e.g.:
    - Interest rate swaps
    - Commodity futures/option contracts
    - Foreign exchange futures/option contracts
  - ◆ Investments in shares where the entity has not elected to account for at FVOCI.



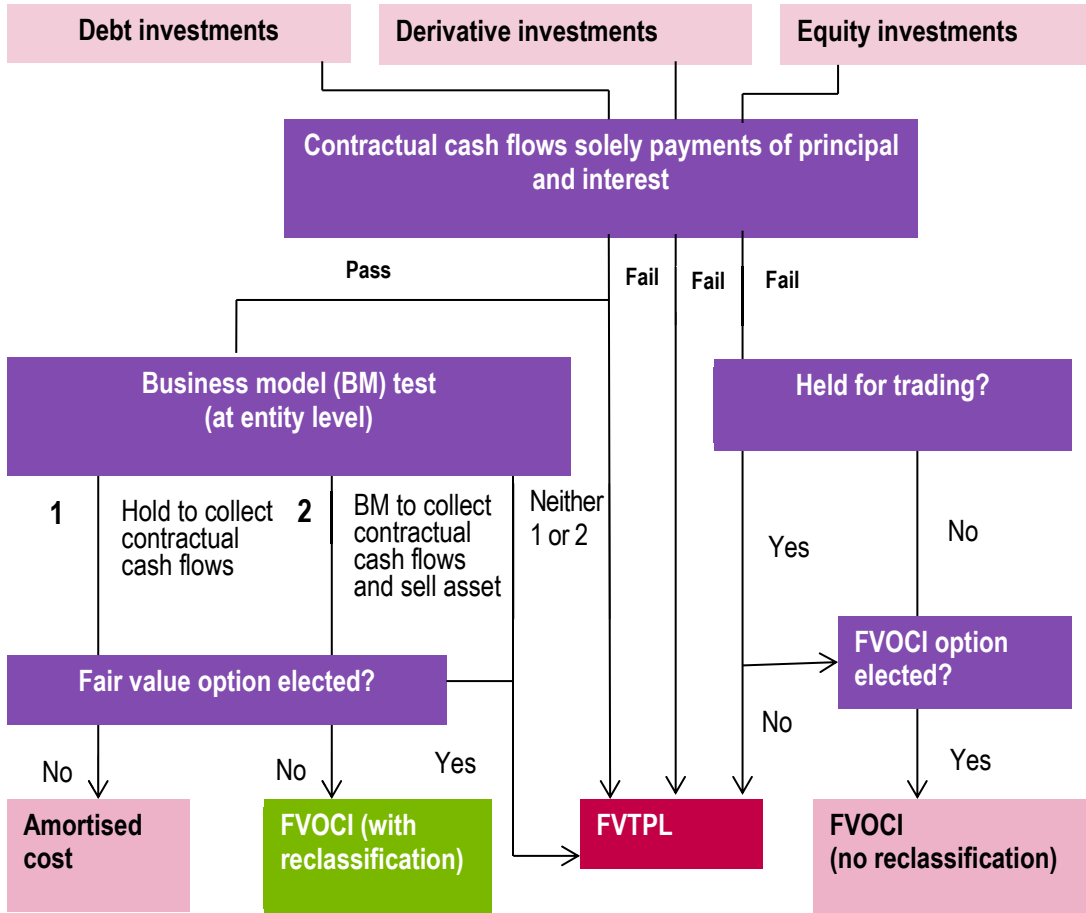
## 2.4 FINANCIAL ASSETS: MEASUREMENT

Measurement of financial assets is driven by their classification and can be broadly explained with the help of following diagrammatic presentation:



\*EIR – Effective interest rate method

Based on the above mentioned guidance, the decision tree for classification of financial assets can be understood with the help of following flow chart:



#### Accounting for transaction costs for the purpose of Effective interest rate method

| Fees that are integral part of effective interest rate                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Fees that are not an integral part of effective interest rate |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------|
| <p>(a) <b>Origination fee</b> received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.</p> | <p>(a) <b>Fee</b> charged for <b>servicing a loan</b>;</p>    |

| Fees that are integral part of effective interest rate                                                                                                                                                                                                                                                                                                                                                                                     | Fees that are not an integral part of effective interest rate                                                                                                                                                                    |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (b) <b>Commitment fee</b> received by the entity to originate a loan where it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.                                                     | (b) <b>Commitment fee</b> to originate a loan when it is unlikely that a specific lending arrangement will be entered into;                                                                                                      |
| (c) <b>Origination fee</b> paid on issuing financial asset measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services. | (c) <b>Loan syndication fee</b> received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants). |

**Illustration 20**

ABC Bank gave loans to a customer – Target Ltd. that carry fixed interest rate @ 10% per annum for a 5 year term and 12% per annum for a 3 year term. Additionally, the bank charges processing fees @1% of the principal amount borrowed. Target Ltd borrowed loans as follows:

- 10 lacs for a term of 5 years
- 8 lacs for a term of 3 years.

Compute the fair value upon initial recognition of the loan in books of Target Ltd. and how will loan processing fee be accounted?

**Solution**

The loans from ABC Bank carry interest @ 10% and 12% for 5 year term and 3 year term respectively. Additionally, there is a processing fee payable @ 1% on the principal amount on date of transaction. It is assumed that ABC Bank charges all customers in a similar manner and hence this is representative of the market rate of interest.

Amortised cost is computed by discounting all future cash flows at market rate of interest. Further, any transaction fees that are an integral part of the transaction are adjusted in the effective interest rate and recognised over the term of the instrument.

Hence loan processing fees shall be reduced from the principal amount to arrive the value on day 1 upon initial recognition.

Fair value (5 year term loan) = 10,00,000 – 10,000 (1% x 10,00,000) = 9,90,000

Fair value (3 year term loan) = 8,00,000 – 8,000 (1% x 8,00,000) = 7,92,000.

Now, effective interest rate shall be higher than the interest rate of 10% and 12% on 5 year loan and 3 year loan respectively, so that the processing fees gets recognised as interest over the respective term of loans.

\*\*\*\*\*

- **Fair value**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Per Ind AS 113.B2 – The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all the following:

- (a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account);
- (b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use);
- (c) the principal (or most advantageous) market for the asset or liability.
- (d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

Now, we go on to understand the key aspects of initial and subsequent measurement along with how classification of assets affects their measurement as explained in detail below:



## 2.5 FINANCIAL ASSETS: INITIAL MEASUREMENT

**Fair value** of a financial instrument at initial recognition is **normally the transaction price** (,ie, fair value of consideration given or received).

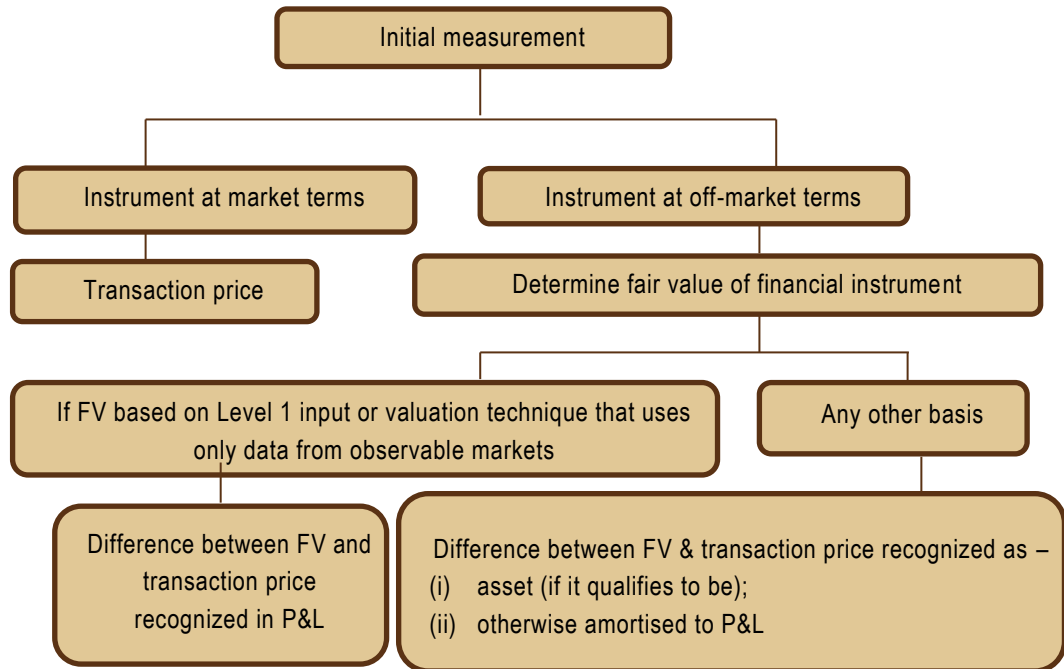
- **Instrument at off-market terms:** Sometimes certain type of instruments may be exchanged at off market terms (,ie, different from market terms for a similar instrument if exchanged between market participants),
  - ◆ For example, a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. In such cases where part of the consideration given or

received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

- ◆ In the aforementioned example, the fair value of the long-term loan or receivable can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. The additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.
- **Transaction costs:**
  - ◆ Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.
  - ◆ Any transaction costs incurred for acquisition of the financial asset or issue of financial liability are adjusted upon initial recognition while determining fair value, if the financial asset or financial liability is not classified as subsequently measured at fair value through profit or loss.
  - ◆ If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives.

The decision tree for the aforementioned basis to be applied in establishing fair value at initial recognition can be understood with following diagrammatic presentation:





- **Specific transactions:**

- ◆ **Determining amortised cost for financial assets carrying floating rate of interest:**

Per Application Guidance in Appendix B – B.5.4.5 – For floating rate financial instruments, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. To calculate the effective interest in each relevant period, the effective interest rate is applied to the amortised cost of the asset or liability at the previous reporting date. However, if the floating rate financial asset or financial liability is initially recognised at an amount equal to the principal receivable or payable on maturity, then this periodic re-estimation does not have a significant effect on the carrying amount of the asset or liability.

Therefore, in such cases, for practical reasons the carrying amount of a floating rate instrument would not generally need to be adjusted at each repricing date because the impact would not generally be significant. In such case –

- Interest income or expense is recognised based on the current market rate.
- For a floating rate financial asset or financial liability that is initially recognised at a discount or premium, the interest income or expense is recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium.

◆ **Revision of estimated cash flows:**

Per Application Guidance in Appendix B to Ind AS 109 – B.5.4.6 – If there is a change in the timing or amount of estimated future cash flows (other than due to impairment) –

- It shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows.
- The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's **original effective interest rate** (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)

Then the carrying amount of the instrument (or group of financial instruments) is adjusted in the period of change to reflect the actual and/or revised estimated cash flows, with a corresponding gain or loss being recognised in profit or loss.

This approach to changes in estimated cash flows should apply to changing prepayment expectations and other estimates of cash flows under the current terms of the financial instrument but not to a renegotiation of the contractual terms of an instrument.

◆ **Interest income after impairment recognition**

If a financial asset or a group of similar financial assets has been written down as a result of an impairment loss –

- Then interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.
- For assets measured at amortised cost, this interest rate would be the original effective interest rate.

◆ **Loans between group companies**

(a) **Repayable on demand:**

As per Ind AS 113.47 – 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 entity could be required to repay the amount. Accordingly –

- The fair value of an interest-free loan liability of which the lender can demand repayment of the face value at any time - i.e. a loan repayable on demand - is not less than its face value.

- This would evenly apply from the perspective of the lender, since a market participant acting in its best interest would be assumed to maximize value by demanding immediate repayment and hence, the fair value shall be equal to the amount payable on demand in books of lender.

**(b) No fixed maturity:**

If a loan has no fixed maturity date and is available in perpetuity, then in measuring its fair value, discounting should reflect these terms because a market participant acting in its best interest would not assume repayment of the loan. Similarly, the asset holder or lender would also measure fair value that should reflect a market participant's assumptions about the timing of the future cash flows.

**In both of above cases–**

- Any difference between the amount lent and the fair value of the instrument on initial recognition is recognized as a gain or a loss unless it qualifies for recognition as an asset or a liability.
- If a low-interest loan is given in anticipation of a right to receive goods or services at favourable prices, then the right may be recognised as an asset if it qualifies for recognition as an asset, for example: prepaid expenses, etc.

◆ **Demand deposits**

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 entity could be required to repay the amount.

Hence, fair value of a demand deposit would be the amount payable on demand in books of the party making the deposit (ie, holder of financial asset) as well as in books of entity accepting the deposit (ie, bearer of financial liability).

**Illustration 21: Deposits carrying off-market rate of interest:**

*Containers Ltd provides containers for use by customers for multiple purposes. The containers are returnable at the end of the service contract period (3 years) between Containers Ltd and its customers. In addition to the monthly charge, there is a security deposit that each customer makes with Containers Ltd for ₹ 10,000 per container and such deposit is refundable when the service contract terminates. Deposits do not carry any interest. Analyse the fair value upon initial recognition in books of customers leasing containers. Market rate of interest for 3 year loan is 7% per annum.*

**Solution**

In the above case, lessee (ie, customers leasing the containers) make interest free deposits, which are refundable at the end of 3 years. Now, this money if it was to lent to a third party would fetch interest @ 7% per annum.

Hence, discounting all future cash flows (ie, ₹ 10,000)

Fair value on initial recognition =  $10,000 / (1+0.07)^3 = 8,163$ .

Differential on day 1 =  $10,000 - 8,163 = 1,837$

The differential on day 1 shall be treated as follows:

- **Scenario 1** – If fair valuation is determined using level 1 inputs or other observable inputs, difference on day 1 recognised in profit or loss
- **Scenario 2** – If fair valuation is determined using other inputs, difference on day 1 shall be recognised in profit or loss unless it meets definition of an asset or liability.

However, in case of security deposits level 1 fair value is not available. Therefore, in the above case, the fair valuation is made based on unobservable inputs and hence applying scenario 2, difference can be recognised as an asset if it meets the definition. Now, since the lessee gets to use the containers in return for making an interest free deposit plus monthly charges, the lost interest representing day 1 difference between value of deposit and its fair value is like 'prepaid lease rent' and can be recognised as such. Prepaid rent (ROU Asset) shall be charged off to profit or loss in a straight lined manner as depreciation as per Ind AS 16.

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## 2.6 FINANCIAL ASSETS: SUBSEQUENT MEASUREMENT

- As defined in the flow chart above, the subsequent measurement of financial assets is based on their classification as defined below:

### (A) Assets measured at amortised cost

- ◆ Assets are classified as measured at amortised cost if below conditions are met (as explained in paragraph – Financial assets: classification):
  - (a) Financial asset is held with BM whose objective is to hold financial assets in order to collect contractual cash flows; and
  - (b) Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding
- ◆ Where assets are classified as 'amortised cost' –
  - They are initially measured at fair value plus or minus transaction costs as explained above
  - Subsequently, the carrying value is adjusted for principal repayments and interest accrued using effective interest rate, as explained earlier.

**(B) Assets measured at fair value**

- ◆ For assets not carried at amortised cost, they shall be carried at fair value. Such assets can be categorised into –

- i. **Measured at fair value through other comprehensive income (FVOCI);**  
if–

- (a) Following criteria are satisfied:

- FA is held with BM whose objective is achieved both by collecting contractual cash flows and selling FA; and
- Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

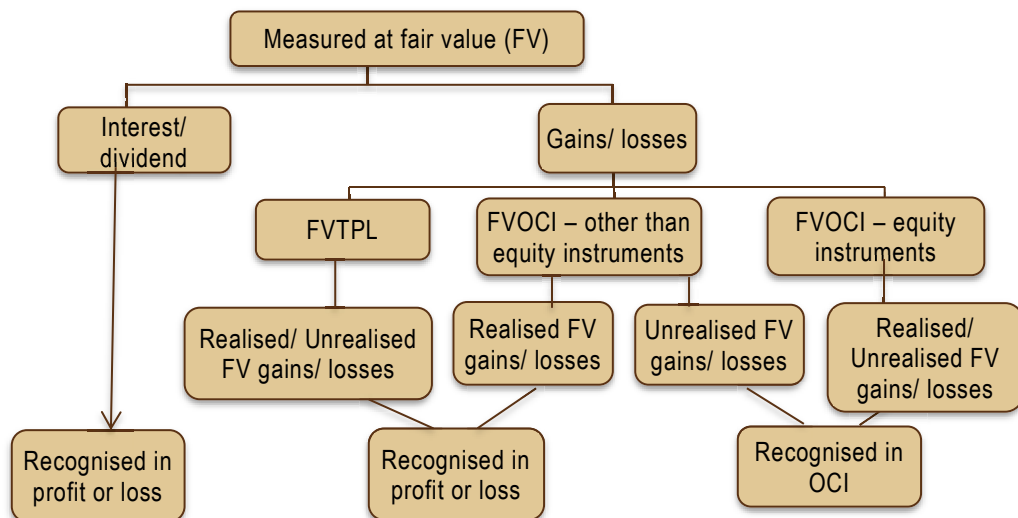
**Or**

- (b) An equity instrument, which otherwise shall be carried at fair value through profit or loss may be irrevocably recognised at fair value through other comprehensive income,

- ii. **Measured at fair value through profit or loss (FVTPL):**

All assets not classified as 'measured at amortised cost' or 'measured at fair value through OCI' shall be classified in this category.

Incomes and/ or expenses on assets measured at fair value shall be recognised as follows:



- If a financial instrument that was previously recognised as a financial asset is measured at fair value through profit or loss and its fair value decreases below zero, it is a financial liability measured at fair value.
  - **Equity instruments – where FV not determinable**
    - ◆ All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range
    - ◆ **Indicators that cost might not be representative of fair value include:**
      - (a) a significant change in the performance of the investee compared with budgets, plans or milestones.
      - (b) changes in expectation that the investee's technical product milestones will be achieved.
      - (c) a significant change in the market for the investee's equity or its products or potential products.
      - (d) a significant change in the global economy or the economic environment in which the investee operates.
      - (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.
      - (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.
      - (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.
    - ◆ The list above is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.
- ◆ Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

**Illustration 22: Accounting for transaction costs on initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income:**

*An entity acquires a financial asset for CU 100 plus a purchase commission of CU 2. Initially, the entity recognises the asset at CU 102. The reporting period ends one day later, when the quoted market price of the asset is CU 100. If the asset were sold, a commission of CU 3 would be paid. How would transaction costs be accounted in books of the entity?*

**Solution**

- On that date, the entity measures the asset at CU 100 (without regard to the possible commission on sale) and recognises a loss of CU 2 in other comprehensive income.
- If the financial asset is measured at fair value through other comprehensive income in accordance with Ind AS 109.4.1.2A, the transaction costs are amortised to profit or loss using the effective interest method.

\*\*\*\*\*

**Illustration 23: Determining fair value upon initial measurement**

*The shareholders of Company C provide C with financing in the form of loan notes to enable it to acquire investments in subsidiaries. The loan notes will be redeemed solely out of dividends received from these subsidiaries and become redeemable only when C has sufficient funds to do so. In this context, 'sufficient funds' refers only to dividend receipts from subsidiaries. Analyse the initial measurement of loan notes.*

**Solution**

In this case –

Loan notes are repayable only when C earns returns in form of dividends from subsidiaries. Hence, C cannot be forced to obtain additional external financing or to liquidate its investments to redeem the shareholder loans. Consequently, the loan notes are not considered payable on demand.

Accordingly –

- Loan notes shall be initially measured at their fair value, being the present value of the expected future cash flows, discounted using a market-related rate. The amount and timing of the expected future cash flows should be determined on the basis of the expected dividend flow from the subsidiaries. Also, the valuation would need to take

into account possible early repayments of principal and corresponding reductions in interest expense.

- Since the loan notes are interest-free or bear lower-than-market interest, there will be a difference between the nominal value of the loan notes - i.e. the amount granted - and their fair value on initial recognition. Because the financing is provided by shareholders, acting in the capacity of shareholders, the resulting credit should be reflected in equity as a shareholder contribution in C's balance sheet. Conversely, in books of shareholders, the difference between amount invested and its fair value shall be recorded as 'investment in C Ltd' being representative of the underlying relationship between shareholders and C Ltd.

\*\*\*\*\*

#### **Illustration 24 : Use of cost v/s fair value determination for equity instruments**

*Silver Ltd. has made an investment in optionally convertible preference shares (OCPS) of a Company – Bronze Ltd. at ₹ 100 per share (face value ₹ 100 per share). Silver Ltd. has an option to convert these OCPS into equity shares in the ratio of 1:1 and if such option not exercised till end of 9 years, then the shares shall be redeemable at the end of 10 years at a premium of 20%.*

*Analyse the measurement of this investment in books of Silver Ltd.*

#### **Solution**

The classification assessment for a financial asset is done based on two characteristics:

- i. Whether the contractual cash flows comprise cash flows that are solely payments of principal and interest on the principal outstanding
- ii. Entity's business model (BM) for managing financial assets – Whether the Company's BM is to collect cash flows; or a BM that involves realisation of both contractual cash flows & sale of financial assets;

In all other cases, the financial assets are measured at fair value through profit or loss.

In the above case, the Holder can realise return either through conversion or redemption at the end of 10 years, hence it does not indicate contractual cash flows that are solely payments of principal and interest. Therefore, such investment shall be carried at fair value through profit or loss. Accordingly, the investment shall be measured at fair value periodically with gain/ loss recorded in profit or loss.

\*\*\*\*\*



**Illustration 25 : Accounting for assets at amortised cost**

A Ltd has made a security deposit whose details are described below. Make necessary journal entries for accounting of the deposit in the first year and last year. Assume market interest rate for a deposit for similar period to be 12% per annum.

| Particulars                                      | Details     |
|--------------------------------------------------|-------------|
| Date of Security Deposit (Starting Date)         | 1-Apr-20X1  |
| Date of Security Deposit (Finishing Date)        | 31-Mar-20X6 |
| Description                                      | Lease       |
| Total Lease Period                               | 5 years     |
| Discount rate                                    | 12.00%      |
| Security deposit (A)                             | 10,00,000   |
| Present value factor at the 5 <sup>th</sup> year | 0.567427    |

**Solution**

The above security deposit is an interest free deposit redeemable at the end of lease term for ₹ 10,00,000. Hence, this involves collection of contractual cash flows and shall be accounted at amortised cost.

**Upon initial measurement –**

| Particulars                                      | Details   |
|--------------------------------------------------|-----------|
| Security deposit (A)                             | 10,00,000 |
| Total Lease Period (Years)                       | 5         |
| Discount rate                                    | 12.00%    |
| Present value factor of 5 <sup>th</sup> year end | 0.56743   |
| Present value of deposit at beginning (B)        | 5,67,427  |
| Prepaid lease payment at beginning (A-B)         | 4,32,573  |

**Journal Entries****Year – 1 beginning**

| Particulars              | Amount   | Amount    |
|--------------------------|----------|-----------|
| Security deposit A/c Dr. | 5,67,427 |           |
| Right-of-Use Asset Dr.   | 4,32,573 |           |
| To Bank A/c              |          | 10,00,000 |

Subsequently, every annual reporting year, interest income shall be accrued @ 12% per annum and prepaid expenses shall be amortised on straight line basis over the lease term.

Year 1 end

| Particulars                           |     | Amount | Amount |
|---------------------------------------|-----|--------|--------|
| Security deposit A/c (5,67,427 x 12%) | Dr. | 68,091 |        |
| To Interest income A/c                |     |        | 68,091 |

At the end of 5<sup>th</sup> year, the security deposit shall accrue ₹ 10,00,000 and prepaid lease expenses shall be fully amortised (i.e. depreciated as per Ind AS 116, this prepaid lease rent would be shown as ROU asset). Journal entry for realisation of security deposit –

| Particulars             |     | Amount    | Amount    |
|-------------------------|-----|-----------|-----------|
| Security deposit A/c    | Dr. | 1,07,143  |           |
| To Interest income A/c  |     |           | 1,07,143  |
| Bank A/c                | Dr. | 10,00,000 |           |
| To Security deposit A/c |     |           | 10,00,000 |

\*\*\*\*\*

#### Illustration 26 : Accounting for assets at FVTPL

A Ltd. invested in equity shares of C Ltd. on 15<sup>th</sup> March for ₹ 10,000. Transaction costs were ₹ 500 in addition to the basic cost of ₹ 10,000. On 31 March, the fair value of the equity shares was ₹ 11,200 and market rate of interest is 10% per annum for a 10 year loan. Pass necessary journal entries. Analyse the measurement principle and pass necessary journal entries.

#### Solution

The above investment is in equity shares of C Ltd and hence, does not involve any contractual cash flows that are solely payments of principal and interest. Hence, these equity shares shall be measured at fair value through profit or loss. Also, an irrecoverable option exists to designate such investment as fair value through other comprehensive income.

#### Journal Entries

| Particulars                                                                                 |     | Amount | Amount |
|---------------------------------------------------------------------------------------------|-----|--------|--------|
| <b>Upon initial recognition –</b>                                                           |     |        |        |
| Investment in equity shares of C Ltd.                                                       | Dr. | 10,000 |        |
| Transaction cost                                                                            | Dr. | 500    |        |
| To Bank A/c                                                                                 |     |        | 10,500 |
| (Being investment recognized at fair value plus transaction costs upon initial recognition) |     |        |        |

|                                                                                      |     |     |     |
|--------------------------------------------------------------------------------------|-----|-----|-----|
| Profit and Loss A/c                                                                  | Dr. | 500 |     |
| To Transaction cost                                                                  |     |     | 500 |
| (Being transaction cost incurred on assets measured at FVTPL transferred to P&L A/c) |     |     |     |

|                                                       |     |       |       |
|-------------------------------------------------------|-----|-------|-------|
| <b>Subsequently –</b>                                 |     |       |       |
| Investment in equity shares of C Ltd.                 | Dr. | 1,200 |       |
| To Fair value gain on financial instruments           |     |       | 1,200 |
| (Being fair value gain recognized at year end in P&L) |     |       |       |
| Fair value gain on financial instruments              | Dr. | 1,200 |       |
| To Profit and Loss A/c                                |     |       | 1,200 |
| (Being fair value gain transferred to P&L A/c)        |     |       |       |

\*\*\*\*\*

**Illustration 27: Accounting for assets at FVOCI**

*Metallics Ltd. has made an investment in equity instrument of a company – Castor Ltd. for 19% equity stake. Significant influence not exercised. The investment was made for ₹ 5,00,000 for 10,000 equity shares on 01 April 20X1. On 30 June 20X1 the fair value per equity share is ₹ 45. The Company has taken an irrevocable option to measure such investment at fair value through other comprehensive income.*

**Solution**

The Company has made an irrecoverable option to carry its investment at fair value through other comprehensive income. Accordingly, the investment shall be initially recognised at fair value and all subsequent fair value gains/ losses shall be recognised in other comprehensive income (OCI).

**Journal Entries**

| Particulars                                                                                 |     | Amount   | Amount   |
|---------------------------------------------------------------------------------------------|-----|----------|----------|
| <b>Upon initial recognition –</b>                                                           |     |          |          |
| Investment in equity shares of C Ltd.                                                       | Dr. | 5,00,000 |          |
| To Bank a/c                                                                                 |     |          | 5,00,000 |
| (Being investment recognized at fair value plus transaction costs upon initial recognition) |     |          |          |

|                                                                                                                                                 |        |        |
|-------------------------------------------------------------------------------------------------------------------------------------------------|--------|--------|
| <b>Subsequently –</b>                                                                                                                           |        |        |
| Fair value loss on equity investment Dr.                                                                                                        | 50,000 |        |
| To Investment in equity shares of C Ltd.                                                                                                        |        | 50,000 |
| (Being fair value loss recognized in OCI section of the Statement of Profit and Loss under items that cannot be reclassified to profit or loss) |        |        |
| Fair Value Reserve for Equity Investments Dr.                                                                                                   | 50,000 |        |
| To Fair value loss on financial instruments                                                                                                     |        | 50,000 |
| (Being fair value loss recognized in other comprehensive income accumulated in equity investments fair value reserve)                           |        |        |

\*\*\*\*\*

**Illustration 28: Accounting for assets at Amortised Cost**

XYZ Ltd. is a company incorporated in India. It provides INR 10,00,000 interest free loan to its wholly owned Indian subsidiary (ABC). There are no transaction costs.

How should the loan be accounted for, in the separate financial statements of XYZ, individual financial statements of ABC and consolidated financial statements of the group?

Consider the following scenarios:

- The loan is repayable on demand.
- The loan is repayable after 3 years. The current market rate of interest for similar loan is 10% p.a. for both holding and subsidiary.
- The loan is repayable when ABC has funds to repay the loan.

**Solution**

Ind AS 109 requires that a financial assets and liabilities are recognized on initial recognition at its fair value, as adjusted for the transaction cost. In accordance with Ind AS 113 Fair Value Measurement, 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.

Using the guidance, the loan will be accounted for as below in various scenarios:

**Scenario (a)**

**Since the loan is repayable on demand**, it has fair value equal to cash consideration given. The parent and subsidiary recognize financial asset and liability, respectively, at the amount of loan given. Going forward, no interest is accrued on the loan.

Upon repayment, both the parent and the subsidiary reverse the entries made at origination.

**Scenario (b)**

Both parent and subsidiary recognize financial asset and liability, respectively, at fair value on initial recognition. The difference between the loan amount and its fair value is treated as an equity contribution to the subsidiary. This represents a further investment by the parent in the subsidiary.

**Accounting in the books of XYZ Ltd (Parent)**

| S. No. | Particulars                                                                  | Amount    | Amount    |
|--------|------------------------------------------------------------------------------|-----------|-----------|
| 1      | <b>On the date of loan</b>                                                   |           |           |
|        | Loan to ABC Ltd (Subsidiary) Dr.                                             | 7,51,315  |           |
|        | Deemed Investment (Capital Contribution) in ABC Ltd. Dr.                     | 2,48,685  |           |
|        | To Bank<br>(Being the loan is given to ABC Ltd and recognised at fair value) |           | 10,00,000 |
| 2      | <b>Accrual of Interest income</b>                                            |           |           |
|        | Loan to ABC Ltd Dr.                                                          | 75,131    |           |
| 3      | To Interest income<br>(Being interest income accrued) – Year 1               |           | 75,131    |
|        | Loan to ABC Ltd Dr.                                                          | 82,645    |           |
| 4      | To Interest income<br>(Being interest income accrued) – Year 2               |           | 82,645    |
|        | Loan to ABC Ltd Dr.                                                          | 90,909    |           |
| 5      | To Interest income<br>(Being interest income accrued) – Year 3               |           | 90,909    |
|        | <b>On repayment of loan</b>                                                  |           |           |
|        | Bank Dr.                                                                     | 10,00,000 |           |
|        | To Loan to ABC Ltd (Subsidiary)                                              |           | 10,00,000 |

**Accounting in the books of ABC Ltd (Subsidiary)**

| S. No. | Particulars                    | Amount    | Amount  |
|--------|--------------------------------|-----------|---------|
| 1      | <b>On the date of loan</b>     |           |         |
|        | Bank Dr.                       | 10,00,000 |         |
|        | To Loan from XYZ Ltd (Payable) |           | 751,315 |

|   |                                                                   |           |           |
|---|-------------------------------------------------------------------|-----------|-----------|
|   | To Equity (Deemed Capital Contribution from XYZ Ltd)              |           | 2,48,685  |
|   | (Being the loan taken from XYZ Ltd. and recognised at Fair value) |           |           |
|   | <b>Accrual of Interest</b>                                        |           |           |
| 2 | Interest expense Dr.                                              | 75,131    |           |
|   | To Loan from XYZ Ltd (Payable)                                    |           | 75,131    |
|   | (Being interest expense recognised) – Year 1                      |           |           |
| 3 | Interest expense Dr.                                              | 82,645    |           |
|   | To Loan from XYZ Ltd (Payable)                                    |           | 82,645    |
|   | (Being interest expense recognised) – Year 2                      |           |           |
| 4 | Interest expense Dr.                                              | 90,909    |           |
|   | To Loan from XYZ Ltd (Payable)                                    |           | 90,909    |
|   | (Being interest expense recognised) – Year 3                      |           |           |
|   | <b>On repayment of loan</b>                                       |           |           |
| 5 | Loan from XYZ Ltd (Payable) Dr.                                   | 10,00,000 |           |
|   | To Bank                                                           |           | 10,00,000 |

**Working Notes:-****1 Computation of Present value of loan**

|                |           |
|----------------|-----------|
| Rate           | 10%       |
| Amount of Loan | 10,00,000 |
| Year           | 3         |
| Present Value  | 7,51,315  |

**2 Computation of interest for Year 1**

|                                    |          |
|------------------------------------|----------|
| Present Value                      | 7,51,315 |
| Rate                               | 10%      |
| Period of interest - for 1 year    | 1        |
| Closing value at the end of year 1 | 8,26,446 |
| Interest for 1 <sup>st</sup> year  | 75,131   |

**3 Computation of interest for Year 2**

|                                             |          |
|---------------------------------------------|----------|
| Value of loan as at the beginning of Year 2 | 8,26,446 |
| Rate                                        | 10%      |

|                                               |          |
|-----------------------------------------------|----------|
| Period of interest - for 2 <sup>nd</sup> year | 1        |
| Closing value at the end of year 2            | 9,09,091 |
| Interest for 2 <sup>nd</sup> year             | 82,645   |

#### 4 Computation of interest for Year 3

|                                               |           |
|-----------------------------------------------|-----------|
| Value of loan as at the beginning of Year 3   | 9,09,091  |
| Rate                                          | 10%       |
| Period of interest - for 3 <sup>rd</sup> year | 1         |
| Closing value at the end of year 3            | 10,00,000 |
| Interest for 3 <sup>rd</sup> year             | 90,909    |

#### Scenario (c)

Generally, a loan, which is repayable when funds are available, can't be stated to be repayable on demand. Rather, the entities need to estimate repayment date and determine its measurement accordingly. If the loan is expected to be repaid in three years, its measurement will be the same as in scenario (b).

In the Consolidated Financial Statements (CFS), the loan and interest income/expense will get eliminated as intra-group transaction in all three scenarios. Hence the above accounting will not have any impact in the CFS. However, if the loan is in foreign currency, exchange difference will continue to impact the statement of profit and loss in accordance with the requirements of Ind AS 21.

\*\*\*\*\*



## 2.7 FINANCIAL LIABILITIES: CLASSIFICATION

- Upon initial recognition, all financial liabilities are measured at fair value. Subsequently, per Ind AS 109.4.2.1 – the classification of financial liabilities shall be as follows:
  - (A) Measured at amortised cost
  - (B) Measured at fair value through profit or loss:
    - ◆ Liabilities that meet the definition of “held for trading”
    - ◆ Contingent consideration recognized by an acquirer in a business combination
  - (C) Designated at fair value through profit or loss
  - (D) Other specific measurement basis (with changes recognized in profit or loss):

- ◆ financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies: refer paragraph 3.2.15 or 3.2.17 of Ind AS 109
- ◆ financial guarantee contracts and commitments to provide a loan at a below-market interest rate are subsequently measured at higher of:
  - the amount of the loss allowance, and
  - the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115.”

**Irrespective of above classification, any financial liabilities may be designated at fair value through profit or loss if:**

- i. It eliminates or significantly reduces a measurement or recognition inconsistency (**‘accounting mismatch’**) that would otherwise arise from measuring assets or liabilities; or their gains on a different basis; or
  - ii. A group of financial liabilities and financial assets is managed and its performance is evaluated on fair value basis, in accordance with a documented risk management or investment strategy, and information about that group is provided internally on that basis to the entity’s key management personnel.
- **Financial assets and financial liabilities held for trading:**
    - ◆ Financial assets and liabilities held for trading are defined as those that:
      - (a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;
      - (b) on initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
      - (c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer’s margin.
    - ◆ In addition to derivatives that are not accounted for as hedging instruments, financial liabilities held for trading include:
      - (a) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);



- (b) financial liabilities that are incurred with an intention to repurchase them in the near term, such as quoted debt instruments that the issuer may buy back in the near term depending on changes in fair value; and
- (c) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

However, the fact that a liability is used merely to fund trading activities does not in itself make that liability one that is held for trading.

#### Illustration 29 : Trade creditors at market terms

*A Company purchases its raw materials from a vendor at a fixed price of ₹ 1,000 per tonne of steel. The payment terms provide for 45 days of credit period, after which an interest of 18% per annum shall be charged. How would the creditors be classified in books of the Company?*

#### Solution

In the above case, creditors for purchase of steel shall be carried at amortised cost, ie, fair value of amount payable upon initial recognition plus interest (if payment is delayed). Here, fair value upon initial recognition shall be the price per tonne. The transaction price is representative of fair value.

\*\*\*\*\*

#### Illustration 30

*An entity is about to purchase a portfolio of **fixed rate assets** that will be **financed by fixed rate debentures**. Both financial assets and financial liabilities are subject to the same interest rate risk that gives rise to opposite changes in fair value that tend to offset each other. Provide your comments.*

#### Solution

The fixed rate assets provide for contractual cash flows and based on business model of the entity, such fixed rate assets may be classified as 'amortised cost' (if entity collects contractual cash flows) or fair value through other comprehensive income (FVOCI) (if entity manages through collecting contractual cash and sale of financial assets).

In the absence of fair value option, the entity can classify the fixed rate assets as FVOCI with gains and losses on changes in fair value recognised in other comprehensive income and fixed rate debentures at amortised cost. However, reporting both assets and liabilities at fair value through profit and loss, ie, FVTPL corrects the measurement inconsistency and produces more relevant information.

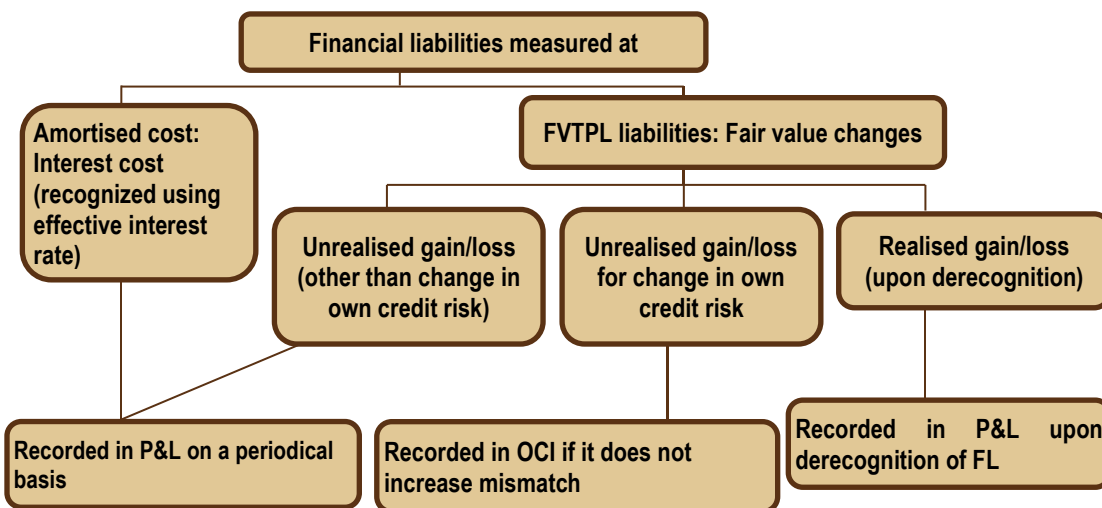
Hence, it may be appropriate to classify the entire group of fixed rate assets and fixed rate debentures at fair value through profit or loss (FVTPL).

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## 2.8 FINANCIAL LIABILITIES: MEASUREMENT

- Measurement of financial liabilities is driven by their classification upon initial recognition as follows:



- Specific transactions – restructuring of financial liability**

If the terms of a financial liability are modified substantially, resulting in an extinguishment of the old financial liability, then the old liability is derecognised and the restructured financial instrument is treated as a new financial liability. If a modification of a financial liability results in derecognition of the financial liability, then the effective interest rate of the new financial liability is calculated based on the revised terms of the financial liability at the date of the modification. In this case, any costs or fees incurred are recognised as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability.

If the exchange or modification is not accounted for as an extinguishment, then any costs and fees incurred are recognised as an adjustment to the carrying amount of the liability. For changes in future cash flows, the entity shall revise the amortised cost of the financial liability to reflect revised future cash flows by discounting them to their present value at the original effective interest rate. The difference between the carrying value and revised amortised cost is recognised as a gain or loss in profit or loss.

Modification is considered to be substantial if the discounted present value of the cash flows under the new terms including any fees paid net of any fees received and discounted using the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. Only fees paid or

received between the borrower and the lender including fees paid or received by either the borrower or lender on the other's behalf are considered in this 10% test.

### Illustration 31: Issue of borrowings with fixed rate of interest

A Ltd has borrowed from RBC Bank ₹ 10,000 at a fixed interest of 10% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable after 5 years in bullet repayment of principal. Details are as follows:

| Particulars                                            | Details                                |
|--------------------------------------------------------|----------------------------------------|
| Loan amount                                            | ₹ 10,000                               |
| Date of loan (Starting Date)                           | 1-Apr-20X1                             |
| Date of repayment of principal amount (Finishing Date) | 31-March-20X6                          |
| Interest rate                                          | 10.00%                                 |
| Interest charge                                        | Interest to be charged and paid yearly |
| Upfront fees                                           | ₹ 500                                  |

How would loan be accounted in books of A Ltd?

### Solution

The loan taken by A Ltd shall be measured at amortised cost as follows:

- Initial measurement – At transaction price less processing fees  
 $= 10,000 - 500 = 9,500$
- Subsequently – interest to be accrued using effective rate of interest as follows:

| Year end | Opening balance | Interest @ 11.42% | Repayment of interest & principal | Closing balance |
|----------|-----------------|-------------------|-----------------------------------|-----------------|
| 1        | 9,500           | 1,085             | 1,000                             | 9,585           |
| 2        | 9,585           | 1,095             | 1,000                             | 9,679           |
| 3        | 9,679           | 1,105             | 1,000                             | 9,785           |
| 4        | 9,785           | 1,117             | 1,000                             | 9,902           |
| 5        | 9,902           | 1,098*            | 11,000                            | -               |

\* Difference due to approximation

### Computation of IRR

IRR would be the rate using which the present value of cash flow should come out to be ₹ 9,500 i.e. (₹ 10,000 less ₹ 500).

For this, we should first compute present value of cashflows using any two rates as follows:

| Year end | Opening balance | Repayment/Cashflows | Closing balance | PVF @ 10% | Present Value at 10% rate | PVF @ 13% | Present Value at 13% rate |
|----------|-----------------|---------------------|-----------------|-----------|---------------------------|-----------|---------------------------|
| 1        | 9,500           | 1,000               | 8,500           | 0.909     | 909                       | 0.885     | 885                       |
| 2        | 8,500           | 1,000               | 7,500           | 0.826     | 826                       | 0.783     | 783                       |
| 3        | 7,500           | 1,000               | 6,500           | 0.751     | 751                       | 0.693     | 693                       |
| 4        | 6,500           | 1,000               | 5,500           | 0.683     | 683                       | 0.613     | 613                       |
| 5        | 5,500           | 11,000              | (5,500)         | 0.621     | 6,830                     | 0.543     | 5,970*                    |
|          |                 |                     |                 |           | <b>10,000</b>             |           | <b>8,945</b>              |

\*Difference is due to approximation

Taking 10% as discount rate, present value (PV) comes out to be ₹ 10,000.

If rate is increased by 3% over a base rate of 10%, PV decreases by ₹ 1,055 (i.e. ₹ 10,000 less ₹ 8945).

To decrease PV by ₹ 1,055, rate should be increased = 3%

To decrease PV by Re.1, rate should be increased =  $\frac{3\%}{1,055}$

To decrease PV by ₹ 500, rate should be increased =  $3\% \times (500/1,055)$   
= 1.42%

This would mean that the discount rate to get present value of cashflows equivalent to ₹ 9,500 should be 11.42% (i.e. 10% + 1.42%).

### Illustration 32: Issue of borrowings with fixed rate of interest

A Ltd has made a borrowing from RBC Bank for ₹ 10,000 at a fixed interest of 12% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable 4 half-yearly instalments of ₹ 2,500 each. Details are as follows:

| Particulars                   | Details                                                             |
|-------------------------------|---------------------------------------------------------------------|
| Loan amount                   | ₹ 10,000                                                            |
| Date of loan (Starting Date)  | 1-Apr-20X1                                                          |
| Date of loan (Finishing Date) | 31-March-20X3                                                       |
| Description of repayment      | Repayment of loan starts from 30-Sept-20X1 (To be paid half yearly) |
| Installment amount            | ₹ 2,500                                                             |
| Interest rate                 | 12.00%                                                              |

|                 |                                  |
|-----------------|----------------------------------|
| Interest charge | Interest to be charged quarterly |
| Upfront fees    | ₹ 500                            |

How would loan be accounted in books of A Ltd?

Consider IRR is 16.60% p.a.

### Solution

The loan taken by A Ltd shall be measured at amortised cost as follows:

- Initial measurement – At transaction price less processing fees  
 $= 10,000 - 500 = 9,500$
- Subsequently – interest to be accrued using effective rate of interest as follows:

| Date        | Amount of Loan | Re-payment | Upfront fees paid | Amount of Interest | Days | IRR Calculation | Revised Interest computed | Loan Balance |
|-------------|----------------|------------|-------------------|--------------------|------|-----------------|---------------------------|--------------|
| 1-Apr-20X1  | 10,000         | -          | 500               | -                  | -    | 9,500           | -                         | -            |
| 30-Jun-20X1 | -              | -          | -                 | 300                | 90   | (300)           | 389                       | 9,589        |
| 30-Sep-20X1 | -              | 2500       | -                 | 300                | 92   | (2,800)         | 401                       | 7,190        |
| 31-Dec-20X1 | -              | -          | -                 | 225                | 92   | (225)           | 301                       | 7,266        |
| 31-Mar 20X2 | -              | 2500       | -                 | 225                | 90   | (2,725)         | 297                       | 4,838        |
| 30-Jun-20X2 | -              | -          | -                 | 150                | 91   | (150)           | 200                       | 4,888        |
| 30-Sep-20X2 | -              | 2500       | -                 | 150                | 92   | (2,650)         | 204                       | 2,442        |
| 31-Dec-20X2 | -              | -          | -                 | 75                 | 92   | (75)            | 102                       | 2,473        |
| 31-Mar-20X3 | -              | 2500       | -                 | 75                 | 91   | (2,575)         | 102                       | -            |
|             |                |            |                   |                    | IRR  | 16.60%          |                           |              |

\*\*\*\*\*

### Illustration 33: Accounting treatment of processing fees belonging to undisbursed loan amount

X Ltd. had taken 6 year term loan in April 20X0 from bank and paid processing fees at the time of sanction of loan.

The term loan is disbursed in different tranches from April 20X0 to April 20X6. On the date of transition to Ind AS, i.e. 1.4.20X5, it has calculated the net present value of term loan disbursed upto 31.03.20X5 by using effective interest rate and proportionate processing fees has been adjusted in disbursed amount while calculating net present value.

What will be the accounting treatment of processing fees belonging to undisbursed term loan amount?

**Solution**

Processing fee is an integral part of the effective interest rate of a financial instrument and shall be included while calculating the effective interest rate.

**(a) Accounting treatment in case future drawdown is probable**

It may be noted that to the extent there is evidence that it is probable that the undisbursed term loan will be drawn down in the future, the processing fee is accounted for as a transaction cost under Ind AS 109, i.e., the fee is deferred and deducted from the carrying value of the financial liabilities when the draw down occurs and considered in the effective interest rate calculations.

**(b) Accounting treatment in case future drawdown is not probable**

If it is not probable that the undisbursed term loan will be drawn down in the future, then the fees is recognised as an expense on a straight-line basis over the term of the loan.

\*\*\*\*\*

**Illustration 34: Accounting treatment of prepayment premium and processing fees for obtaining new loan to prepay old loan**

*PQR Limited had obtained term loan from Bank A in 20X1-20X2 and paid loan processing fees and commitment charges.*

*In May 20X5, PQR Ltd. has availed fresh loan from Bank B as take-over of facility i.e. the new loan is sanctioned to pay off the old loan taken from Bank A. The company paid prepayment premium to Bank A to clear the old term loan and paid processing fees to Bank B for the new term loan.*

*Whether the prepayment premium and the processing fees both will be treated as transaction cost (as per Ind AS 109, Financial Instruments) of obtaining the new loan, in the financial statements of PQR Ltd?*

**Solution****(a) Accounting treatment of prepayment premium**

Ind AS 109, provides that if an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment in the statement of profit and loss.

Since the original loan was prepaid, the prepayment would result in extinguishment of the original loan. The difference between the CV of the financial liability extinguished and the consideration paid shall be recognised in profit or loss as per Ind AS 109.

Accordingly, the prepayment premium shall be recognised as part of the gain or loss on extinguishment of the old loan.

**(b) Accounting treatment of unamortised processing fee of old loan**

Processing fees are not amortised separately from the loan. Processing fees are part of EIR and therefore are amortised with the loan. Therefore, the accounting treatment of unamortised processing fee will be the same as for the loan that is derecognised from financial liability and recognised in profit or loss. In other words, unamortised processing fee related to the old loan will also be required to be charged to the statement of profit and loss.

**(c) Accounting treatment of processing fee for new loan**

Transaction costs are “Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.”

It is assumed that the loan processing fees solely relates to the origination of the new loan (i.e. does not represent loan modification/renegotiation fees). Hence, the processing fees paid to avail fresh loan from Bank B will be considered as transaction cost in the nature of origination fees of the new loan and will be included while calculating effective interest rate as per Ind AS 109.

\*\*\*\*\*

**Illustration 35: Accounting treatment of share held as stock in trade**

*A share broking company is dealing in sale/purchase of shares for its own account and therefore is having inventory of shares purchased by it for trading.*

*How will these instruments be accounted for in the financial statements?*

**Solution**

Ind AS 2, Inventories, states that this Standard applies to all inventories, except financial instruments (Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments).

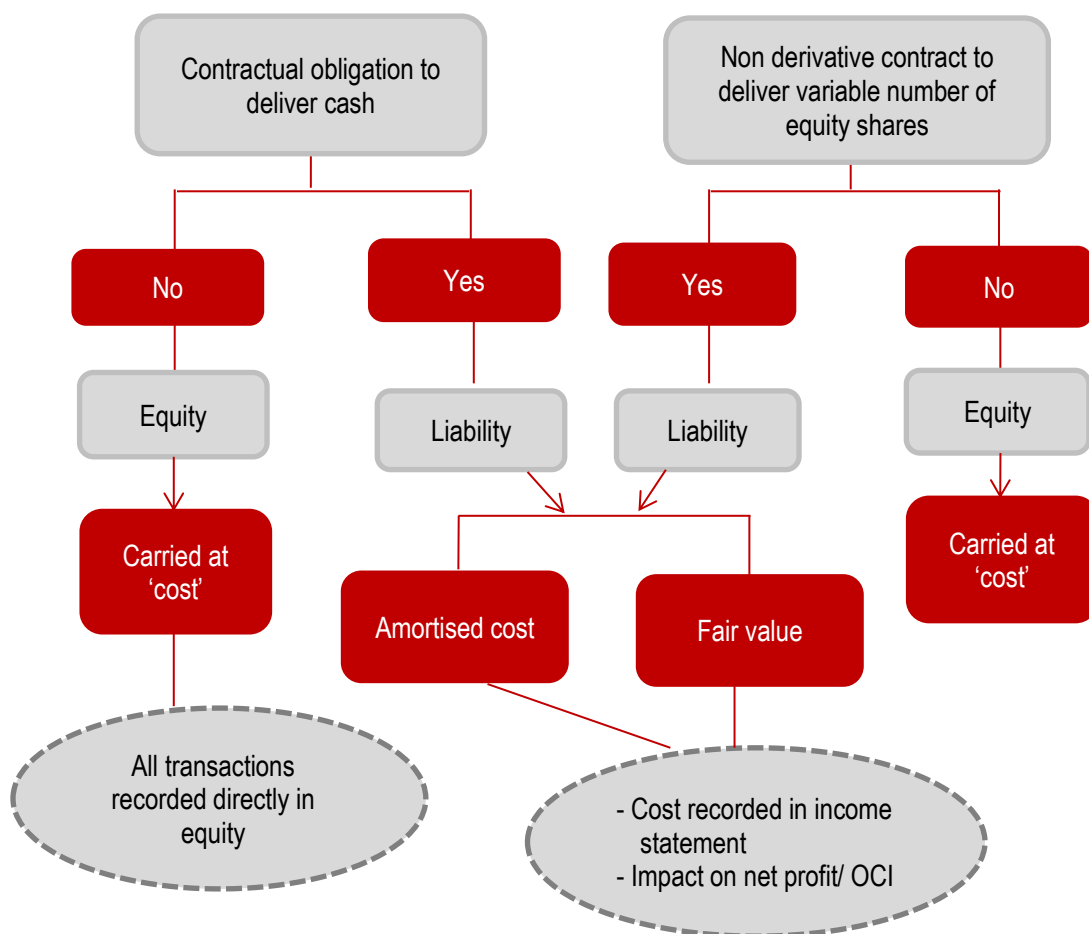
Accordingly, the principles of recognising and measuring financial instruments are governed by Ind AS 109, its presentation is governed by Ind AS 32 and disclosures are in accordance with Ind AS 107, Financial Instruments: Disclosures, even if these instruments are held as stock-in trade by a company.

Further Ind AS 101, First-time Adoption of Indian Accounting Standards does not provide any transitional relief from the application of the above standards.

Accordingly, in the given case, the relevant requirements of Ind AS 109, Ind AS 32 and Ind AS 107 shall be applied retrospectively.

\*\*\*\*\*

Difference between measurement requirements of financial liability and equity and their comparison can be understood with the help of following diagrammatic presentation –



## 2.9 RECLASSIFICATION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Per Ind AS 109.4.4.1 – An entity shall reclassify financial assets, *only* if the entity changes its business model for managing those financial assets.

- **Such changes are expected to be very infrequent.** Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line.



- **Examples** of a change in business model include the following:
  - (a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
  - (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.
- **Accounting for reclassification of financial assets:**
  - ◆ A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.
  - ◆ If an entity reclassifies any financial asset, it must do so **prospectively from reclassification date**.
  - ◆ The entity shall **not restate** any previously recognised gains, losses (including impairment gains or losses) or interest.
- **Following are not changes in business model:**
  - (a) a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
  - (b) the temporary disappearance of a particular market for financial assets;
  - (c) a transfer of financial assets between parts of the entity with different business models.
- **Following changes in circumstances are not reclassifications:**
  - (a) an item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;
  - (b) an item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and
  - (c) changes in measurement for a financial instrument, if the entity takes credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or part of such financial instrument and consequently, the underlying financial instrument is also designated at fair value through profit or loss.

- **Financial liabilities are not permitted to be reclassified.**

#### Illustrative examples:

##### ◆ **Case 1:** Amortised cost to FVTPL

- It is measured at fair value on reclassification date.
- Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

#### Illustration 36

*Bonds for ₹ 1,00,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.*

#### Solution

| Particulars                |     | Amount | Amount   |
|----------------------------|-----|--------|----------|
| Bonds at FVTPL             | Dr. | 90,000 |          |
| Loss on reclassification   | Dr. | 10,000 |          |
| To Bonds at amortised cost |     |        | 1,00,000 |

\*\*\*\*\*

##### ◆ **Case 2:** Amortised cost to FVOCI

- It is measured at fair value on reclassification date.
- Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income
- Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

#### Illustration 37

*Bonds for ₹ 1,00,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.*

#### Solution

| Particulars                    |     | Amount | Amount   |
|--------------------------------|-----|--------|----------|
| Bonds at FVOCI                 | Dr. | 90,000 |          |
| OCI (Loss on reclassification) | Dr. | 10,000 |          |
| To Bonds at amortised cost     |     |        | 1,00,000 |

\*\*\*\*\*

◆ **Case 3: FVTPL to Amortised cost**

- It is measured at fair value on reclassification date and this fair value becomes the new gross carrying amount. Effective interest rate is computed based on this new gross carrying amount.
- Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

**Illustration 38**

*Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.*

**Solution**

| Particulars              |     | Amount | Amount   |
|--------------------------|-----|--------|----------|
| Bonds at Amortised cost  | Dr. | 90,000 |          |
| Loss on reclassification | Dr. | 10,000 |          |
| To Bonds at FVTPL        |     |        | 1,00,000 |

\*\*\*\*\*

◆ **Case 4: FVTPL to FVOCI**

- The financial asset continues to be measured at fair value.
- The effective interest rate is determined on the basis of fair value of asset at reclassification date.

**Illustration 39**

*Bonds for ₹ 100,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.*

**Solution**

| Particulars              |     | Amount | Amount   |
|--------------------------|-----|--------|----------|
| Bonds at FVOCI           | Dr. | 90,000 |          |
| Loss on reclassification | Dr. | 10,000 |          |
| To Bonds at FVTPL        |     |        | 1,00,000 |

\*\*\*\*\*

◆ **Case 5: FVOCI to Amortised cost**

- The financial asset is measured at fair value on reclassification date.
- However, cumulative gain or loss previously recognised in other comprehensive income (OCI) is removed from equity and adjusted against fair value of financial asset at reclassification date.

- As a result, the financial asset is measured at reclassification date as if it had always been measured at amortised cost. This adjustment affects OCI but does not affect profit or loss and therefore, is not a reclassification adjustment.
- Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

**Illustration 40**

*Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000 and ₹ 10,000 loss was recognised in OCI till date of reclassification. Pass required journal entry.*

**Solution**

| Particulars                                                           | Amount   | Amount   |
|-----------------------------------------------------------------------|----------|----------|
| Bonds at FVOCI Dr.                                                    | 10,000   |          |
| To OCI - Loss on reclassification                                     |          | 10,000   |
| [Being loss recognized in OCI now reversed prior to reclassification] |          |          |
| Bonds (Amortised cost) Dr.                                            | 1,00,000 |          |
| To Bonds at FVOCI                                                     |          | 1,00,000 |
| [Being bonds reclassified from FVOCI to Amortised cost]               |          |          |

\*\*\*\*\*

◆ **Case 6: FVOCI to FVTPL**

- The financial asset continues to be measured at fair value.
- The cumulative gain or loss previously recognised in other comprehensive income (OCI) is reclassified from equity to profit or loss as a reclassification adjustment at the reclassification date.

**Illustration 41**

*Bonds for ₹ 100,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.*

**Solution**

| Particulars                        | Amount | Amount |
|------------------------------------|--------|--------|
| P&L - Loss on reclassification Dr. | 10,000 |        |
| To Bonds at FVOCI                  |        | 10,000 |
| Bonds at FVTPL Dr.                 | 90,000 |        |
| To Bonds at FVOCI                  |        | 90,000 |

\*\*\*\*\*



## 2.10 IMPAIRMENT

- **Scope of impairment**

An entity shall recognise a loss allowance for expected credit losses on the following:

- (a) a financial asset that is measured at amortised cost
- (b) a financial asset that is measured at fair value through other comprehensive income
- (c) a lease receivable,
- (d) a contract asset or a loan commitment; and
- (e) a financial guarantee contract

- **The impairment model does not apply to:**

- (a) All financial assets that are equity instruments (because these are measured either at FVTPL or FVTOCI),
- (b) Financial assets that are debt instruments and are measured as at FVTPL,
- (c) Any other financial instrument measured as at FVTPL.

- **What is a credit loss allowance?**

- ◆ For financial assets, a credit loss is the present value of the difference between:
  - (a) the contractual cash flows that are due to an entity under the contract; and
  - (b) the cash flows that the entity expects to receive (i.e., cash short falls) discounted at original effective interest rate (or credit adjusted effective interest rate in case of purchased or originated credit-impaired financial assets).
- ◆ An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for eg.: prepayment, extension, call and similar options) through the expected life of the financial instrument.
- ◆ The cash flows that are considered shall include cash flows from sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of the financial instrument can be estimated reliably. In those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

- **Different approaches for impairment of financial assets.**

- (a) **General Approach**

- The general approach requires an entity to recognise, at each reporting date, an impairment loss allowance using either 12 month ECL or lifetime ECL.
    - 12 month ECL typically results in lower impairment since it focuses only on probability of default (PD) within next 12 month period, as against PD over the life of an instrument.
    - The use of ECL depends on whether there has been a significant increase in credit risk on the instrument since its initial recognition.
    - This approach is applicable to all financial instruments covered by impairment requirements of Ind AS 109, except instruments covered in the following two approaches.

- (b) **Simplified Approach**

- This approach does not require an entity to track changes in credit risk. Rather, each entity recognises impairment loss allowance based on lifetime ECLs at each reporting date, right from its initial recognition.
    - The application of simplified approach is mandatory for trade receivables or any contractual right to receive cash or another financial asset that result from transactions that are within the scope of Ind AS 115 having no significant financing component.

- (c) **Purchased or originated credit-impaired (POCI) financial assets approach**

- This approach is applicable to financial assets which are credit impaired on purchase/origination.

- **What is 12-month expected credit losses and lifetime expected credit losses?**

- Lifetime expected credit loss is the expected credit losses that result from all possible default events over the expected life of a financial instrument.
  - 12-Month expected credit loss is the portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

- **How the entity determine whether it should apply 12-month ECL or lifetime ECL?**

The decision tree to be applied in determining whether the entity needs to provide for 12-month expected credit losses or life time expected credit losses is applied as follows:

| Three Stage Model for Impairment |                                   |                                     |                            |
|----------------------------------|-----------------------------------|-------------------------------------|----------------------------|
| Particular                       | Stage 1                           | Stage 2                             | Stage 3                    |
|                                  | Initial Recognition               | Significant increase in credit risk | Credit Impaired            |
| Credit Risk                      | Low                               | Moderate to High                    | Significant                |
| ECL Model                        | 12 Month ECL                      | Life-time ECL                       | Life-time ECL              |
| Interest recognition             | Interest on gross carrying amount | Interest on gross carrying amount   | Interest on amortised cost |

- **Appendix A of Ind AS 109 defines gross carrying amount of a financial asset as** the amortised cost of a financial asset, before adjusting for any loss allowance.
- **Appendix A of Ind AS 109 defines amortised cost of a financial asset or financial liability as** the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.
- **Determining whether credit risk has increased significantly:**

Ind AS 107 defines **credit risk** as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

- ◆ When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect the credit risk on a financial instrument.
- ◆ The following non-exhaustive list of information may be relevant in assessing changes in credit risk:
  - (a) significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.
  - (b) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

- (c) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:
  - i. the credit spread;
  - ii. the credit default swap prices for the borrower;
  - iii. the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and
  - iv. other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.
- (d) an actual or expected significant change in the financial instrument's external credit rating.
- (e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally.
- (f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates
- (g) an actual or expected significant change in the operating results of the borrower, for eg.: actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure, etc. that results in a significant change in the borrower's ability to meet its debt obligations
- (h) significant increases in credit risk on other financial instruments of the same borrower
- (i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower
- (j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements;
- (k) a significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion
- (l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of



credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments

- (m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument
- (n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group
- (o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.
- (p) Other past due information.

- **30 days past due rebuttable presumption:**

Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

- An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due.
- When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

- **What is credit impaired financial assets:**

- ◆ A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:
  - (a) Significant financial difficulty of the issuer or the borrower;
  - (b) Breach of contract, such as a default or past due event;

- (c) Lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
- (d) It is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- (e) the disappearance of an active market for that financial asset because of financial difficulties; or
- (f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event-instead, the combined effect of several events may have caused financial assets to become credit-impaired.

- **Measurement of expected credit losses:**

- ◆ An entity shall measure expected credit losses of a financial instrument in a way that reflects:
  - (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
  - (b) the time value of money; and
  - (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.
- ◆ When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.
- ◆ The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.
- ◆ **An entity may use practical expedients when measuring expected credit losses.**
  - An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for

example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90–180 days past due etc).

- Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

#### **Illustration 42 : 12 month expected credit loss – Probability of default approach**

*Entity A originates a single 10 year amortising loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PoD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PoD are a reasonable approximation of the changes in the lifetime PoD for determining whether there has been a significant increase in credit risk since initial recognition. Loss given default (LGD) is estimated as 25% of the balance outstanding. Calculate loss allowance.*

#### **Solution**

At reporting date, no change in 12-month POD and entity assesses that there is no significant increase in credit risk since initial recognition – therefore lifetime ECL is not required to be recognised.

| Particulars                        | Details         |
|------------------------------------|-----------------|
| Loan                               | ₹ 1,000,000 (A) |
| LGD                                | 25% (B)         |
| PoD – 12 months                    | 0.5% (C)        |
| Loss allowance (for 12-months ECL) | ₹ 1,250 (A*B*C) |

\*\*\*\*\*

#### **Illustration 43: 12 month expected credit loss – Loss rate approach**

*Bank A originates 2,000 bullet loans with a total gross carrying amount of CU 500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU 200, for a total gross carrying amount of CU 200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU 300, for a total gross carrying amount of CU 300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees. Calculate loss rate when*

| Group | Historic per annum average defaults | Present value of observed loss assumed |
|-------|-------------------------------------|----------------------------------------|
| X     | 4                                   | CU 600                                 |
| Y     | 2                                   | CU 450                                 |

**Solution**

- Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans.
- In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

|       | Number of clients in sample | Estimated per client gross carrying amount at default | Total estimated gross carrying amount at default | Historic per annum average defaults | Estimated total gross carrying amount at default | Present value of observed loss assumed | Loss rate      |
|-------|-----------------------------|-------------------------------------------------------|--------------------------------------------------|-------------------------------------|--------------------------------------------------|----------------------------------------|----------------|
| Group | A                           | B                                                     | $C = A \times B$                                 | D                                   | $E = B \times D$                                 | F                                      | $G = F \div C$ |
| X     | 1,000                       | CU 200                                                | CU 2,00,000                                      | 4                                   | CU 800                                           | CU 600                                 | 0.3%           |
| Y     | 1,000                       | CU 300                                                | CU 3,00,000                                      | 2                                   | CU 600                                           | CU 450                                 | 0.15%          |

\*\*\*\*\*

**Illustration 44: Life time expected credit losses (provision matrix for short term receivables)**

Company M, a manufacturer, has a portfolio of trade receivables of CU 30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with Ind AS 115. In accordance with paragraph 5.5.15 of Ind AS 109 the loss allowance for such trade receivables is always measured at an amount equal to lifetime expected credit losses.

Please use the following information of debtors outstanding:

|                     | Gross carrying amount |
|---------------------|-----------------------|
| Current             | CU 15,000,000         |
| 1–30 days past due  | CU 7,500,000          |
| 31–60 days past due | CU 4,000,000          |

|                            |                             |
|----------------------------|-----------------------------|
| 61–90 days past due        | CU 2,500,000                |
| More than 90 days past due | <u>CU 1,000,000</u>         |
|                            | <b><u>CU 30,000,000</u></b> |

Company M uses following default rates for making provisions:

|              | <b>Current</b> | <b>1–30 days past due</b> | <b>31–60 days past due</b> | <b>61–90 days past due</b> | <b>More than 90 days past due</b> |
|--------------|----------------|---------------------------|----------------------------|----------------------------|-----------------------------------|
| Default rate | 0.3%           | 1.6%                      | 3.6%                       | 6.6%                       | 10.6%                             |

Determine the expected credit losses for the portfolio

### Solution

To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

|              | <b>Current</b> | <b>1–30 days past due</b> | <b>31–60 days past due</b> | <b>61–90 days past due</b> | <b>More than 90 days past due</b> |
|--------------|----------------|---------------------------|----------------------------|----------------------------|-----------------------------------|
| Default rate | 0.3%           | 1.6%                      | 3.6%                       | 6.6%                       | 10.6%                             |

The trade receivables from the large number of small customers amount to CU 30 million and are measured using the provision matrix.

|                            | <b>Gross carrying amount</b> | <b>Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)</b> |
|----------------------------|------------------------------|-------------------------------------------------------------------------------------------------------------|
| Current                    | CU 15,000,000                | CU 45,000                                                                                                   |
| 1–30 days past due         | CU 7,500,000                 | CU 120,000                                                                                                  |
| 31–60 days past due        | CU 4,000,000                 | CU 144,000                                                                                                  |
| 61–90 days past due        | CU 2,500,000                 | CU 165,000                                                                                                  |
| More than 90 days past due | <u>CU 1,000,000</u>          | <u>CU 106,000</u>                                                                                           |
|                            | <b><u>CU 30,000,000</u></b>  | <b><u>CU 580,000</u></b>                                                                                    |

\*\*\*\*\*

## QUICK RECAP

- The classification and measurement of financial instruments are summarized as below :

|                                | Financial Assets                                                                             |                                                                                                    |                                                                                           | Financial Liabilities                                                                        |                                                                                                                              | Equity                                                              |
|--------------------------------|----------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------|
| Classification                 | Amortised Cost                                                                               | FVTOCI                                                                                             | FVTPL                                                                                     | Amortised Cost                                                                               | FVTPL                                                                                                                        | -                                                                   |
| <b>Basis of Classification</b> | <ul style="list-style-type: none"> <li>BM test to collect</li> <li>SPPI test</li> </ul>      | <ul style="list-style-type: none"> <li>BM test to collect &amp; sell</li> <li>SPPI test</li> </ul> | <ul style="list-style-type: none"> <li>Held for trading (SPPI or BM test fail)</li> </ul> | <ul style="list-style-type: none"> <li>Default criterial</li> </ul>                          | <ul style="list-style-type: none"> <li>If held for trading</li> <li>Entity elects FVTPL (using fair value option)</li> </ul> | -                                                                   |
| <b>Initial recognition</b>     | <ul style="list-style-type: none"> <li>Fair Value plus or minus transaction costs</li> </ul> | <ul style="list-style-type: none"> <li>Fair Value plus or minus transaction costs</li> </ul>       | <ul style="list-style-type: none"> <li>Fair Value</li> </ul>                              | <ul style="list-style-type: none"> <li>Fair Value plus or minus transaction costs</li> </ul> | <ul style="list-style-type: none"> <li>Fair Value</li> </ul>                                                                 | <ul style="list-style-type: none"> <li>Fair Value</li> </ul>        |
| <b>Subsequent recognition</b>  | <ul style="list-style-type: none"> <li>Amortised Cost</li> </ul>                             | <ul style="list-style-type: none"> <li>Fair Value</li> </ul>                                       | <ul style="list-style-type: none"> <li>Fair Value</li> </ul>                              | <ul style="list-style-type: none"> <li>Amortised cost</li> </ul>                             | <ul style="list-style-type: none"> <li>Fair Value</li> </ul>                                                                 | <ul style="list-style-type: none"> <li>No Re-measurement</li> </ul> |

- Financial asset (FA) will be classified as amortised cost if the objective is to hold the financial asset in order to collect contractual cash flows and contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.
- Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest on the principal amount outstanding. Contractual cash flows must be consistent with a basic lending arrangement. In respect of Interest element, factors such as time value of money, Credit risk, Liquidity, profit margin, service or administrative costs etc. should be considered. Contractual cash flows linked to features such as changes in equity or commodity prices, would not pass the SPPI test because they introduce exposure to risks or volatility. SPPI Test will be met if there is a prepayment penalty i.e. additional compensation for early termination or extension of contract.

- An entity may have one of the following models for its debt instruments :
  - (a) Hold to collect contractual cash flows
  - (b) Hold to collect contractual cash flows and selling financial assets
  - (c) Other business model – Actively buying & Selling
- Financial asset (FA) in debt instruments is measured at fair value through OCI (FVTOCI) if it meets both 'Hold-to-collect and sell' business model test and 'SPPI' contractual cash flow characteristics test.
- In respect of Financial asset (FA) in equity instruments, Ind AS 109 requires all equity investments to be measured at fair value. All changes in fair value to be recognised in profit or loss. However, Entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI. Such option is available instrument by instrument i.e. (item by item) and all subsequent changes in fair value being recognised in OCI. Dividends received on equity investments to be recognised in profit or loss.
- Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument

## UNIT 3: FINANCIAL INSTRUMENTS: EQUITY AND FINANCIAL LIABILITIES



### 3.1 INTRODUCTION

Ind AS 32 lays down the accounting principles for classifying a financial instrument issued by an entity as either a financial liability or equity or both (a compound instrument). The classification of a financial instrument is governed by the substance of a contract and not its legal form.

As you would see in the following paragraphs, classification of a financial instrument into financial liability or equity or compound involves analysis of each component of a contract. Incorrect classification results in misstatement of financial statements and significantly affects the financial ratios that are derived therefrom.



### 3.2 DEFINITIONS – FINANCIAL LIABILITY AND EQUITY

It is important to read paragraphs 11 and 16 of Ind AS 32 together to identify the accounting principles that distinguish a financial liability instrument from an equity instrument.

Before we look at the two definitions in a comparative format, it is important to highlight here that the classification of a financial instrument under Ind AS 32 is done from the perspective of the issuer and not from the perspective of the holder.

| Financial liability (Ind AS 32.11)                                                                                                                                                                                                                                                                                                                                                                                                                         | Equity (Ind AS 32.16)                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>A financial instrument that fulfils <b><u>either of (A) or (B)</u></b> below:</p> <p><b>Condition (A):</b><br/>An instrument that <b><u>is a contractual obligation</u></b>:</p> <ol style="list-style-type: none"> <li>to deliver cash or another financial asset to another entity; or</li> <li>to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity</li> </ol> | <p>A financial instrument that fulfils <b><u>both (A) and (B)</u></b> below:</p> <p><b>Condition (A):</b><br/>An instrument that contains <b><u>no contractual obligation</u></b>:</p> <ol style="list-style-type: none"> <li>to deliver cash or another financial asset to another entity; or</li> <li>to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity</li> </ol> |



|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>Condition (B):</b><br/>An instrument that will or may be settled in the entity's own equity instruments and is:</p> <ul style="list-style-type: none"> <li>i. a non-derivative <b><u>for which the entity is or may be obliged</u></b> to deliver a variable number of the entity's own equity instruments; or</li> <li>ii. a derivative that will or may be settled <b><u>other than by</u></b> the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.</li> </ul> | <p><b>Condition (B):</b><br/>An instrument that will or may be settled in the entity's own equity instruments and is:</p> <ul style="list-style-type: none"> <li>i. a non-derivative <b><u>that includes no contractual obligation for the issuer</u></b> to deliver a variable number of the entity's own equity instruments; or</li> <li>ii. a derivative that will or may be settled <b><u>only by</u></b> the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.</li> </ul> |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

As can be seen from the table above, the two definitions are mirror images of each other. In the following paragraphs, we will discuss each of these aspects in detail.

### **Importance of the phrase “contract” and “contractual”**

It is important to know that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing [Ind AS 32.13]. Liabilities that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities. Accounting for income taxes is dealt with in Ind AS 12. Similarly, constructive obligations, as defined in Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets, do not arise from contracts and are not financial liabilities.

Items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset. [Ind AS 32.AG11]

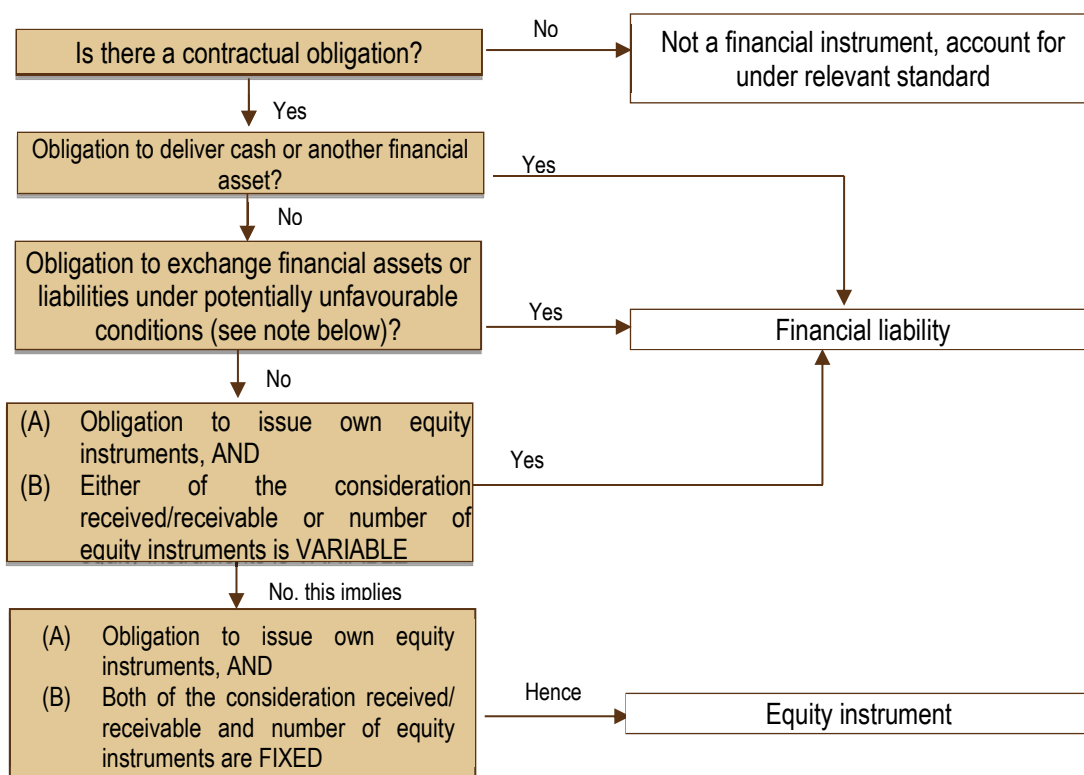
It should also be remembered that the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual obligation of the guarantor to pay the lender, if the borrower defaults [Ind AS 32.AG8].

### **Analysis of the definitions**

The following points must be remembered in determination of classification of a financial instrument as a financial liability or equity:

- **Evaluation of components**- it is not always that the entire instrument is either a financial liability or equity. The issuer makes this determination for each component part of a contract in accordance with 'substance' thereof and definitions given above [Ind AS 32.15].
- **Contract is supreme** - The evaluation of 'substance' does not override or contravene the contractual terms.
- **Contract cannot override laws** - The entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

The flowchart below summarises the distinction between the definitions of a financial liability and equity:



**Note: Potential unfavourable conditions**

#### Example 1

PQR Ltd. issues a call option (i.e. an option to buy) to ABC Ltd. to subscribe to PQR Ltd.'s equity shares at a price of ₹ 100 per share. The call option is to be settled on a 'net' basis i.e. without physical delivery of shares. If at the balance sheet date, market value of equity share of

PQR Ltd. is ₹ 110 per share, PQR Ltd. will be obliged to pay ₹ 10 to settle the option. Such a condition is potentially unfavourable to PQR Ltd. and hence ₹ 10 represents a financial liability for PQR Ltd.



### 3.3 OBLIGATION TO DELIVER CASH

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer (Ind AS 32.17).

There are very limited exceptions to this principle in the form of “puttable instruments” and “obligations arising on liquidation”. We will discuss these exceptions in the subsequent paragraphs, “Puttable instruments and obligations arising on liquidation”.

The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. [Ind AS 32.18(b)]

Subject to certain exceptions as mentioned above, if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. (Ind AS 32.19)

A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. (Ind AS 32.20)

#### Illustration 1: Redeemable preference shares with mandatory dividend

*A Ltd. (issuer) issues preference shares to B Ltd (holder). Those preference shares are redeemable at the end of 10 years from the date of issue and entitle the holder to a cumulative dividend of 15% p.a. The rate of dividend is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.*

#### Solution

This instrument provides for mandatory fixed dividend payments and redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the preference shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

\*\*\*\*\*

**Illustration 2 : Redeemable debentures with discretionary dividend**

*X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.*

**Solution**

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

The second component of interest payable is discretion of the issuer and hence will be classified as equity. This is also discussed in detailed in the compound financial instrument section (Also refer Illustration 27 in the subsequent section).

\*\*\*\*\*

**Illustration 3: Perpetual loan with mandatory interest**

*P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.*

**Solution**

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

\*\*\*\*\*

**Illustration 4: Restriction on the ability of an entity to satisfy a contractual obligation**

*Does the lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, will lead to contractual obligation?*

**Solution**

Lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

\*\*\*\*\*

**Illustration 5: Optionally convertible redeemable preference shares**

*D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.*

**Solution**

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

\*\*\*\*\*

***In the section “Compound financial instruments”, we will also analyse the other component – the conversion option with the holder and we will explain the nature of the instrument in its entirety.***

**Illustration 6: Settlement alternative is non-financial obligation**

*LMN Ltd. issues preference shares to PQR Ltd. These preference shares are redeemable at the end of 5 years from the date of issue.*

*The instrument also provides a settlement alternative to the issuer whereby it can transfer a particular commercial building to the holder, whose value is estimated to be significantly higher than the cash settlement amount. Examine the nature of the financial instrument.*

**Solution**

Such preference shares are financial liability because the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation.

\*\*\*\*\*

### **3.3.1 Puttable instruments and obligations arising on liquidation – Exceptions to classification as ‘financial liability’ for instruments settled in cash or another financial asset**

Let us analyse this in the following two contexts:

- A. Mutual funds and unit trusts, wherein the redemption amount is equal to a proportionate share in the net assets of the entity
- B. Limited life entities like special purpose vehicles (SPV) for execution of an infrastructure project

First, let us look at one definition which is relevant for our discussion – “Puttable instrument” is a financial instrument that gives the holder:

- the right to put the instrument back to the issuer for cash or another financial asset, or
- is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

[The phrase “put back to the issuer” refers to redemption of the instrument. If the holder has a right, but not an obligation to require the issuer to redeem the instrument, it is referred to as “put option”.]

As discussed above, financial instruments that contain an obligation of the issuer to deliver cash or another financial asset are classified as financial liabilities. As per this principle, the following shall be classified as financial liabilities:

- Puttable instruments (see context A above in Section 3.3.1), and
- Instruments that create an obligation only on liquidation of the entity (see context B above). Liquidation may be certain to occur and outside issuer’s control or uncertain to occur and at the option of holder.

However, Ind AS 32 contains an exception whereby such instruments are classified as “equity”, despite the fact that they otherwise meet all the conditions for “financial liability”. This exception applies if all of the following conditions are fulfilled by the instrument (Ind AS 32.16A, 16B, 16C and 16D):

1. It entitles the holder to a pro rata share of the entity’s net assets in the event of the entity’s liquidation. In other words, the instrument should not entitle its holder to a higher or lower share of entity’s net assets upon liquidation.

The logic behind this requirement is that entitlement to a pro rata share of the entity’s net assets on liquidation is equivalent to having a residual interest in the assets of an entity.

#### **Illustration 7: Cap on amount payable on liquidation**

*ABC Ltd. has two classes of puttable shares – Class A shares and Class B shares. On liquidation, Class B shareholders are entitled to a pro rata share of the entity’s residual assets up to a maximum of ₹ 10,000,000.*

*There is no limit to the rights of the Class A shareholders to share in the residual assets on liquidation. Examine the nature of the financial instrument.*

#### **Solution**

The cap of ₹ 10,000,000 means that Class B shares do not have entitlement to a pro rata share of the residual assets of the entity on liquidation. They cannot therefore be classified as equity.

\*\*\*\*\*

2. It is in the class of instruments that is **subordinate to all other classes of instruments**, that is, in its present form, it has no priority over other claims to the entity's assets **on liquidation** (entity will need to assume liquidation on date of classification).

**Illustration 8: Investment manager's share in a mutual fund**

*Mutual Fund X has an Investment Manager Y. At the inception of the fund, Y had invested a nominal or token amount in units of X. Such units rank last for repayment in the event of liquidation. Accordingly, they constitute the most subordinate class of instruments. Examine the nature of the financial instrument.*

**Solution**

The units held by Y holders are classified as equity as they are most subordinate class of instruments and will be entitled to residual interest.

However, the units held by other unit holders are classified as financial liability as they are not the most subordinate class of instruments – they are entitled to pro rate share of net assets on liquidation, and their claim has a priority over claims of Y.

It may be noted that the most subordinate class of instruments may consist of two or more legally separate types of instruments.

\*\*\*\*\*

3. (a) In case of puttable instruments, all financial instruments in the most subordinate class have **identical features**: For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

**Illustration 9: Differential voting rights**

*T Motors Ltd. has issued puttable ordinary shares and puttable 'A' ordinary shares whereby holders of ordinary shares are entitled to one vote per share whereas holders of 'A' ordinary shares are not entitled to any voting rights. The holders of two classes of shares are equally entitled to receive share in net assets upon liquidation. Examine whether the financial instrument will be classified as equity.*

**Solution**

Neither of the two classes of puttable shares can be classified as equity, as they do not have identical features due to the difference in voting rights. It is not possible for T Motors Ltd. to achieve equity classification of the ordinary shares by designating them as being more subordinate than the 'A' ordinary shares, as this does not reflect the fact that the two classes of share are equally entitled to share in entity's residual assets on liquidation.

\*\*\*\*\*

- (b) In contrast to the above, in case of instruments that impose on the entity an obligation to deliver pro rata share of net assets only on liquidation, all financial instruments in the most subordinate class have such identical contractual obligation.
4. In case of puttable instruments, apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, there are **no other contractual obligations**:
- ◆ to deliver cash or another financial asset, or
  - ◆ to settle in variable number of entity's own equity instruments

In other words, there are no other features of the instrument which could satisfy the definition of "financial liability".

#### Illustration 10: Conversion into a variable number of equity instruments

*S Ltd. has issued a class of puttable ordinary shares to T Ltd. Besides the put option (which is consistent with other classes of ordinary shares), T Ltd. is also entitled to convert the class of ordinary shares held by it into equity instruments of S Ltd. whose number will vary as per the market value of S Ltd. Examine whether the financial instrument will be classified as equity.*

#### Solution

The shares cannot qualify for equity classification in their entirety as in addition to the put option there is also a contractual obligation to settle the instrument in variable number of entity's own equity instruments.

\*\*\*\*\*

5. In case of puttable instruments, the **total expected cash flows attributable to the instrument** over the life of the instrument are based substantially on the:
- ◆ profit or loss,
  - ◆ change in the recognised net assets or
  - ◆ change in the fair value of the recognised and unrecognised net assets
- of the entity over the life of the instrument (excluding any effects of the instrument).
- In other words, if the cash flows are attributable to any factors other than the three listed above, for example, an index, the puttable instrument will fail the equity classification.
6. The issuer must have **no other financial instrument or contract** that has:
- ◆ total cash flows on same terms as (5) above, with
  - ◆ the effect of substantially restricting or fixing the residual return to the puttable instrument holders.



The intent behind this “anti-abuse” clause is to ensure that puttable instruments are not artificially structured to satisfy conditions (1) to (5) above and at the same time the holder of that puttable instrument also holds another financial instrument or has entered into another contract with the issuer whose cash flows indirectly restrict or fix the return on puttable instrument.

However, “another financial instrument” held by or “another contract” entered into, by the holder of puttable instrument, in its capacity as non-owner of puttable instrument, does not affect the classification of the puttable instrument.

**Illustration 11: Management fee contract between issuer and puttable instrument holder**

*P Ltd. has issued puttable ordinary shares to Q Ltd. Q Ltd. has also entered into an asset management contract with P Ltd. whereby Q Ltd. is entitled to 50% of the profit of P Ltd. Normal commercial terms for similar contracts will entitle the service provider to only 4%-6% of the net profits. Examine whether the financial instrument will be classified as equity.*

**Solution**

The puttable ordinary shares cannot qualify for equity classification as (a) in addition to the put option, there is another contract between the issuer (P Ltd.) and holder of puttable instrument (Q Ltd.) whose cash flows are based substantially on profit or loss of issuer, (b) whose contractual terms are not similar to a contract between a non-instrument holder and issuer and (c) it has the effect of substantially restricting return on puttable ordinary shares.

\*\*\*\*\*

If the terms of asset management contract were assessed to be similar to terms of a contract between a non-instrument holder and the issuer, it would not have precluded equity classification for puttable shares, provided other conditions are met.

To summarise, the following conditions are required to be fulfilled in each of the two contexts set out at the beginning of this paragraphs:

- ◆ **Puttable instruments** (see context A above in Section 3.3.1) – conditions (1) to (6)
- ◆ **Instruments that create an obligation only on liquidation of the entity** (see context B above) – conditions (1) to (3) and condition (6).

### 3.3.1.1 Reclassification

- **Date of classification** of a financial instrument as an equity instrument in accordance with exceptions mentioned above – from the date when the instrument has all the features and meets the conditions set out above (Ind AS 32.16E).
- **Date of reclassification** of a financial instrument – from the date when the instrument ceases to have all the features or meet all the conditions set out above (Ind AS 32.16E).

For example, if an entity redeems all its issued non-puttable instruments and any puttable instrument that remain outstanding have all the features and meet all the conditions mentioned above, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

- **Accounting for reclassification** (Ind AS 32.16F):

| Reclassification from | Reclassification to | Measurement                                | Recognition of difference in carrying amount and measurement of reclassified instrument |
|-----------------------|---------------------|--------------------------------------------|-----------------------------------------------------------------------------------------|
| Financial liability   | Equity              | Carrying value at date of reclassification | -N.A.-                                                                                  |
| Equity                | Financial liability | Fair value at date of reclassification     | In equity                                                                               |

#### Illustration 12 : Issue of variable number of shares against issue of CCPS

*A Ltd. issued compulsorily convertible preference shares (CCPS) at ₹100 each (₹10 face value + ₹90 premium per share) for ₹10,00,000. These are convertible into equity shares at the end of 10 years, where the number of equity shares to be issued shall be determined based on fair value per equity share to be determined at the time of conversion.*

*Evaluate if this is financial liability or equity? What if the conversion ratio was fixed at the time of issue of such preference shares?*

#### Solution

- As per Ind AS 32, non-derivative contracts which will be settled against issue of variable number of own equity shares meet the definition of financial liability.

In this case, A Ltd. has issued CCPS which are convertible into variable number of shares. Hence, it is akin to use of own equity shares as currency for settlement of the liability of CCPS issued. Accordingly, it meets the definition of financial liability.

#### Measurement –

**Initial measurement** – This shall be measured at fair value on date of transaction. Since A Ltd shall give shares worth ₹ 10 lacs at the end of 10 years which is equal to the amount borrowed on day 1, the liability is recognised at fair value, determined by discounting future settlement of the borrowed amount. For difference arising on day 1 between amount borrowed and that recognised as liability using level 3 inputs, it is deferred and recognised on a systematic basis over the period of liability.

**Subsequent measurement** – Such liability shall be carried at fair value through profit or loss.

- Per Ind AS 109, a non-derivative contract that involves issue of fixed number of equity shares shall be classified as equity.

In this case, if the conversion of CCPS was into a fixed number of equity shares at the end of 10 years, then it meets the definition of equity and hence, shall be classified as 'equity instrument'.

An equity instrument is carried at cost and no further adjustments made to its carrying value after initial recognition.

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### 3.3.2 Obligation to purchase own equity instruments

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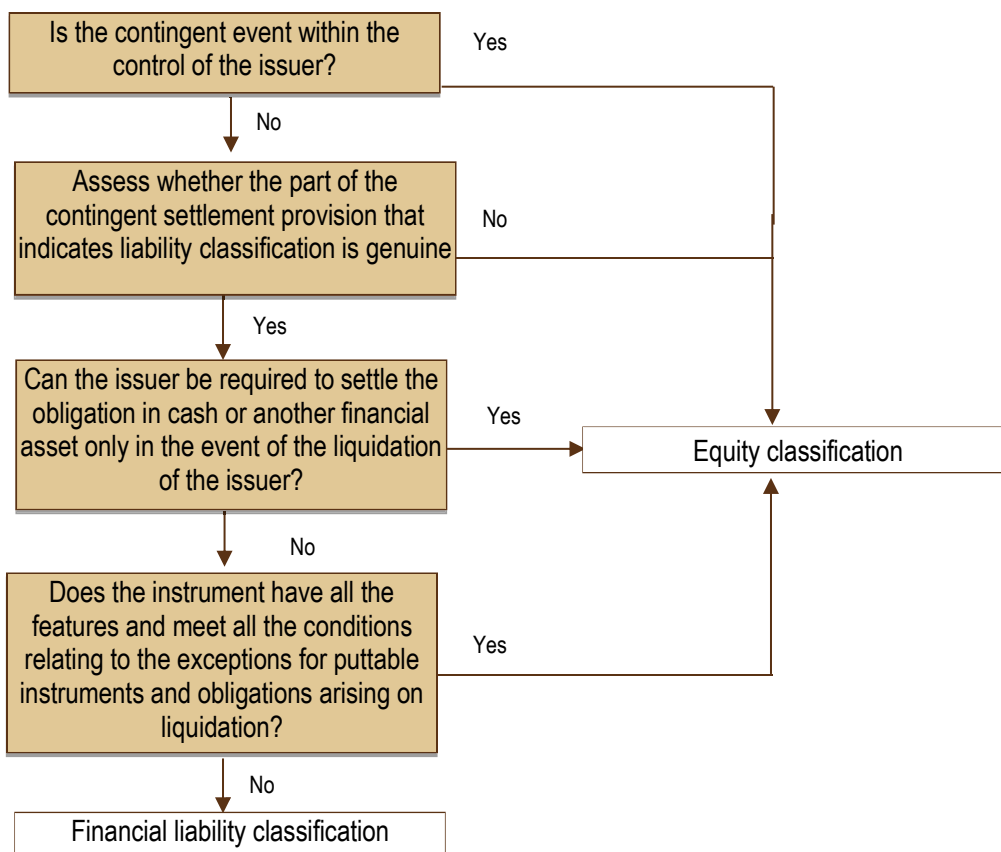
With the exception of the circumstances described above (paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32), a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount. This is the case even for derivatives over equity instruments that meet the fixed for fixed test and would be equity in the absence of this rule. (Ind AS 32.23)

### 3.3.3 Contingent settlement provisions

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A financial instrument may require an entity to deliver cash or another financial asset, or settle it in some other way that would require it to be classified as a financial liability, but only in the event of the occurrence or non-occurrence of some uncertain future event. The 'event' may be within the control of the issuer or of the holder, or beyond the control of both. These types of contractual arrangements are referred to as 'contingent settlement provisions'.

The flowchart below explains the classification process for contingent settlement provisions:



### 3.3.4 Written put options over non-controlling interests

In consolidated financial statements, an entity presents non-controlling interests — ie the interests of other parties in the equity and income of its subsidiaries – in accordance with Ind AS 1 and Ind AS 110. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.

When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole.

To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements. (Ind AS 32.AG29)



### 3.4 SETTLEMENT IN ENTITY'S OWN EQUITY INSTRUMENTS

A financial instrument is classified as a liability not just when there is an obligation to deliver cash or another financial asset. It is **sometimes** so classified even when the entity's obligation is to settle the instrument through delivery of its own equity instruments.

Let us evaluate two alternate situations for an instrument that is convertible at the option of the issuer:

#### Illustration 13: Conversion into a number of equity instruments equivalent to a fixed value

*CBA Ltd. issues convertible debentures to RQP Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into equity shares of CBA Ltd. using a pre-determined formula. The formula is:*

$$\frac{100 \text{ crores} \times (1+10\%)^5}{\text{Fair value on date of conversion}}$$

*Examine the nature of the financial instrument.*

#### Solution

Such a contract is a financial liability of the entity even though the entity can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. The underlying thought behind this conclusion is that the entity is using its own equity instruments 'as currency'.

\*\*\*\*\*

#### Illustration 14: Conversion into a fixed number of equity instruments

*DF Ltd. issues convertible debentures to JL Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of ₹ 10 each.*

*Examine the nature of the financial instrument.*

### Solution

This contract is an equity instrument because changes in the fair value of equity shares arising from market related factors do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered.

\*\*\*\*\*

From the above two situations, we can conclude as below:

- A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. **If an entity has a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation, such a contract is a financial liability.** Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). (Ind AS 32.21). The number of equity instruments to be delivered could vary as a result of entity's own share price. [Ind AS 32.AG27(d)]
- **A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument.** (Ind AS 32.22)

The above requirements are summarised in the table below:

| S. No. | Consideration for financial instrument | Number of own equity instruments to be issued in settlement | Classification and rationale                                                                                       |
|--------|----------------------------------------|-------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------|
| 1      | Fixed                                  | Variable                                                    | Financial liability – own equity instruments are being used as currency to settle an obligation for a fixed amount |
| 2      | Fixed                                  | Fixed                                                       | Equity – issuer does not have an obligation to pay cash and holder is not exposed to any variability               |
| 3      | Variable                               | Fixed                                                       | Financial liability – though issuer does not have an obligation to pay cash, but holder is exposed to variability  |

|   |          |          |                                                                                                                          |
|---|----------|----------|--------------------------------------------------------------------------------------------------------------------------|
| 4 | Variable | Variable | Financial liability – though issuer does not have an obligation to pay cash, but both parties are exposed to variability |
|---|----------|----------|--------------------------------------------------------------------------------------------------------------------------|

The principle at **serial number 2 in table above** is also called “**fixed for fixed**” test i.e. fixed amount of cash or other financial asset for fixed number of own equity instruments.

Another point to note is a fine distinction highlighted in the definition of financial liability and equity, as mentioned in the paragraph “Definitions – financial liability and equity”. Being mirror images of each other.

#### Illustration 15: Written option for a fixed or variable number of equity instruments

*ST Ltd. purchases an option from AT Ltd. entitling the holder to subscribe to fixed number of equity shares of issuer at a fixed exercise price of ₹ 50 per share at any time during a period of 3 months. Holder paid an initial premium of ₹ 2 per option. Examine whether the financial instrument will be classified as equity.*

#### Solution

For the issuer AT Ltd., this option is an equity instrument as it will be settled by the exchange of a fixed amount of cash for a fixed number of its own equity instruments.

If, on the other hand, if the exercise price of the option was variable, say benchmarked to an index or a variable, the written option will be classified as a “financial liability” in the books of the issuer, AT Ltd.

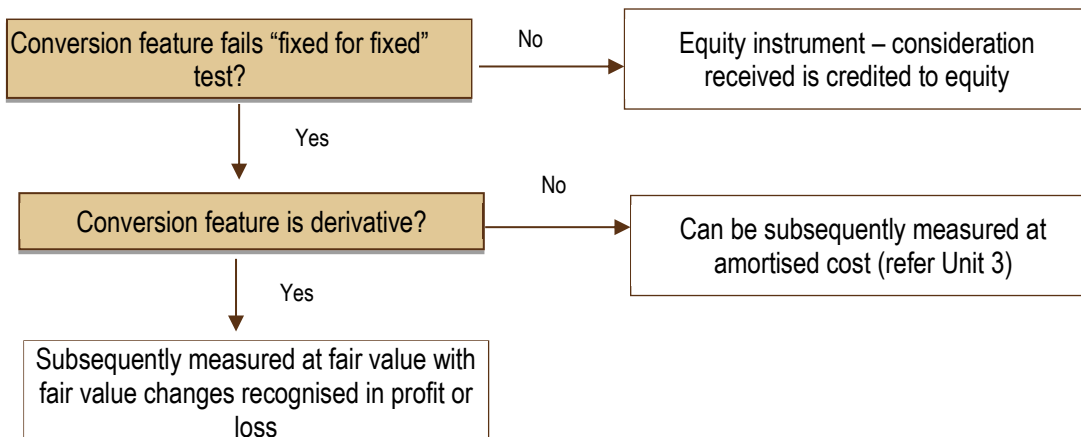
\*\*\*\*\*

***For discussion on derivative instruments, refer Unit 4: Derivatives and Embedded derivatives.***

In the above illustration, if the instrument is classified as “equity instrument”, any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. It must also be noted that changes in the fair value of an equity instrument are not recognised in the financial statements. (Ind AS 32.22)

On the contrary, if the derivative instrument (i.e. the written option) is classified as “financial liability”, any consideration received is measured initially at fair value and subsequently also at fair value, with fair value changes recognised in profit or loss. ***For detailed discussion on measurement of financial liabilities, refer Unit 2.***

The chart below summarises the discussion above:



#### Illustration 16: Written option with multiple exercise prices

*WC Ltd. writes an option in favour of GT Ltd. wherein the holder can purchase issuer's equity instruments at prices that fluctuate in response to the share price of issuer.*

*As per the terms, if the share price of issuer is less than ₹ 50 per share, option can be exercised at ₹ 40 per share. If the share price is equal to or more than ₹ 50 per share, option can be exercised at ₹ 60 per share. Explain the nature of the financial instrument.*

#### Solution

As the contract will be settled by delivery of fixed number of instruments for a variable amount of cash, it is a financial liability.

\*\*\*\*\*

#### Illustration 17: Share swap arrangements

*Acquirer Ltd. enters into an arrangement with shareholders of Target Ltd. wherein Acquirer Ltd. will purchase shares of Target Ltd. in a share swap arrangement against a variable amount of cash i.e. market value of Target Ltd.'s equity shares. The share swap ratio is agreed as 1:5 i.e. 1 equity share of Acquirer Ltd. for every 5 equity shares held in Target Ltd. Examine whether the financial instrument will be classified as equity.*

#### Solution

Such arrangements will not meet the condition for classification as "equity instrument" since the contract will be settled by delivery of fixed number of Acquirer Ltd.'s own equity instruments against a variable amount of cash i.e. market value of Target Ltd.'s equity shares.

Such a contract will likely result in a derivative liability or asset for both the parties.

\*\*\*\*\*



**Illustration 18: Conversion ratio changes with time**

*On 1 January 20X1, NKT Ltd. subscribes to convertible preference shares of VT Ltd. The conversion ratio varies as below:*

*Conversion upto 31 March 20X1: 1 equity share of VT Ltd. for each preference share held*

*Conversion upto 30 June 20X1: 1.5 equity share of VT Ltd. for each preference share held*

*Conversion upto 31 December 20X1: 2 equity share of VT Ltd. for each preference share held.*

*Examine whether the financial instrument will be classified as equity.*

**Solution**

The convertible preference shares can be classified as “equity instrument” in the books of the issuer, VT Ltd. The conversion ratio doesn’t change corresponding to any underlying variable, it only varies in response to passage of time which is a certain event and hence fixed.

\*\*\*\*\*

**Illustration 19: Conversion ratio changes to protect rights of convertible instrument holders**

*On 1 January 20X1, HT Ltd. subscribes to convertible preference shares of RT Ltd. The preference shares are convertible in the ratio of 1:1.*

*The terms of the instrument entitle HT Ltd. to proportionately more equity shares of RT Ltd. in case of a stock split or bonus issue. Examine whether the financial instrument will be classified as equity.*

**Solution**

The convertible preference shares can be classified as “equity instrument” in the books of the issuer, RT Ltd. The variability in the conversion ratio is only to protect the rights of the holder of convertible instrument vis-à-vis other equity shareholders.

The conversion was always intended to be in a fixed ratio and hence the holder is exposed to the change in equity value. The variability is brought in to maintain holder’s exposure in line with other holders.

\*\*\*\*\*

**Illustration 20: Conversion ratio changes if issuer subsequently issues shares to others at a lower price**

*On 1 January 20X1, PG Ltd. subscribes to convertible preference shares of BG Ltd. at ₹ 100 per preference share. The preference shares are convertible in the ratio of 10:1 i.e. 10 equity shares for each preference share held. On a fully diluted basis, PG Ltd. is entitled to 30% stake in BG Ltd.*

*If subsequent to the issuance of these convertible preference shares, BG Ltd. issues any equity instruments at a price lower than ₹ 10 per share, conversion ratio will be changed to*

*compensate PG Ltd. for dilution in its stake below the expected dilution at a price of ₹ 10 per share. Examine the nature of the financial instrument.*

### Solution

The convertible preference shares will be classified as “financial liability” in the books of the issuer, BG Ltd. The variability in the conversion ratio underwrites the return on preference shares and not just protects the rights of convertible instrument holders vis-à-vis equity shareholders.

\*\*\*\*\*

### Illustration 21: Conversion ratio is variable in a narrow range

*On 1 January 20X1, NG Ltd. subscribes to convertible preference shares of AG Ltd. at ₹ 100 per preference share. On a fully diluted basis, NG Ltd. is entitled to 30% stake in AG Ltd.*

*The preference shares are convertible at fair value, subject to, NG Ltd.'s stake not going below 15% and not going above 40%. Examine the nature of the financial instrument.*

### Solution

The convertible preference shares will be classified as “financial liability” in the books of the issuer, AG Ltd. The variability in the conversion ratio underwrites the return on preference shares to an extent and also restricts that return. The preference shareholder is not entitled to residual net assets of the issuer.

In certain situations, an instrument is convertible only at the option of issuer. While such instruments provide the issuer with an unconditional right to avoid payment of cash, it is important to understand the economic substance of the option. It is also very important to determine whether the option is exercised by the issuer or by shareholders acting in their capacity as instrument holders.

For example, if the convertible instrument is held by the equity shareholders of the issuer and the conversion requires unanimous consent of all the shareholders, it would be inappropriate to consider that the issuer has an unconditional right to avoid payment of cash. In this situation, it would be more relevant to consider the rights of the instrument holders in their capacity as equity shareholders of the issuer.

\*\*\*\*\*

### Illustration 22: Conversion ratio changes under independent scenarios

*On 1 January 20X1, STAL Ltd. subscribes to convertible preference shares of ATAL Ltd.*

*The preference shares are convertible as below:*

*Convertible 1:1 if another strategic investor invests in the issuer within one year*

*Convertible 1.5:1 if a prospectus filing is successfully completed within 2 years*

*Convertible 2:1: if a binding agreement for sale of majority stake by equity shareholders is entered into within 3 years*

*Convertible 3:1: if none of these events occur in 3 years' time.*

*Examine whether the financial instrument will be classified as equity.*

### Solution

In this case the four events can be viewed as discrete because the achievement of each one of these can occur independently of the other (as they relate to different periods). The arrangement can therefore be considered to be economically equivalent to four separate contracts. The price per share and the amount of shares to be issued is fixed in each of these discrete periods, with each event relating to a different year and therefore a separate risk. The “fixed for fixed” test is therefore met.

The instrument is therefore classified as “equity instrument”.

\*\*\*\*\*

### Illustration 23: Conversion ratio changes under inter-dependent scenarios

On 1 January 20X1, RHT Ltd. subscribes to convertible preference shares of RDT Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests at an enterprise valuation (EV) of USD 100 million.

Convertible 1.5:1: if another strategic investor invests at EV of USD 150 million

Convertible 2:1: if another strategic investor invests at EV of USD 200 million

Convertible 3:1: if no strategic investment is made within a period of 3 years

Examine the nature of the financial instrument.

### Solution

The four events are interdependent because the second event cannot be met without also meeting the first event, and the third event cannot be met unless the first two are met.

Therefore, this contract should be treated as a single instrument when applying the “fixed for fixed” test. The test is then failed because the number of shares to be exchanged for cash are variable.

\*\*\*\*\*

## 3.4.1 Settlement Options

When a derivative financial instrument gives one party a choice over how it is settled, it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument. (Ind AS 32.26)

For instance - a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash is a financial liability.

### **3.4.2 Settlement by delivery of instruments that meet conditions for exceptions to classification as financial liability**

If the entity's own equity instruments to be received, or delivered, by the entity upon settlement of a contract are:

- puttable financial instruments with all the features and meeting the conditions described in paragraphs 16A and 16B of Ind AS 32 (as discussed above), or
- 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 with all the features and meeting the conditions described in paragraphs 16C and 16D of Ind AS 32 (as discussed above),

the contract is a financial asset or a financial liability.

This includes a contract that will be settled by the entity receiving or delivering a fixed number of such instruments in exchange for a fixed amount of cash or another financial asset. (Ind AS 32.22A)

### **3.4.3 Rights issues, options or warrants to acquire entity's own equity instruments for any currency**

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. (Ind AS 32.11).

#### **Carve out from IFRS: Equity conversion option embedded in a foreign currency convertible bond**

Ind AS 32 considers the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments as an equity instrument if the exercise price is fixed in any currency.

#### **As per IFRS**

As per accounting treatment prescribed under IAS 32, equity conversion option in case of foreign currency denominated convertible bonds is considered a derivative liability which is embedded in the bond. Gains or losses arising on account of change in fair value of the derivative need to be recognised in the statement of profit and loss as per IAS 32.

#### **Carve out**

In Ind AS 32, an exception has been included to the definition of 'financial liability' in paragraph 11 (b) (ii), whereby conversion option in a convertible bond denominated in foreign currency to

acquire a fixed number of entity's own equity instruments is classified as an equity instrument if the exercise price is fixed in any currency.

### Reasons

This treatment as per IAS 32 is not appropriate in instruments, such as, FCCBs since the number of shares convertible on the exercise of the option remains fixed and the amount at which the option is to be exercised in terms of foreign currency is also fixed; merely the difference in the currency should not affect the nature of derivative, i.e., the option. Further, the fair value of the option is based on the fair value of the share prices of the company. If there is decrease in the share price, the fair value of derivative liability would also decrease which would result in recognition of gain in the statement of profit and loss. This would bring unintended volatility in the statement of profit and loss due to volatility in share prices. This will also not give a true and fair view of the liability as in this situation, when the share prices fall, the option will not be exercised. However, it has been considered that if such option is classified as equity, fair value changes would not be required to be recognised. Accordingly, the exception has been made in definition of financial liability in Ind AS 32.

Let's understand this carve-out using an illustration:

#### Illustration 24: Foreign currency convertible bond

*Entity A issues a bond with face value of USD 100 and carrying a fixed coupon rate of 6% p.a. Each bond is convertible into 1,000 equity shares of the issuer. Examine the nature of the financial instrument.*

### Solution

While the number of equity shares is fixed, the amount of cash is not. The variability in cash arises on account of fluctuation in exchange rate of INR-USD. Such a foreign currency convertible bond (FCCB) will qualify the definition of "financial liability".

However, Ind AS 32.11 provides, "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." Accordingly, FCCB will be treated as an "equity instrument".

But one cannot ignore the fixed coupon rate of 6% which is an obligation to deliver cash and therefore, financial liability. Accordingly, FCCBs under Ind AS 32 shall be classified as compound financial instruments if the interest liability is to be delivered in cash or shares in lieu of cash.

\*\*\*\*\*



### 3.5 COMPOUND FINANCIAL INSTRUMENTS

So far we have discussed two broad aspects of classification:

- Obligations to deliver cash – generally, instruments with such obligations are classified as “financial liability”
- Settlement in own equity instruments – generally, instruments with such provisions are classified as “equity”

There are several exceptions to the general principles stated above, as we have seen in several illustrations discussed so far.

Let us now study those instruments which have features of both a financial liability and equity instrument. Such instruments are called “compound financial instruments”. This topic is aimed at discussing the accounting treatment of such instruments and practical complexities that arise due to issuance of such instruments.

The following illustrations demonstrate the identification of separate components of a financial instrument and determining whether it is a compound financial instrument.

#### **Illustration 25: Redeemable debentures with discretionary dividend (continued from Illustration 2)**

*X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.*

#### **Solution**

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

The other component, discretionary interest is an equity feature because issuer can avoid payment of cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

\*\*\*\*\*

#### **Illustration 26: Perpetual loan with mandatory interest (continued from Illustration 3)**

*P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.*

**Solution**

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

The other component, perpetual principal, is an equity feature because issuer is not required to pay cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

\*\*\*\*\*

**Illustration 27: Optionally convertible redeemable preference shares (continued from Illustration 5)**

*D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.*

**Solution**

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

The other component, conversion option with the holder, is an equity feature if the “fixed for fixed” test is satisfied. If the conversion option does not fulfil that test, say, because the conversion ratio varies in response to an underlying variable, it is a derivative liability.

Such an instrument is called a “hybrid instrument”.

\*\*\*\*\*

### 3.5.1 Split accounting for compound financial instruments

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 i.e.
  - ◆ fair value of the instrument as a whole, less
  - ◆ the amount separately determined for 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.

(Ind AS 32.31)

In Illustrations 26 and 27 above, split accounting is performed by first determining the carrying amount of the liability component. This is done by measuring the net present value of the discounted cash flows of interest and/or principal, ignoring the possibility of exercise of the conversion option, if any. The discount rate is the market rate at the time of inception for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by perpetual principal in Illustration 26 and conversion option in Illustration 27 is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

**Illustration 28: Perpetual loan with mandatory interest (continued from Illustration 3)**

*P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder) for ₹ 12 lakhs. The loan is perpetual and entitles the holder to fixed interest of 8% p.a. The rate of interest commensurate with credit risk profile of the issuer is 12% p.a. Calculate the value of the liability and equity components.*

**Solution**

The values of the liability and equity components are calculated as follows:

Present value of interest payable in perpetuity (₹ 96,000 discounted at 12%) = ₹ 800,000

Therefore, equity component = fair value of compound instrument, say, ₹ 1,200,000 less financial liability component i.e. ₹ 800,000 = ₹ 400,000.

In subsequent years, the profit and loss account is charged with interest of 12% on the debt instrument.

\*\*\*\*\*

**Illustration 29: Optionally convertible redeemable preference shares (continued from Illustration 27)**

*On 1 July 20X1, D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a fixed*



*coupon of 6% p.a. and is payable every year. The prevailing market rate for similar preference shares, without the conversion feature, is 9% p.a.*

*Calculate the value of the liability and equity components.*

### **Solution**

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 9% for 3 years) = ₹ 772,183

Present value of interest payable in arrears for 3 years (₹ 60,000 discounted at 9% for each of 3 years) = ₹ 151,878

Total financial liability = ₹ 924,061

Therefore, equity component = fair value of compound instrument, say, ₹ 1,000,000 less financial liability component i.e. ₹ 924,061 = ₹ 75,939.

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument.

\*\*\*\*\*

## **3.5.2 Separation of non-equity embedded derivatives**

Sometimes, the issuer also has the option to early redeem the instrument mentioned in Illustration 29. Such an option is issuer's call option. This call option is considered an embedded derivative which is a financial liability. 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. (Ind AS 32.31)

### **Illustration 30: Optionally convertible preference shares with issuer's redemption option**

*D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a coupon of RBI base rate plus 1% p.a. and is payable at the end of every year.*

*The prevailing market rate for similar preference shares, without the conversion feature or issuer's redemption option, is RBI base rate plus 4% p.a. On the date of contract, RBI base rate is 9% p.a.*

*Calculate the value of the liability and equity components.*

**Solution**

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 13% for 3 years) = ₹ 6,93,050

Present value of interest payable in arrears for 3 years (₹ 100,000 discounted at 13% for each of 3 years) = ₹ 2,36,115

Paragraph AG 31 of Ind AS 32 states that a common form of compound financial instruments is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivatives features.

The liability component = Present value of principal + Present value of Interest

$$= ₹ 6,93,050 + ₹ 2,36,115 = ₹ 9,29,165$$

$$\text{Equity Component} = ₹ 10,00,000 - ₹ 9,29,165 = ₹ 70,835$$

\*\*\*\*\*

**Illustration 31: Instrument convertible only at the option of issuer**

*XYZ Ltd. issues optionally convertible debentures with the following terms:*

*The debentures carry interest at the rate of 7% p.a.*

*Issuer has option to either:*

*Convert the instrument into a fixed number of its own shares at any time, or redeem the instrument in cash at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted.*

*The holder has no conversion or redemption options.*

*Debentures have a tenor of 12 years and, if not converted or redeemed earlier, will be repaid in cash at maturity, including accrued interest, if any.*

*Examine the nature of the financial instrument.*

**Solution**

The issuer has the ability to convert the debentures into a fixed number of its own shares at any time. The issuer, therefore, has the ability to avoid making a cash payment or settling the debentures in a variable number of its own shares. Therefore, such a financial instrument is likely to be classified as equity.

However, it must be noted that mere existence of a right to avoid payment of cash is not conclusive. The instrument is to be accounted for as per its substance and hence it needs to be seen whether the conversion option is substantive.

In this particular situation, the issuer will need to determine whether it is favourable to exercise the conversion option or redemption option. In case of latter, the instrument will be classified as a financial liability (a hybrid instrument, whose measurement is dealt with in a subsequent section).

Practical situations do arise wherein the issuer has an option or obligation to issue own equity instruments only in particular circumstances i.e. the instrument is contingently convertible.

\*\*\*\*\*

### **3.5.3 Conversion or early settlement of compound financial instruments**

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#### **3.5.3.1 Conversion**

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. (Ind AS 32.30)

On conversion of a convertible instrument at maturity, the entity:

- derecognises the liability component and
- recognises it as equity.
- original equity component remains as equity (although it may be transferred from one line item within equity to another).
- there is no gain or loss on conversion at maturity.

#### **3.5.3.2 Early settlement**

When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is

consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued. (Ind AS 32.AG33)

In other words, the issuer:

- starts by **allocating the settlement price to the remaining liability** i.e. it determines the fair value of the remaining liability using a discount rate that is based on circumstances at the settlement date (this rate may differ from the rate used for the original allocation), and
- allocates the residual settlement amount to the equity component.

As per Ind AS 32.AG34, once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

- a) the amount of gain or loss relating to the liability component is recognised in profit or loss; and
- b) the amount of consideration relating to the equity component is recognised in equity.

**Illustration 32: Optionally convertible redeemable preference shares (continued from Illustration 29)**

*The amortisation schedule of the instrument is set out below:*

| <b>Dates</b> | <b>Cash flows</b> | <b>Finance cost at effective interest rate</b> | <b>Liability</b> | <b>Equity</b> |
|--------------|-------------------|------------------------------------------------|------------------|---------------|
| 1 July 20X1  | 1,000,000         | -                                              | 9,24,061         | 75,939        |
| 30 June 20X2 | (60,000)          | 83,165                                         | 9,47,226         | 75,939        |
| 30 June 20X3 | (60,000)          | 85,250                                         | 9,72,476         | 75,939        |
| 30 June 20X4 | (10,60,000)       | 87,524                                         | -                | 75,939        |

*Assume that D Ltd. has an early redemption option to prepay the instrument at ₹ 11 lakhs and on 30 June 20X3, it exercises that option. At 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%. Calculate the value of the liability and equity components.*

**Solution**

Ind AS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

The split will be made as below:

| Particulars                                                                                                      | Amount (₹)       |
|------------------------------------------------------------------------------------------------------------------|------------------|
| Present value of principal payable at 30 June 20X4 in one year's time (₹ 10 lakhs discounted at 5% for one year) | 9,52,381         |
| Present value of interest payable (₹ 60,000 discounted at 5% for one year)                                       | <u>57,142</u>    |
| Total liability component                                                                                        | 10,09,523        |
| Consideration paid                                                                                               | <u>11,00,000</u> |
| Residual – equity component                                                                                      | <u>90,477</u>    |

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is recognised in equity.

\*\*\*\*\*

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date.

The difference, at the date the terms are amended, between:

- the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and
- the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.



### 3.6 TREASURY SHARES

If an entity reacquires its own equity instruments:

- Consideration paid for those instruments ('treasury shares') shall be deducted from equity. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired.
- Consideration received shall be recognised directly in equity.

- No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments

In the consolidated financial statements, consideration for treasury shares acquired and held by other members of the consolidated group, is deducted from equity.

It may be noted that when an entity holds its own equity on behalf of others, eg a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.



### 3.7 INTEREST, DIVIDENDS, LOSSES AND GAINS

The accounting principles related to transactions arising consequent to recognition of financial instruments are summarised below (Ind AS 32.35-41):

- 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.
  - ◆ 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:**
  - ◆ Equity transaction – accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.
  - ◆ Compound financial instrument – allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.
- Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12 Income Taxes
- Changes in the fair value of an equity instrument are not recognised in the financial statements.
- **Presentation:**
  - ◆ The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately in accordance with Ind AS 1.
  - ◆ Dividends classified as an expense may be presented in the Statement of Profit and Loss either with interest on other liabilities or as a separate item.

- ◆ Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset.



### 3.8 OFFSETTING A FINANCIAL ASSET AND A FINANCIAL LIABILITY

In many situations, an entity has the right to receive or pay a single net amount in relation to two or more separate financial instruments and intends to do so as well.

As per Ind AS 32.42 and Ind AS 32.AG38A, a financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

- a) currently has a **legally enforceable right to set off** the recognised amounts – this means that the right of set off:
  - i. must not be contingent on a future event; and
  - ii. must be legally enforceable in the normal course of business, in the event of default and in the event of insolvency or bankruptcy of the entity and all of the counterparties.
- b) **intends** either to settle on a net basis, or to realise the asset and settle the liability simultaneously - If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion. This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle.

Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the balance sheet but also may result in recognition of a gain or loss. (Ind AS 32.44).

A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. (Ind AS 32.45).

The conditions set out above are generally not satisfied and offsetting is usually inappropriate when (Ind AS 32.49):

- a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument') - For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt:
- Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions
  - Each may be transferred or settled separately.
  - Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed.

Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented in an entity's balance sheet on a net basis unless they meet the criteria for offsetting.

- b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counter parties;
- c) financial or other assets are pledged as collateral for non-recourse financial liabilities;
- d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or
- e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

### QUICK RECAP

- Classification as a financial liability or as equity depends on the substance of a financial instrument rather than its legal form. The substance depends on the instrument's contractual rights and obligations.
- Liability classification - a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset or own equity shares in lieu of cash to the instrument holder
- There are certain rule-based exceptions to the basic principle for classification of an instrument as financial liability – puttable instruments and obligations arising only on liquidation
- Financial instrument containing a contingent settlement provision, under which the instrument would be classified as a financial liability on the occurrence or non-occurrence of



some uncertain future event beyond the control of both the issuer and the holder – usually classified as a financial liability unless the part of the contingent settlement provision that indicates liability classification is not genuine; or the issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer

- Instruments which may or will be settled in an entity's own equity instruments – apply “fixed for fixed” test
- Instruments with both equity and liability features are compound instruments – equity and liability components are accounted for separately ('split accounting')
- Split accounting involves first calculating the fair value of the liability component. The equity component is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole
- Subsequent changes in the value of the equity instruments are not recognised in the financial statements.
- The accounting implication of classification of a financial instrument as a financial liability or equity is given in table below:

| Accounting aspect                                    | Financial liability                                                                                   | Equity instrument                                    |
|------------------------------------------------------|-------------------------------------------------------------------------------------------------------|------------------------------------------------------|
| Re-measurement standard                              | Ind AS 109                                                                                            | Generally, not re-measured after initial measurement |
| Recognition of interest, dividends, losses and gains | Profit or loss                                                                                        | Retained earnings                                    |
| Recognition of transaction costs                     | Included in calculation of effective interest rate and amortised over expected life of the instrument | Deduction from equity                                |

## UNIT 4: DERIVATIVES AND EMBEDDED DERIVATIVES



### 4.1 INTRODUCTION

Derivatives may exist as standalone financial instruments or may be embedded in other financial or non-financial instruments.

In Unit 3 of this chapter, we analysed the definitions of financial liability and equity. Both these definitions envisage situations in which an instrument is settled by exchange of own equity instruments which are derivatives. To be specific, let's reproduce the relevant portion of these definitions and set the context of discussion for this paragraph in terms of this situation.

#### Financial liability

A financial instrument that fulfils **either** of (A) or (B) below:

(A) .....

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) .....

(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.

#### Equity

A financial instrument that fulfils both (A) and (B) below:

(A) .....

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) .....

(ii) **a derivative** that will or may be settled **only by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.



### 4.2 DEFINITION

#### 4.2.1 Derivatives

Ind AS 109 Appendix A defines a derivative as a financial instrument or other contract with all of the following three characteristics:

- i. **Value changes due to an underlying:** its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided **in the case of a non-financial variable that the variable is not specific to a party to the contract** (sometimes called the 'underlying');

Examples of common derivative contracts and the identified underlying variable:

| Type of contract                                                   | Main pricing-settlement variable (underlying variable)     |
|--------------------------------------------------------------------|------------------------------------------------------------|
| Interest rate swap                                                 | Interest rates                                             |
| Currency swap (foreign exchange swap)                              | Currency rates                                             |
| Commodity swap                                                     | Commodity prices                                           |
| Equity swap                                                        | Equity prices (equity of another entity)                   |
| Credit swap                                                        | Credit rating, credit index or credit price                |
| Total return swap                                                  | Total fair value of the reference asset and interest rates |
| Purchased or written treasury bond option (call or put)            | Interest rates                                             |
| Purchased or written currency option (call or put)                 | Currency rates                                             |
| Purchased or written commodity option (call or put)                | Commodity prices                                           |
| Purchased or written stock option (call or put)                    | Equity prices (equity of another entity)                   |
| Interest rate futures linked to government debt (treasury futures) | Interest rates                                             |
| Currency futures                                                   | Currency rates                                             |
| Commodity futures                                                  | Commodity prices                                           |
| Interest rate forward linked to government debt (treasury forward) | Interest rates                                             |
| Currency forward                                                   | Currency rates                                             |
| Commodity forward                                                  | Commodity prices                                           |
| Equity forward                                                     | Equity prices (equity of another entity)                   |

The definition of derivative excludes contracts which fulfil following two conditions:

- Value of the contract changes with reference to one or more non-financial variables; and

- That non-financial variable is specific to one of the parties to the contract.

As per paragraph BA.5 of Ind AS 109, a change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable).

Examples of non-financial variables that are not specific to a party to the contract are an index of earthquake losses in a particular region and an index of temperatures in a particular city.

Non-financial variables specific to a party to the contract include:

- the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract
- residual value of an asset which changes in response to changes in the asset's physical condition

Derivatives give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. Because the terms of the exchange are determined at inception, as prices in the financial markets change, those terms may become favourable or unfavourable.

A derivative usually has a notional amount, which can be an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. The changes in value of a derivative are measured corresponding to the notional amount. Refer illustration 1 and 2 below.

- ii. **No or little initial net investment:** it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

**Illustration 1: Prepaid interest rate swap (fixed rate payment obligation prepaid at inception)**

*Entity S enters into a ₹ 100 crores notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C.*

- ◆ *The interest rate of the variable part of the swap is reset on a quarterly basis to three-month Mumbai Interbank Offer Rate (MIBOR).*
- ◆ *The interest rate of the fixed part of the swap is 10% p.a.*
- ◆ *Entity S prepaes its fixed obligation under the swap of ₹ 50 crores (₹ 100 crores × 10% × 5 years) at inception, discounted using market interest rates*

- ◆ Entity S retains the right to receive interest payments on the ₹ 100 crores reset quarterly based on three-month MIBOR over the life of the swap.

Analyse.

### Solution

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond.

Therefore, the contract fulfils the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'.

Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

\*\*\*\*\*

### Illustration 2: Prepaid pay-variable, receive-fixed interest rate swap

- ◆ Entity S enters into a ₹ 100 crores notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C.
- ◆ The variable leg of the swap is reset on a quarterly basis to three-month MIBOR.
- ◆ The fixed interest payments under the swap are calculated as 10% of the swap's notional amount, i.e. ₹ 10 crores p.a.
- ◆ Entity S prepays its obligation under the variable leg of the swap at inception at current market rates. Say, that amount is ₹ 36 crores.
- ◆ It retains the right to receive fixed interest payments of 10% on ₹ 100 crores every year.

Analyse.

### Solution

In effect, this contract results in an initial net investment of ₹ 36 crores which yields a cash inflow of ₹ 10 crores every year, for five years. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions.

For this reason, the instrument fails the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'. Therefore, the contract is not accounted for as a derivative contract.

\*\*\*\*\*

### Illustration 3: Prepaid forward

*Entity XYZ enters into a forward contract to purchase 1 million ordinary shares of Entity T in one year*

- ◆ *The current market price of T is ₹ 50 per share*
- ◆ *The one-year forward price of T is ₹ 55 per share*
- ◆ *XYZ is required to prepay the forward contract at inception with a ₹ 50 million payment.*

*Analyse.*

### Solution

Purchase of 1 million shares for current market price is likely to have the same response to changes in market factors as the contract mentioned above. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

\*\*\*\*\*

iii. **Future settlement:** it is settled at a future date.

However, it is not relevant whether the derivative is settled gross or not. For example, an interest rate swap is a derivative instrument, whether the counterparties pay interest to each other or settle it on a net basis.

Further, an option, say a call option i.e. a right to purchase shares at a fixed price at a certain date in future, may expire unexercised at maturity because it is 'out of money'. Such a contract is still a derivative contract because expiry at maturity is also a form of settlement even though there is no exchange of consideration eventually.

### Illustration 4

*Entity ABC Ltd., whose functional currency is Indian Rupees, sells products in France denominated in Euro. ABC enters into a contract with an investment bank to convert Euro to Indian Rupees at a fixed exchange rate. The contract requires ABC to remit Euro based on its sales volume in France in exchange for Indian Rupees at a fixed exchange rate of 80.00. Is that contract a derivative?*

### Solution

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales); no initial net investment or an initial net investment that is smaller than would be

required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision.

\*\*\*\*\*

#### Illustration 5

*The definition of a derivative requires that the instrument “is settled at a future date”. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?*

#### Solution

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

\*\*\*\*\*

### Accounting for derivatives

All derivatives are measured at fair value with changes in fair value being recognized in profit and loss for the period, except derivatives that qualify as hedging instruments. Accounting for derivatives that qualify as hedging instruments is dealt with in the Hedge Accounting chapter.

#### Illustration 6

*Silver Ltd. has purchased 100 ounces of gold on 10 March 20X1. The transaction provides for a price payable which is equal to market value of 100 ounces of gold on 10 April 20X1 and shall be settled by issue of such number of equity shares as is required to settle the aforementioned transaction price at ₹ 10 per share on 10 April 20X1. Whether this is classified as liability or equity? Own use exemption does not apply.*

#### Solution

In the above scenario, there is a contract for purchase of 100 ounces of gold whose consideration varies in response to changing value of gold. Analysing this contract as a derivative –

- (a) Value of contract changes in response to change in market value of gold;
- (b) There is no initial net investment
- (c) It will be settled at a future date, i.e. 10 April 20X1.

Since the above criteria are met, this is a derivative contract.

Now, a derivative contract that is settled in own equity other than exchange of fixed amount of cash for fixed number of shares is classified as ‘liability’. In this case, since the contract results in issue of variable number of shares based on transaction price to be determined in future, hence, this shall be classified as ‘derivative financial liability’.

Per Ind AS 109.4.2.1 – A derivative financial liability shall be carried at fair value through profit or loss.

\*\*\*\*\*

**Illustration 7 : Derivative contract:**

*Entity – B Ltd writes an option contract for sale of shares of Target Ltd. at a fixed price of ₹ 100 per share to C Ltd. This option is exercisable anytime for a period of 90 days ('American option'). Evaluate this under the definition of financial instrument.*

**Solution**

In the above case – B Ltd has written an option, which if exercised by C Ltd. will result in B Ltd. selling equity shares of Target Ltd. for fixed price of ₹ 100 per share. Such option will be exercised by C Ltd. only if the market price of shares of Target Ltd. increases beyond ₹ 100, thereby resulting in contractual obligation over B Ltd. to settle the contract under potential unfavorable terms.

If the market price goes to ₹ 120 then the option will be exercised by C Ltd. So, B Ltd has to buy shares from the market at ₹ 120 per share and sell at ₹ 100, thereby resulting in a loss or exchange at unfavorable terms to B Ltd. Hence, the option will meet the definition of financial liability in the books of B Ltd.

The additional question that arises here is the nature of this financial liability and whether it meets the definition of derivative. A derivative is a financial instrument that meets following conditions:

- (a) Its value changes in response to change in specified variable like interest rate, equity index, commodity price, etc. If the variable is non-financial, it is not specific to party to the contract
- (b) It requires no or little initial net investment
- (c) It is settled at a future date.

Evaluating the above instrument, B Ltd. has written an option whose value changes based on change in market price of equity share, it requires no initial net investment and is settled at a future date (anytime in 90 days). Hence, it meets definition of derivative financial liability in books of B Ltd.

\*\*\*\*\*

**Illustration 8: Derivative contract to be settled in own equity instruments**

*A Ltd. issues warrants to all existing shareholders entitling them to purchase additional equity shares of A Ltd. (with face value of ₹ 100 per share) at an issue price of ₹ 150 per share. Evaluate whether this constitutes an equity instrument or a financial liability?*

**Solution**

In this case, Company A Ltd. has issued warrants entitling the shareholders to purchase equity shares of the Company at a fixed price. Hence, it constitutes a contractual arrangement for issuance of fixed number of shares against fixed amount of cash.

Now, evaluating this contract under definition of derivative –

- (i) The value of warrant changes in response to change in value of underlying equity shares;
- (ii) This involves no initial net investment



(iii) It shall be settled at a future date.

Hence, this warrant meets the definition of derivative.

Applying definition of equity under Ind AS 32, a derivative contract that will be settled by exchange of fixed number of equity shares for fixed amount of cash meets definition of equity instrument. The above contract is derivative contract that will be settled by issue of fixed number of own equity instruments by A Ltd. for fixed amount of cash and hence meets definition of equity instrument.

\*\*\*\*\*

## 4.2.2 Embedded derivatives

Paragraph 4.3.1 of Ind AS 109 defines an embedded derivative as:

“An embedded derivative is:

- a component of a hybrid contract
- that also includes a non-derivative host
- with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

An embedded derivative causes:

- some or all of the cash flows that otherwise would be required by the contract
- to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable,
- provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.”

### Examples 1 - 3 of embedded derivatives:

1. Company MNL Ltd. holds a bond which is convertible into the ordinary shares of Company Z Ltd. The hybrid contract is the convertible bond; the host contract is the bond asset; the embedded derivative is the conversion option.
2. Company ABC Ltd. enters into a lease with an inflation factor, such that each year rentals are adjusted for changes in risk price index. The hybrid contract is the entire lease; the host is the lease contract, the embedded derivative is the adjustment to the risk price index.
3. Company PQR Ltd. sells furniture to Company XYZ Ltd. in USD. Both companies are located in India. The hybrid contract is the entire sale contract which will be settled in USD; the host contract is the Rupee sale contract; the embedded derivative is the foreign exchange ₹/USD forward.

**Illustration 9**

*A lease contract contains a provision that rentals increase each year by ₹ 3 million. Is there an embedded derivative in this contract?*

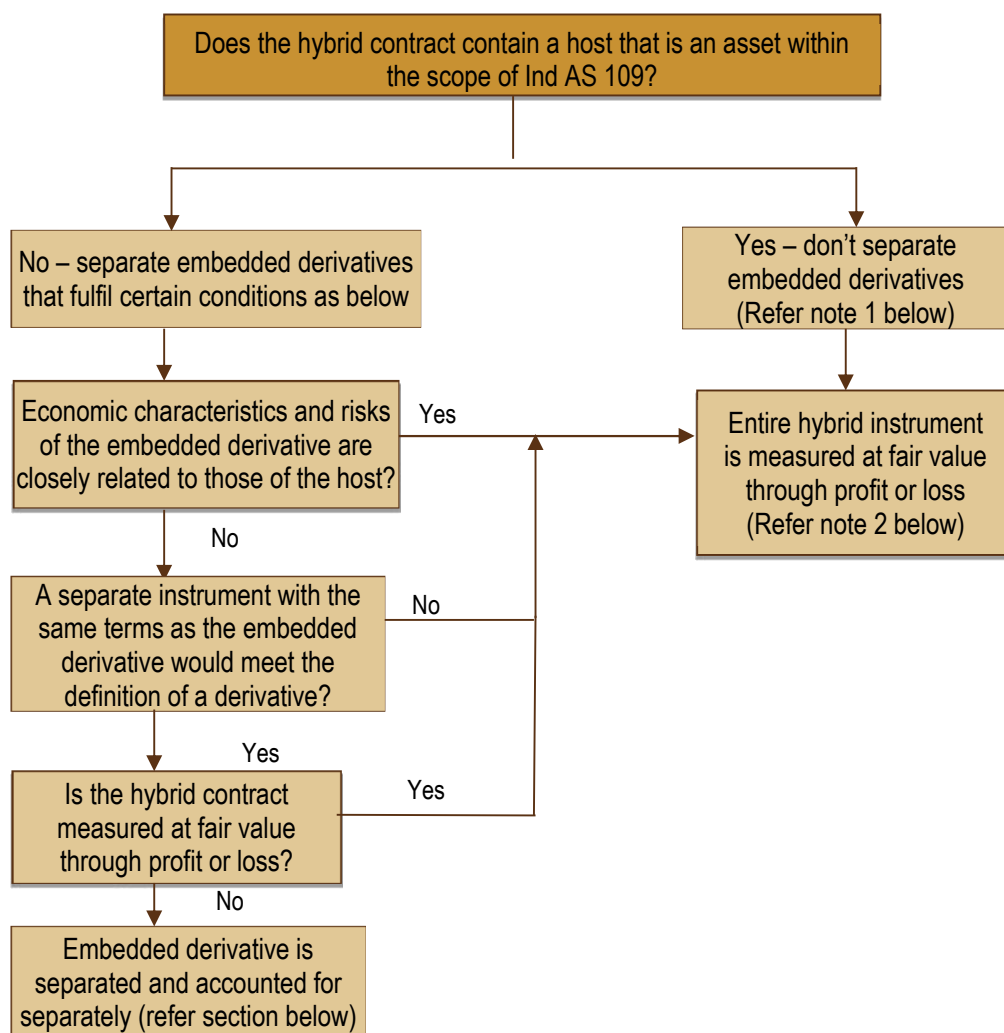
**Solution**

The price adjustment feature does not meet the definition of a derivative on a stand-alone basis since its value does not change in response to changes of some underlying. There is no underlying in this case; hence there is no embedded derivative in the lease contract.

\*\*\*\*\*

**4.2.2.1 Separation of embedded derivatives from host contract**

In certain circumstances, an embedded derivative is required to be separated from the host contract and accounted for separately as a financial instrument. The flowchart below analyses those circumstances:



**Note 1:** This implies that embedded derivatives are permitted to be separated from only such hybrid contracts that contain a host which is either a (a) financial instrument classified as financial liability or equity or compound; or (b) contract for purchase or sale of a non-financial item.

**Note 2:** If both the host and embedded derivative have economic characteristics of an equity instrument, the hybrid instrument is not carried at fair value through profit or loss. In other words, this measurement category is applicable only for host contracts which are financial liabilities.

#### 4.2.2.2 Economic characteristics and risks of the embedded derivative – whether closely related to those of the host?

Paragraphs B4.3.5 and B4.3.8 of Ind AS 109 provide examples of situations in which economic characteristics of the embedded derivative are considered to be closely related or not closely related to those of the host.

Some of these examples are explained below, though students are advised to understand all the examples given in the application guidance of the standards.

##### 1. Underlying indices

###### Illustration 10: Debt instrument with indexed repayments

*Entity X issues a redeemable fixed interest rate debenture to Entity Y. Amount of interest and principal is indexed to the value of equity instruments of Entity X.*

*Analyse*

###### Solution

In the given case, the host is a fixed interest rate debt instrument. The economic characteristics and risks of a debt instrument are not closely related to those of an equity instrument.

Hence, the exposure of this hybrid instrument to changes in value of equity instruments is an embedded derivative which is required to be separated.

The response above will not change even if the interest payment and principal repayments are indexed to a commodity index or similar underlying.

\*\*\*\*\*

###### Illustration 11: Lease contracts dependent on inflation index

*A lease contract, between two Indian companies of an asset in India, includes contingent lease rentals that are dependent upon an US inflation index. Can the entity treat inflation linked features as closely related?*

**Solution**

For inflation linked features, an embedded derivative in a lease contract is considered as closely related to the host if it is an inflation—related index related to inflation in the entity's own economic environment.

In this case, whilst the asset and the lessor and lessee are located in India, lease payment are linked to US index. Hence, embedded derivative is not closely related and needs to be separated.

\*\*\*\*\*

**Illustration 12: Lease contracts dependent on inflation index**

*As per the contract entered between lease and lessor, lease rentals will increase by ₹ 3 million, if profit after tax is over ₹ 200 million. Can the entity treat inflation linked features as closely related?*

**Solution**

No. Whilst contingent rentals based on sales are closely related to a host lease contract, the same is not true of contingent rentals based on profit after tax.

\*\*\*\*\*

**2. Prepayment options in debt instruments**

It is very common to have debt prepayment options in ordinary borrowing arrangements. Paragraph B4.3.5(e) of Ind AS 109 provides the guidance in this respect:

"A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

- i. the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract;

or

- ii. the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with Ind AS 32."

Ind AS 109 does not interpret the term “approximately equal”. Management of entities will need to adopt a consistent accounting policy to apply this principle in general.

### Illustration 13: Debt instrument with prepayment option

Entity PQR borrows ₹ 100 crores from CFDH Bank on 1 April 20X1. Interest is payable at 12% p.a. and there is a bullet repayment of principal at the end of the term.

Term of the loan is 6 years.

The loan includes an option to prepay the loan at 1<sup>st</sup> April each year with a prepayment penalty of 3%. There are no transaction costs. Without the prepayment option, the interest rate quoted by bank is 11% p.a.

Analyse

### Solution

*Step 1: Identify the host contract and embedded derivative, if any*

In the given case,

- Host is a debt instrument comprising annual interest payment at 12% p.a. and bullet principal repayment at the end of 6 years.
- Option to prepay the debt at ₹ 103 crores is an embedded derivative

*Step 2: Determine the amortised cost of the host debt instrument*

Whether the prepayment option is likely to be exercised or not, the amortised cost of the host debt instrument should be calculated as present value (PV) of expected cash flows using a fair market interest rate for a debt without the prepayment option (11% p.a. in this case). This is calculated below as ₹ 104.23 crores:

| Year     | Cash outflow | PV @ 11% p.a. | Finance cost | Amortised cost |
|----------|--------------|---------------|--------------|----------------|
| ₹ crores |              |               |              |                |
| 1        | 12.00        | 10.81         | 11.46        | 103.68         |
| 2        | 12.00        | 9.74          | 11.41        | 103.09         |
| 3        | 12.00        | 8.77          | 11.34        | 102.43         |
| 4        | 12.00        | 7.90          | 11.27        | 101.70         |
| 5        | 12.00        | 7.12          | 11.20        | 100.90         |
| 6        | 112.00       | <u>59.88</u>  | <u>11.10</u> | -              |
|          |              | <u>104.22</u> | <u>67.78</u> |                |

**Step 3: Compare the exercise price of the prepayment option with the amortised cost of the host debt instrument**

| Year     | Amortised cost | Exercise price of prepayment option | Difference |
|----------|----------------|-------------------------------------|------------|
| ₹ Crores |                |                                     |            |
| 1        | 103.68         | 103.00                              | 0.7%       |
| 2        | 103.09         | 103.00                              | 0.1%       |
| 3        | 102.43         | 103.00                              | -0.6%      |
| 4        | 101.70         | 103.00                              | -1.3%      |
| 5        | 100.90         | 103.00                              | -2.1%      |
| 6        | -              | N/A                                 |            |

The management of Entity PQR may formulate an appropriate accounting policy to determine what constitutes “approximately equal”. In this case, if the management determines that a difference of more than 2% will indicate that the option's exercise price is not approximately equal to the amortised cost of the host debt instrument, it will need to separate the embedded derivative and account for it as per principles given in the subsequent sub-section.

It may be questioned as to why an option to repay a fixed rate loan early meets the definition of embedded derivative. Let us revisit an important phrase from the definition of embedded derivative:

“...some or all of the cash flows that otherwise would be required by the contract to be modified...”

In the context of a fixed rate debt, it may be interpreted that:

- the option affects cash flows only if exercised; and
- the cash flows of a fixed rate debt do not vary with interest rates.

However, in this context, a variation in cash flows should be interpreted as a possible change in the fair value of expected cash flows. Accordingly, the option's expected cash flows vary according to interest rates in a similar way as a separate option to purchase a fixed rate debt asset at a fixed price. A fixed price option to prepay a fixed rate loan will increase in value as interest rates decline (and vice versa).

\*\*\*\*\*

### ***3. Foreign currency derivative embedded in contract for purchase or sale of non-financial items***

Another common situation in trade and commerce in today's world is a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency. Paragraph B4.3.8(d) provides following guidance in this respect.

"An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

- i. the functional currency of any substantial party to that contract;
- ii. the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
- iii. a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade)."

The functional currencies of the parties should be determined in accordance with the definition and guidance in Ind AS 21.9 to 13.

Unless the above exceptions apply, the embedded foreign currency derivative should be separated from the host contract. Certain guidance on how to carry out the separation are enumerated below in detail:

1. the host contract is a sale or purchase contract denominated in the functional currency of the reporting entity
2. the amount of functional currency is determined using the relevant forward exchange rate (to the date of delivery) at the date the contract is entered into
3. the embedded derivative is a forward currency contract to buy or sell the applicable amount of the contract currency for the functional currency, at the same forward exchange rate. The effect is that the fair value of the embedded derivative is initially zero
4. subsequent changes in the fair value of the embedded derivative are recorded in profit or loss
5. on delivery of the non-financial item, the host contract is fulfilled and the embedded derivative is effectively settled. A foreign currency debtor or creditor is recognised for the contract amount, translated at the spot rate in accordance with Ind AS 21.23(a). The

closing carrying amount of the embedded derivative is added to the functional currency amount of the host contract to give the initial carrying amount of the debtor or creditor.

#### **4. Option and non-option based derivatives**

##### **A. Non-option based derivatives**

The terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid contract. Non-option based derivatives represent obligations of the counterparties to a contract.

Fair value of a financial instrument is a combination of its intrinsic value and time value. In a fair and perfect market, it would be inappropriate to conclude that immediately at the inception of a contract, it results in creation of rights and obligations for two independent parties i.e. the contract has no intrinsic value at inception. Also, the time value starts accumulating only after the first day of the contract.

The standard specifies that if it were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid contract.

Further, in the case of non-option based derivatives, terms of the host debt instrument reflect the (a) stated or (b) implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement of the terms.

##### **B. Option based derivatives**

The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or exercise price) specified for the option feature in the hybrid contract. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, options or swap feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract (unlike a non-option based derivative which is separated on the basis of implied terms also). As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a



zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price of the underlying variable at the initial recognition of the hybrid contract.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid contract. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid contract, that amount would essentially represent a borrowing or lending. Accordingly, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid contract.

#### 4.2.2.3 Accounting for embedded derivatives

If the flowchart given in paragraph “Separation of embedded derivatives” results in the conclusion that the embedded derivatives are required to be separated, an entity shall measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss. *[Paragraph 4.3.4 of Ind AS 109]*

The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative. *[Paragraph B4.3.3 of Ind AS 109]*

As per paragraph 4.3.5 of Ind AS 109, if a contract contains one or more embedded derivatives and the host is not a financial asset, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

- i. the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or

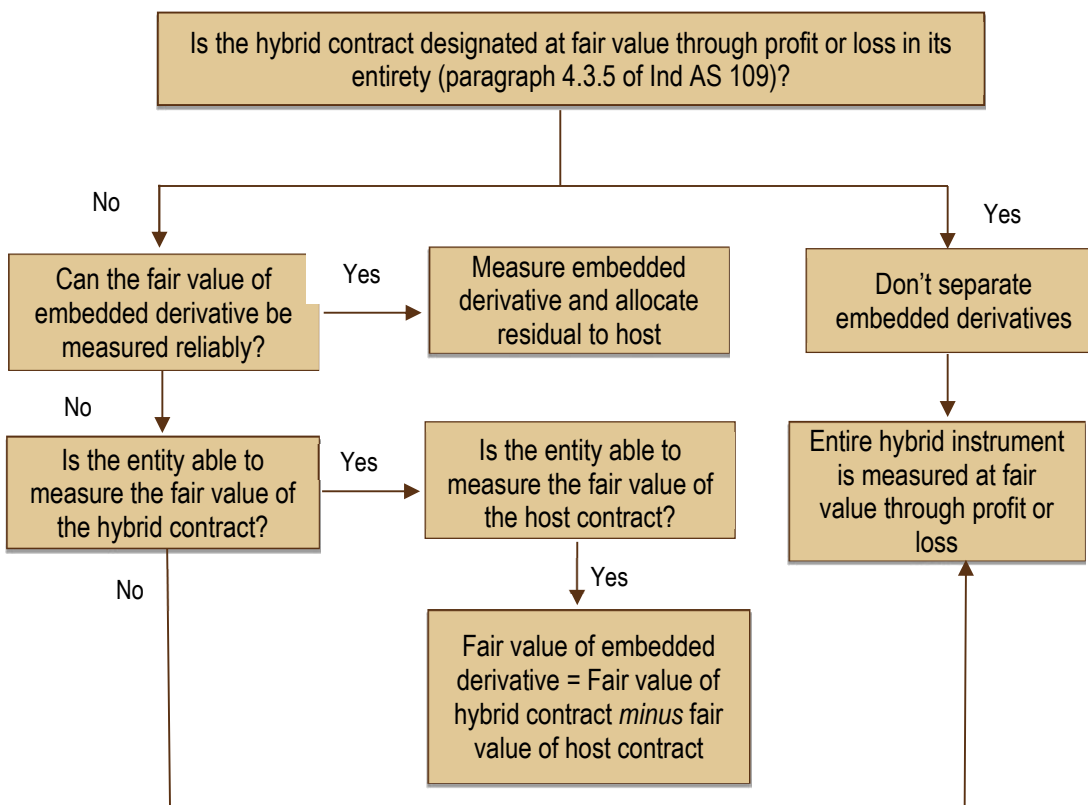
- ii. it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

These are two exceptions to the general principle that hybrid contracts can be measured at fair value in their entirety, without separation of embedded derivatives. **Refer explanation below for interpretation of the phrase “significantly modify cash flows” mentioned above.**

Further, as per paragraph 4.3.6 of Ind AS 109, if an entity is required to separate an embedded derivative from its host (as per flowchart presented earlier in this paragraph), but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.

If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, the hybrid contract is designated as at fair value through profit or loss.

To conclude, picking up from the flowchart presented earlier in this paragraph, the accounting implications are demonstrated in the flow chart below:



### Reassessment of Embedded Derivatives

An entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract.

Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

#### Illustration 14: Contracts for purchase or sale of non-financial item

##### Key terms of contracts to buy/sell non-financial items

*Company Z is engaged in the business of importing oil seeds for further processing as well as trading purposes. It enters into the following types of contracts as on 1 October 20X1:*

| Particulars                                             | Contract 1                                                                                                                                                                                                                   | Contract 2                                                                                                                                                                                                                                                                                 | Contract 3                                                                                                                                                                                                             |
|---------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Nature of Contract</b>                               | Import of oil seeds from a foreign supplier                                                                                                                                                                                  | Purchase of oil seeds from a domestic producer / supplier                                                                                                                                                                                                                                  | Contract to sell oil seeds on the commodity exchange                                                                                                                                                                   |
| <b>Quantity and rate</b>                                | 100 MT at USD 400 per MT to be delivered as on 31 March 20X2                                                                                                                                                                 | 50 MT at ₹ 30,000 per MT to be delivered as on 31 January 20X2                                                                                                                                                                                                                             | 50 MT at USD 450 per MT, maturing as on 15 January 20X2                                                                                                                                                                |
| <b>Net settlement clause included in the contract</b>   | Yes                                                                                                                                                                                                                          | Yes                                                                                                                                                                                                                                                                                        | Yes                                                                                                                                                                                                                    |
| <b>Net settlement in practice for similar contracts</b> | There have also been several instances of the oil seeds being sold prior to or shortly after taking delivery. These instances of net settlement constitute approximately 30 per cent of the value of total import contracts. | Yes – company Z has net settled some of the domestic purchase contracts. However, these instances constitute only 1 per cent of the total domestic purchase contracts in value. The remaining contracts are settled by taking delivery of oil seeds which are used for further processing. | Yes – these contracts are required to be net settled with the exchange on the maturity date. Company Z enters into these types of derivative contracts to hedge the risks on its domestic oil seeds purchase contracts |

*Company Z is required to determine if the contracts entered into for purchase and sale of oil seeds are derivatives within the scope of Ind AS 109 or are executory contracts outside the scope of Ind AS 109.*

### **Solution**

#### **Contract 1:**

The following factors indicate that this contract does not meet the 'own use' exemption:

- The contract permits net settlement, and
- There is a past practice of a significant proportion (30 per cent in this illustration) of similar contracts being settled on a net basis either in cash or by sale of the oil seeds prior to delivery/shortly after taking delivery.

Therefore, this contract would fall within the scope of Ind AS 109 and should be recognised as a derivative instrument as on 1 October 20X1. The contract would be in the nature of a forward contract to buy 100 MT of oil seeds as on 31 March 20X2 at USD 400 per MT. Company Z would have to recognise the fair value changes (based on change in forward purchase rate) on this contract in the statement of profit and loss at each reporting date.

#### **Contract 2**

Contract 2 also permits net settlement in cash. Further, there have been some instances of similar domestic purchase contracts being settled net in cash in the past. However, these have been infrequent in nature and insignificant in proportion to the total value of similar contracts (i.e. 1 percent in this illustration).

Company Z is in the practice of taking delivery of the oil seeds purchased under similar contracts and using them for further processing in its plants.

This indicates that the domestic purchase contract meets the criteria for the 'own-use' exemption and should be considered as an executory contract.

Therefore, this contract would not fall within the scope of Ind AS 109.

#### **Contract 3**

This contract is in the nature of a derivative contract transacted on a commodity exchange and is required to be net settled in cash on maturity. Therefore, this derivative contract would be covered by Ind AS 109 and required to be classified and measured at FVTPL.

\*\*\*\*\*

### **Illustration 15: Foreign currency embedded derivatives**

Company A, an Indian company whose functional currency is ₹, enters into a contract to purchase machinery from an unrelated local supplier, company B. The functional currency of company B is also ₹. However, the contract is denominated in USD, since the machinery is sourced by company B from a US based supplier. Payment is due to company B on delivery of the machinery.

**Key terms of the contract:**

| <b>Contractual features</b>                                          | <b>Details</b>   |
|----------------------------------------------------------------------|------------------|
| Contract/order date                                                  | 9 September 20X1 |
| Delivery/payment date                                                | 31 December 20X1 |
| Purchase price                                                       | USD 1,000,000    |
| USD/₹ Forward rate on 9 September 20X1 for 31 December 20X1 maturity | 67.8             |
| USD/₹ Spot rate on 9 September 20X1                                  | 66.4             |
| USD/₹ Forward rates for 31 December, on:                             |                  |
| 30 September                                                         | 67.5             |
| 31 December (spot rate)                                              | 67.0             |

Company A is required to analyse if the contract for purchase of machinery (a capital asset) from company B contains an embedded derivative and whether this should be separately accounted for on the basis of the guidance in Ind AS 109. Also give necessary journal entries for accounting the same.

**Solution**

Based on the guidance above, the USD contract for purchase of machinery entered into by company A includes an embedded foreign currency derivative due to the following reasons:

- The host contract is a purchase contract (non-financial in nature) that is not classified as, or measured at FVTPL.
- The embedded foreign currency feature (requirement to settle the contract by payment of USD at a future date) meets the definition of a stand-alone derivative – it is akin to a USD-₹ forward contract maturing on 31 December 20X1.
- USD is not the functional currency of either of the substantial parties to the contract (i.e., neither company A nor company B).
- Machinery is not routinely denominated in USD in commercial transactions around the world. In this context, an item or a commodity may be considered 'routinely denominated' in a particular currency only if such currency was used in a large majority of similar commercial transactions around the world. For example, transactions in crude oil are generally considered routinely denominated in USD. A transaction for acquiring machinery in this illustration would generally not qualify for this exemption.
- USD is not a commonly used currency for domestic commercial transactions in the economic environment in which either company A or B operate. This exemption generally applies when the business practice in a particular economic environment is to use a more stable or liquid foreign currency (such as the USD), rather than the local currency, for a majority of internal or cross-border transactions, or both. In the illustration above, companies A and B are companies operating in India and the purchase contract is an internal/domestic transaction. USD is not a commonly used currency for internal trade

within this economic environment and therefore the contract would not qualify for this exemption.

Accordingly, company A is required to separate the embedded foreign currency derivative from the host purchase contract and recognise it separately as a derivative.

The separated embedded derivative is a forward contract entered into on 9 September 20X1, to exchange USD 10,00,000 for ₹ at the USD/₹ forward rate of 67.8 on 31 December 20X1. Since the forward exchange rate has been deemed to be the market rate on the date of the contract, the embedded forward contract has a fair value of zero on initial recognition.

Subsequently, company A is required to measure this forward contract at its fair value, with changes in fair value recognised in the statement of profit and loss. The following is the accounting treatment at quarter-end and on settlement:

**Accounting treatment:**

| Date      | Particulars                                                                                                                                                                                     | Amount<br>(₹) | Amount<br>(₹)           |
|-----------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|-------------------------|
| 09-Sep-X1 | <b>On initial recognition of the forward contract</b><br>(No accounting entry recognised since initial fair value of the forward contract is considered to be nil)                              | Nil           | Nil                     |
| 30-Sep-X1 | <b>Fair value change in forward contract</b><br>Derivative asset (company B) Dr.<br>[(67.8-67.5) x 10,00,000]<br>To Profit or loss                                                              | 3,00,000      | 3,00,000                |
| 31-Dec-X1 | <b>Fair value change in forward contract</b><br>Forward contract asset (company B) Dr.<br>[{(67.8-67) x 10,00,000} - 3,00,000]<br>To Profit or loss                                             | 5,00,000      | 5,00,000                |
| 31-Dec-X1 | <b>Recognition of machinery acquired and on settlement</b><br>Property, plant and equipment Dr.<br>(at forward rate)<br>To Forward contract asset (company B)<br>To Creditor (company B) / Bank | 6,78,00,000   | 8,00,000<br>6,70,00,000 |

\*\*\*\*\*

## UNIT 5: RECOGNITION AND DERECOGNITION OF FINANCIAL INSTRUMENTS

The concepts of recognition and derecognition of any asset or liability refer to the timing i.e. when is the financial instrument included in an entity's balance sheet (recognition) and when is it removed from the entity's balance sheet (derecognition).



### 5.1 INITIAL RECOGNITION

As per paragraph 3.1.1 of Ind AS 109, an entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument.

Paragraph B3.1.2 of Ind AS 109 provides certain examples of applying the aforementioned accounting principle:

| Nature of contract                                                                                                                     | Recognition principle – when are assets or liabilities recognised?                                                                                                                                                                                                                                                                     |
|----------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Unconditional receivables and payables                                                                                                 | When the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash                                                                                                                                                                                                  |
| Firm commitment to purchase or sell goods or services                                                                                  | When at least one of the parties has performed under the agreement i.e. until the ordered goods or services have been shipped, delivered or rendered.                                                                                                                                                                                  |
| Firm commitment to purchase or sell goods or services designated as measured at fair value through profit or loss (refer note 2 below) | Net fair value is recognised as an asset or a liability on the commitment date                                                                                                                                                                                                                                                         |
| Forward contract                                                                                                                       | On the commitment date. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero (refer note 1 below). If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability. |
| Option contracts                                                                                                                       | When the holder or writer becomes a party to the contract (refer note 1 below).                                                                                                                                                                                                                                                        |
| Planned future transactions                                                                                                            | Never                                                                                                                                                                                                                                                                                                                                  |

**Note 1:** Generally, no upfront premium is paid by one party in a forward contract to the other at the inception of the contract. This is indicative of the fact that the fair value of a forward contract on inception is approximately zero. On the other hand, the option holder generally pays an upfront

premium to the option writer at the inception of the option contract. This provides evidence that there is some fair value of the rights and obligations of the parties at the inception of an options contract.

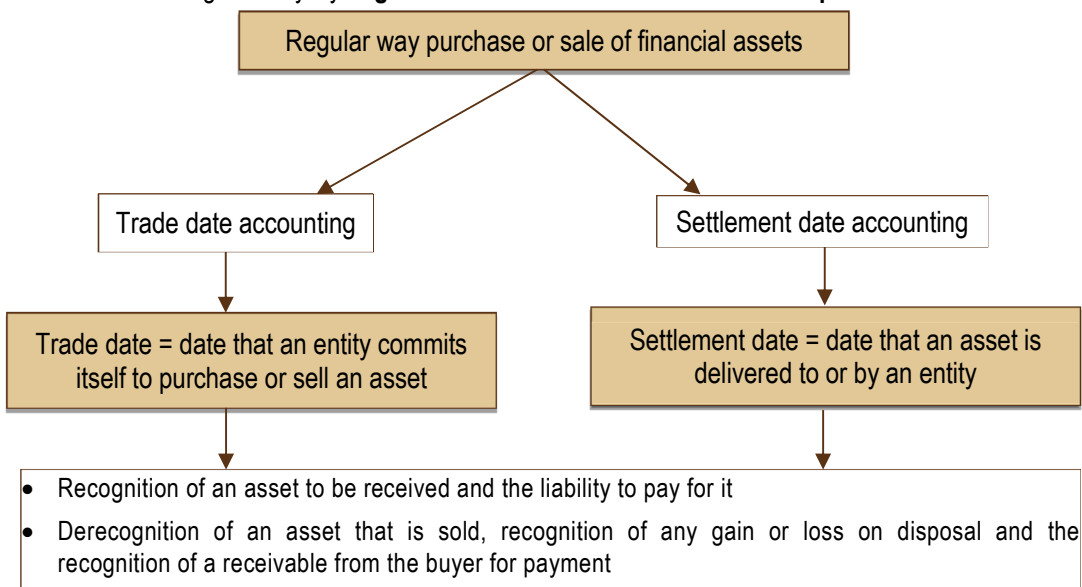
**Note 2:** Contracts to buy or sell non-financial assets that can be settled net or by exchanging financial instruments are treated as if they are financial instruments, that is, derivatives unless they were entered into and continued to be held to meet the entity's normal purchase, sale or usage requirements



## 5.2 REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS

Ind AS 109 defines a regular way purchase or sale as,

- a **purchase or sale** of a financial asset
- under a **contract**
- whose terms require **delivery** of the asset
- within the **time frame**
- established generally by **regulation or convention in the marketplace** concerned



For instance, on the Bombay Stock Exchange in India, all transactions in all groups of securities in the Equity segment, Fixed Income securities and Government securities are settled on "T+2" basis. In this case, "T" is the trade date and "T+2" is the settlement date i.e. exchange of monies and securities between the buyers and sellers respectively takes place on second business day (excluding Saturdays, Sundays, bank and Exchange trading holidays) after the trade date.

It follows that if a contract is entered into with a broker for purchase or sale of securities which is normally traded on the Bombay Stock Exchange, with a settlement period that differs from the norms mentioned above, it would not be regarded as a regular way purchase or sale.



When trade date accounting is applied, the buyer of a financial asset recognises the financial asset and its liability to pay on the trade date itself. Correspondingly, the seller derecognises the financial asset and recognises any gain or loss on sale on the trade date. The buyer subsequently measures the financial asset in accordance with its classification category.

When settlement date accounting is applied, a **buyer of financial asset accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date** in the same way as it accounts for the acquired asset. In other words,

- assets measured at amortised cost - change in value is not recognised;
- assets classified as financial assets measured at fair value through profit or loss (whether mandatorily or designated) – change in value is recognised in profit or loss;
- financial assets measured at fair value through other comprehensive income (including investments in equity instruments for which irrevocable option is selected) – change in fair value is recognised in other comprehensive income.

Correspondingly, the seller of a financial asset derecognises the same at the settlement date and does not recognise any fair value changes between the trade date and settlement date.

An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with Ind AS 109.

#### **Illustration 1: Regular way contracts: forward contracts**

*ST Ltd. enters into a forward contract to purchase 10 lakh shares of ABC Ltd. in a month's time for ₹ 50 per share. This contract is entered into with a broker, Mr. AG and not through regular trading mode in a stock exchange. The contract requires Mr. AG to deliver the shares to ST Ltd. upon payment of agreed consideration. Shares of ABC Ltd. are traded on a stock exchange. Regular way delivery is two days. Assess the forward contract.*

#### **Solution**

In this case, the forward contract is not a regular way transaction and hence must be accounted for as a derivative i.e. between the date of entering into the contract to the date of delivery, all fair value changes are recognised in profit or loss.

\*\*\*\*\*

#### **Illustration 2: Regular way contracts: option contracts**

*NKT Ltd. purchases a call option in a public market permitting it to purchase 100 shares of VT Ltd. at any time over the next one month at a price of ₹ 1,000 per share. If NKT Ltd. exercises its option, it has 7 days to settle the transaction according to regulation or convention in the options market. VT Ltd.'s shares are traded in an active public market that requires two-day settlement.*

#### **Solution**

In this case, the options contract is a regular way transaction as the settlement of the option is governed by regulation or convention in the marketplace for options. Fair value changes between the trade date and settlement date are recognised in profit or loss.

\*\*\*\*\*

The illustrations below explain the flow of journal entries in case of trade date accounting and settlement date accounting for regular way purchase and sale of financial assets.

### Illustration 3: Regular way purchase of financial asset

On 1 January 20X1, X Ltd. enters into a contract to purchase a financial asset for ₹ 10 lakhs, which is its fair value on trade date. On 4 January 20X1 (settlement date), the fair value of the asset is ₹ 10.5 lakhs. The amounts to be recorded for the financial asset will depend on how it is classified and whether trade date or settlement date accounting is used. Pass necessary journal entries.

#### Solution

#### Journal Entries in the Buyer's Books

##### Trade date accounting

| Dr. / Cr.             | Particulars                  | Amortised cost | Fair value through P&L | Fair value through OCI |
|-----------------------|------------------------------|----------------|------------------------|------------------------|
| <b>1 January 20X1</b> |                              |                |                        |                        |
| Dr.                   | Financial asset              | 10,00,000      | 10,00,000              | 10,00,000              |
| Cr.                   | Financial liability (to pay) | (10,00,000)    | (10,00,000)            | (10,00,000)            |
| <b>4 January 20X1</b> |                              |                |                        |                        |
| Dr.                   | Financial asset              | -              | 50,000                 | 50,000                 |
| Dr.                   | Financial liability (to pay) | 10,00,000      | 10,00,000              | 10,00,000              |
| Cr.                   | Profit or loss               | -              | (50,000)               | -                      |
| Cr.                   | Other comprehensive income   | -              | -                      | (50,000)               |
| Cr.                   | Cash                         | (10,00,000)    | (10,00,000)            | (10,00,000)            |

##### Settlement date accounting

| Dr. / Cr.             | Particulars                | Amortised cost | Fair value through P&L | Fair value through OCI |
|-----------------------|----------------------------|----------------|------------------------|------------------------|
| <b>4 January 20X1</b> |                            |                |                        |                        |
| Dr.                   | Financial asset            | 10,00,000      | 10,50,000              | 10,50,000              |
| Cr.                   | Profit or loss             | -              | (50,000)               | -                      |
| Cr.                   | Other comprehensive income | -              | -                      | (50,000)               |
| Cr.                   | Cash                       | (10,00,000)    | (10,00,000)            | (10,00,000)            |

The above mentioned accounting principles apply only to financial assets and Ind AS 109 does not contain any such principles for financial liabilities.

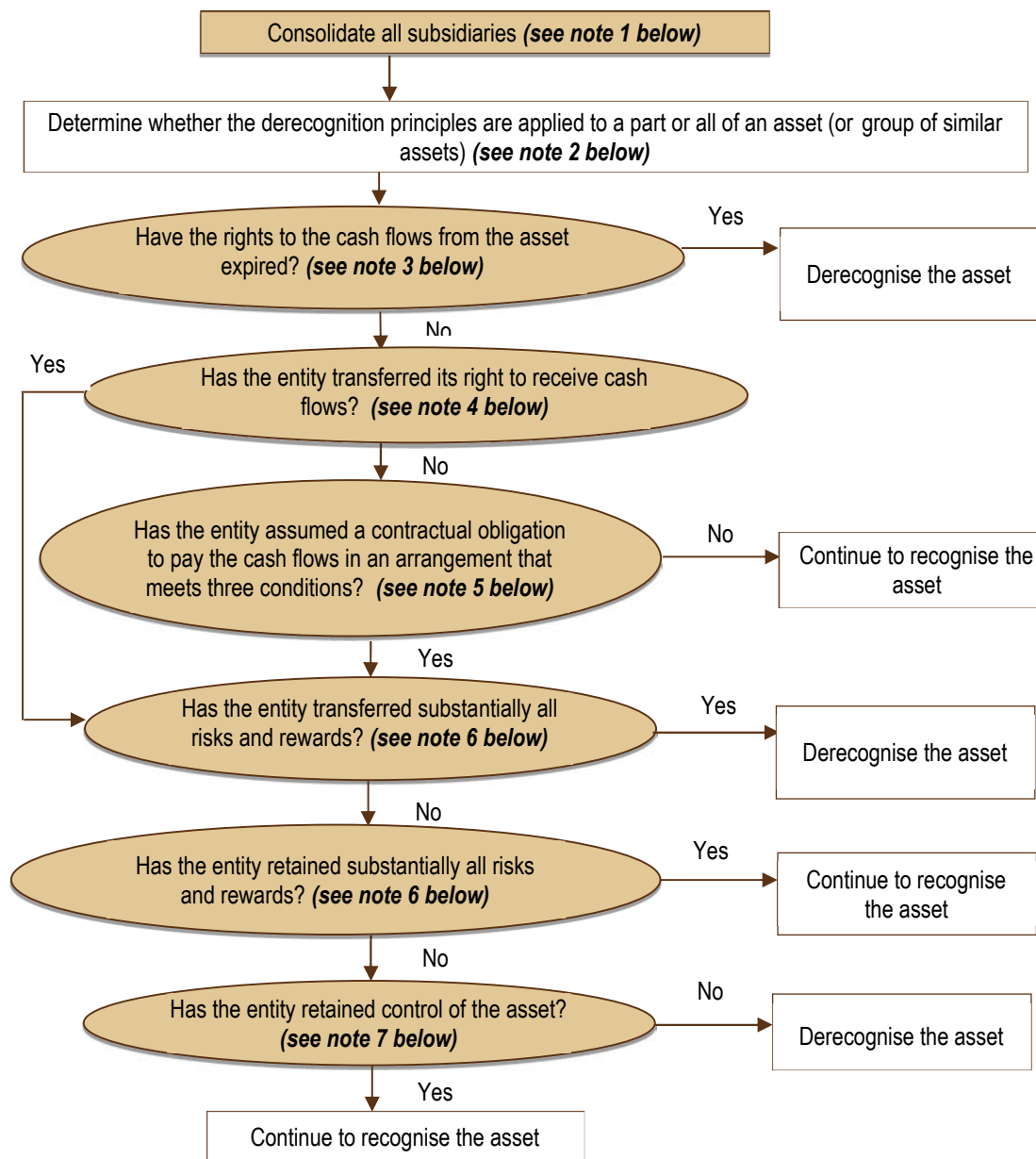
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## 5.3 DERECOGNITION OF FINANCIAL ASSETS

In simple words, derecognition refers to the timing of removing a financial asset from the balance sheet. To take an example, if a company gets its trade receivables discounted from a bank, it would need to determine whether it can remove those trade receivables from its balance sheet.

Paragraph B3.2.1 of Ind AS 109 provides a step-by-step flowchart for making this determination.



**Notes:**

1. In consolidated financial statements, accounting principles for derecognition are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with Ind AS 110 and then applies those requirements to the resulting group. (Ind AS 109.3.2.1)

The importance of this criteria is that sometimes sales of financial assets are made to entities which are specifically designed for this purpose. In those circumstances, it would be inappropriate to derecognise the financial asset if the purchaser entity is indirectly controlled by the seller entity.

2. Let's understand this step using a few fact patterns:

**Illustration 4: Part of a financial asset**

*State whether the derecognition principles will be applied or not.*

- i. *Interest strip of an interest-bearing financial asset i.e. the part entitles its holder to interest cash flows of a financial asset*
- ii. *Dividend strip of an equity share i.e. the part entitles its holder to only dividends arising from an equity share*
- iii. *Cash flows (principal and asset) upto a certain tenure or first right on a proportion of cash flows of an amortising financial asset. Say, the part entitles its holder to first 80% of the cash flows or cash flows for first 4 of the 6 years' tenure.*

**Solution**

Derecognition requirements are applied to a part of a financial asset if that part meets **any of the following three** conditions:

- a) The part comprises only **specifically identified cash flows** from a financial asset (or a group of similar financial assets).

For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, derecognition principles are applied to the interest cash flows

- b) The part comprises only a **fully proportionate (pro rata) share of the cash flows** from a financial asset (or a group of similar financial assets).

For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, derecognition principles are applied to 90 per cent of those cash flows.

- c) The part comprises only a **fully proportionate (pro rata) share of specifically identified cash flows** from a financial asset (or a group of similar financial assets).

For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, derecognition principles are applied to 90 per cent of those interest cash flows.

The example of a part of a financial asset at (iii) in Illustration 4 above will not qualify conditions at (b) and (c) above since it does not represent pro rata share of all or specifically identified cash flows.

In (b) and (c) above, if there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

In all other cases, derecognition principles are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety).

\*\*\*\*\*

#### **Illustration 5: Part of a financial asset**

*State whether the derecognition principles will be applied or not.*

- i. *Entity Y transfers the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets)*
- ii. *Entity Z transfers the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables.*

#### **Solution**

In the above circumstances, Entity Y and Entity Z need to apply the derecognition requirements to the financial asset (or a group of similar financial assets) in its entirety.

\*\*\*\*\*

3. Cash flows from a financial asset expire upon payment of entire due amount or the legal release of the debtor by the creditor from the obligation to pay. In case of derivatives, this condition is considered met when, for example, contractual exercise period of an option expires and option is not exercised.

Ind AS 109 contains elaborate guidance on when renegotiation of the terms of a financial liability results in derecognition thereof. Refer paragraph "Exchange of financial liability instruments" for more details on the same. However, in respect of financial assets, such elaborate guidance has not been provided.

One may use the principles of quantitative and qualitative tests prescribed for financial liabilities to evaluate whether renegotiation of the terms of a financial asset results in derecognition or not.

We discuss below a few circumstances wherein renegotiation does result in “expiry of right to receive cash flows”:

- Agreeing to a moratorium period for repayment of principal or extension of the overall tenor of the loan.
  - Substantial reduction in the interest rates
  - Agreeing to a right to convert loan or a part thereof into equity shares after a certain period of time
4. Examples of transfer of rights to receive cash flows include sale of a financial asset, such as an investment in a debenture or assignment of a receivable (like factoring arrangements with banks or financial institutions). Refer comprehensive examples below on debt factoring and invoice discounting.
  5. In some situations, though an entity retains the contractual rights to receive cash flows of a financial asset ('original asset'), it does assume a contractual obligation to pay those cash flows to one or more entities ('eventual recipients').

For example, securitisation arrangements are a common form of transfer of financial assets in India. In these arrangements, the originator of a financial asset, say a bank or a NBFC, settle a Trust and transfer a portfolio of financial assets to that Trust. Thereafter, securities of that Trust are issued to unrelated parties or investors. Such arrangements are often “pass through” arrangements, in the sense that the originator or the Trust retains the rights to receive cash flows from the financial asset, but they have a simultaneous obligation to pay those cash flows to a recipient.

As per paragraph 3.2.5 of Ind AS 109, **all of the** following conditions need to be met in such situations for the transaction to qualify as a “transfer”:

- The entity has **no obligation to pay amounts** to the eventual recipients **unless it collects equivalent amounts** from the original asset.

Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition. However, existence of guarantees or options that allow the transferee to transfer receivables back to the entity and other recourse arrangements are likely to conflict with this condition.

- The entity is **prohibited** by the terms of the transfer contract **from selling or pledging the original asset** other than as security to the eventual recipients for the obligation to pay them cash flows.
- The entity has an **obligation to remit any cash flows** it collects on behalf of the eventual recipients **without material delay**.

- ♦ entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period, and interest earned on such investments is passed to the eventual recipients.

The standard does not define the word “material” in this condition. Therefore, the same should be understood in common trade parlance.

#### Illustration 6: Proportionate “pass through” arrangement

*Entity A makes a five-year interest-bearing loan (the 'original asset') of ₹ 100 crores to Entity B. Entity A settles a Trust and transfers the loan to that Trust. The Trust issues participatory notes to an investor, Entity C, that entitle the investor to the cash flows from the asset.*

*As per Trust's agreement with Entity C, in exchange for a cash payment of ₹ 90 crores, Trust will pass to Entity C 90% of all principal and interest payments collected from Entity B (as, when and if collected). Trust accepts no obligation to make any payments to Entity C other than 90% of exactly what has been received from Entity B. Trust provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90% of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B.*

*Compute the amount to be derecognised.*

#### Solution

If the three conditions are met, the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, Entity A would report a loan asset of ₹ 10 crores and derecognise ₹ 90 crores.

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- Let's illustrate the “risks and rewards” test with certain examples given in application guidance of Ind AS 109:

Examples of when an entity **has transferred** substantially all the risks and rewards of ownership are:

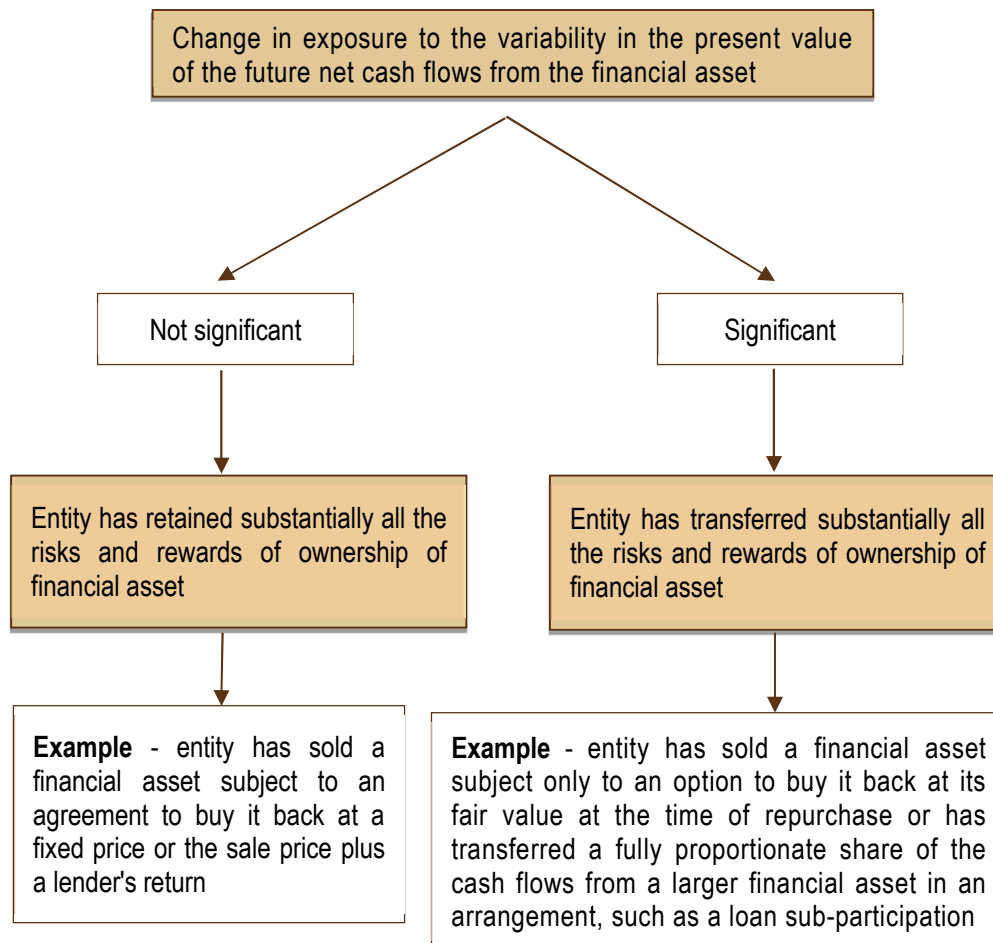
- an unconditional sale of a financial asset;
- a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
- a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).

Examples of when an entity **has retained** substantially all the risks and rewards of ownership are:

- a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
- a securities lending agreement;

- (c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
- (d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
- (e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

Paragraph 3.2.7 of Ind AS 109 provides the guidance on “**risks and rewards**” test



In evaluating the extent to which risks and rewards are transferred or retained, risks and rewards that are reasonably expected to be significant in practice should be considered.

So, what is the most significant risk in a portfolio of short term receivables? It is usually credit risk i.e. the risk that the customer will default. Therefore, an **arrangement that involves the transferee having full recourse to the transferor for credit losses will "fail" the risks and rewards tests. An arrangement in which the transferee has no**



recourse to the transferor for credit losses will generally "pass" the risks and rewards tests.

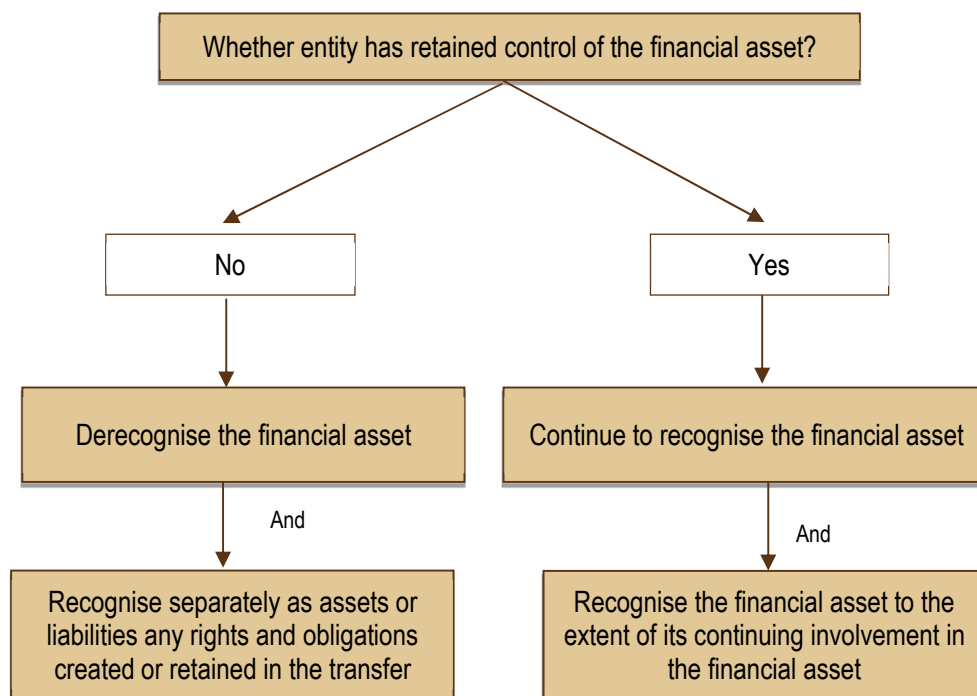
What are the most significant risks in longer term receivables? Well, interest rate risk and slow payment risk are fairly significant in those cases. An arrangement in which the entity continues to pay interest to the transferee until the underlying debtor settles involves the transferee retaining the risk of slow payment.

7. Whether the entity has retained control of the transferred asset depends on the **transferee's ability to sell the asset**. If the transferee,
- has the practical ability to sell the asset in its entirety to an unrelated third party, and
  - is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer

the entity has not retained control.

In all other cases, the entity has retained control.

The accounting treatment as a consequence of this decision is as below:



The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist.

Paragraphs B3.2.7 and 3.2.8 give examples of certain situations in which transferee is evaluated to have such practical ability and situations in which it doesn't have.

**Example 1: Situation when transferee has practical ability to sell the financial asset**

Transferred asset is subject to an option that allows the entity to repurchase it and it is traded in an active market: transferee has the practical ability to sell the financial asset as it can readily obtain the transferred asset in the market if the option is exercised.

**Example 2: Situations when transferee doesn't have practical ability to sell the financial asset**

- ◆ Transferred asset is subject to an option that allows the entity to repurchase it and it is not traded in an active market: transferee doesn't have the practical ability to sell the financial asset as it cannot readily obtain the transferred asset in the market if the option is exercised.
- ◆ A put option or guarantee with respect to the transferred asset which is sufficiently valuable in the sense that it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. In this situation, the transferor has retained control of the transferred asset.

**Illustrations on application of derecognition principles**

Paragraph B3.2.16 of Ind AS 109 provides certain illustrations which are summarised below:

**Illustration 7: Repurchase agreements**

*A financial asset is sold under repurchase agreement. The repurchase price as per that agreement is (a) fixed price or (b) sale price plus a lender's return. Let's look at three alternate scenarios:*

- i. Repurchase agreement is for the same financial asset.*
- ii. Repurchase agreement is for substantially the same asset*
- iii. Repurchase agreement provides the transferee a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date.*

*State whether the derecognition principles will be applied or not.*

**Solution**

In each of these scenarios, the transferred financial asset is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

Let's look at another scenario:

Repurchase agreement provides the transferor only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it

In this scenario, the transferred financial asset is derecognised because the transferor has transferred substantially all the risks and rewards of ownership.

\*\*\*\*\*

#### **Illustration 8: Put options on transferred financial assets**

*A financial asset is sold and the transferee has a put option. Let's look at some alternate scenarios:*

- i. Put option is deeply in the money*
- ii. Put option is deeply out of the money.*

*State whether the derecognition principles will be applied or not.*

#### **Solution**

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

\*\*\*\*\*

#### **Illustration 9: Call options on transferred financial assets**

*A financial asset is sold and the transferor has a call option. Let's look at some alternate scenarios:*

- i. Call option is deeply in the money*
- ii. Call option is deeply out of the money.*

*What if the transferor holds a call option on an asset that is readily obtainable in the market?*

- iii. Call option is neither deeply in the money nor deeply out of the money*

*State whether the derecognition principles will be applied or not.*

#### **Solution**

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

In the third scenario, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control.

\*\*\*\*\*

#### **Illustration 10: Amortising interest rate swaps**

*An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount.*

*Scenarios:*

- i. Notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time.*
- ii. Amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset.*

*State whether the derecognition principles will be applied or not.*

#### **Solution**

In the first scenario, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement.

Such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

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### **5.3.1 Accounting treatment of transfers**

#### **5.3.1.1 Transfers that qualify for derecognition**

If the arrangement results in de-recognition of the financial asset in its entirety:

- in the case of assets included in the "fair value through other comprehensive income" category, any gain or loss previously recorded in equity is recycled to the statement of profit and loss as per the requirements of the standards;
- any new financial assets obtained, financial liabilities assumed and any servicing obligations are recognised at fair value. new asset is part of the proceeds of sale. Any

liability assumed, even if it is related to the transferred asset, is a reduction of the sales proceeds.

- the difference between the carrying amount and the consideration received is recognised in the statement of comprehensive income.

#### Illustration 11: Assignment of receivables

*ST Ltd. assigns its trade receivables to AT Ltd. The carrying amount of the receivables is ₹ 10,00,000. The consideration received in exchange of this assignment is ₹ 9,00,000. Customers have been instructed to deposit the amounts directly in a bank account for the benefit of AT Ltd. AT Ltd. has no recourse to ST Ltd. in case of any shortfalls in collections.*

*State whether the derecognition principles will be applied or not.*

#### Solution

In this situation, ST Ltd. has transferred the rights to contractual cash flows and has also transferred substantially all the risks and rewards of ownership (credit risk being the most significant risk in this situation).

Accordingly, ST Ltd. derecognises the financial asset and recognises ₹ 1,00,000, the difference between consideration received and carrying amount, as an expense in the statement of profit or loss.

\*\*\*\*\*

#### 5.3.1.2 Transfers that do not qualify for derecognition

If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset (for example, in a situation when the transferor guarantees transferee against any default losses), the entity shall,

- continue to recognise the transferred asset in its entirety,
- recognise a financial liability for the consideration received, recognised at fair value less any transaction costs incurred. The liability is subsequently measured at amortised cost using the effective interest method, and
- in subsequent periods, recognise any income on the transferred asset and any expense incurred on the financial liability.

#### 5.3.1.3 Continuing involvement in transferred assets (partial de-recognition)

If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset,

- the entity **continues to recognise the transferred asset to the extent of its continuing involvement**. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset.
  - ◆ *Guarantees for transferred asset*

The extent of the entity's continuing involvement is the lower of

- (i) the amount of the asset, and
- (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').

#### Illustration 12A: Debt factoring with recourse – continuing involvement asset

*Entity C agrees with factoring company D to enter into a debt factoring arrangement. Under the terms of the arrangement, the factoring company D agrees to pay ₹ 91.5 crores, less a servicing charge of ₹ 1.5 crores (net proceeds of ₹ 90 crores), in exchange for 100% of the cash flows from short-term receivables.*

*The receivables have a face value of ₹ 100 crores and carrying amount of ₹ 95 crores.*

*The customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses upto ₹ 5 crores, over and above the expected credit losses of ₹ 5 crores. The guarantee is estimated to have a fair value of ₹ 0.5 crores. Calculate the amount of continuing involvement asset.*

#### Solution

In this situation, the “continuing involvement asset” will be recognised at ₹ 5.5 crores i.e. lower of:

- i. the amount of the asset – ₹ 95 crores
- ii. the guarantee amount – ₹ 5.5 crores

\*\*\*\*\*

- the entity also **recognises an associated liability** that is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:
  - ◆ the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost, or
  - ◆ equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.
- Recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other and shall not be offset.
- If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.
- In case of guarantees, as per the application guidance in Ind AS 109, the associated liability is initially measured at
  - ◆ the guarantee amount plus

- ♦ the fair value of the guarantee (which is normally the consideration received for the guarantee).

#### Illustration 12B: Debt factoring with recourse – associated liability

*Continuing illustration 12A, calculate the amount of associated liability.*

#### Solution

The amount of associated liability is recognised at ₹ 5.5 crores, as below:

- the guarantee amount (i.e. ₹ 5 crores) plus
- the fair value of the guarantee (i.e. ₹ 0.5 crores).

\*\*\*\*\*

- If an entity's continuing involvement is in only a part of a financial asset, the entity **allocates the previous carrying amount** of the financial asset **between the part it continues to recognise under continuing involvement, and the part it no longer recognises** on the basis of the relative fair values of those parts on the date of the transfer. The difference between:
  - ♦ the carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised and
  - ♦ the consideration received for the part no longer recognised
 shall be recognised in profit or loss.
- the entity shall **continue to recognise any income arising on the transferred asset to the extent of its continuing involvement** and shall recognise any expense incurred on the associated liability

#### Illustration 12C: Debt factoring with recourse – gain or loss on derecognition

*Continuing illustration 12A and 12B, pass the necessary Journal Entry.*

#### Solution

The journal entries passed by Entity C on the date of derecognition is as below:

|                              |     |              |              |
|------------------------------|-----|--------------|--------------|
| Cash                         | Dr. | ₹ 90 crores  |              |
| Loss on derecognition        | Dr. | ₹ 5 crores   |              |
| Continuing involvement asset | Dr. | ₹ 5.5 crores |              |
| To Receivables               |     |              | ₹ 95 crores  |
| To Associated liability      |     |              | ₹ 5.5 crores |

The guarantee liability of ₹ 0.5 crores shall be amortised in profit or loss over the underlying period.

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## 5.4 DERECOGNITION OF FINANCIAL LIABILITIES

### 5.4.1 General principles

#### 5.4.1.1 Timing of derecognition

An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires. (Paragraph 3.3.1 of Ind AS 109)

A financial liability (or part of it) is extinguished when the debtor either:

- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

(Paragraph B3.3.1 of Ind AS 109)

If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party. (Paragraph B3.3.4 of Ind AS 109)

#### 5.4.1.2 Accounting treatment for extinguishment

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss. (Paragraph 3.3.3 of Ind AS 109)

Further, in some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:

- (a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and
- (b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.



## 5.4.2 Exchange of financial liability instruments

Many times entities re-negotiate terms of their existing debt with the lenders. In India, this is popularly known as “Strategic Debt Restructuring” or SDR. Sometimes, entities approach their lenders to renegotiate terms of their debt, when they want to take advantage of the falling interest rate regime.

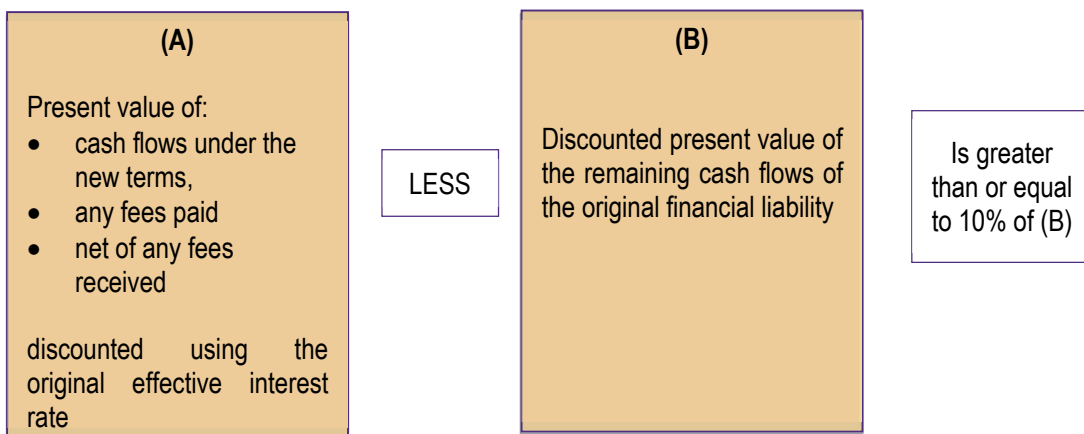
In accounting terms, such situations need to be evaluated to determine whether the original debt is extinguished.

As per paragraph 3.3.2 of Ind AS 109, an exchange between an existing borrower and lender of debt instruments with **substantially different terms** shall be accounted for as:

- an extinguishment of the original financial liability, and
- the recognition of a new financial liability.

Similarly, a **substantial modification** of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted as mentioned above.

As per application guidance in paragraph B3.3.6 of Ind AS 109, the **terms are substantially different if:**

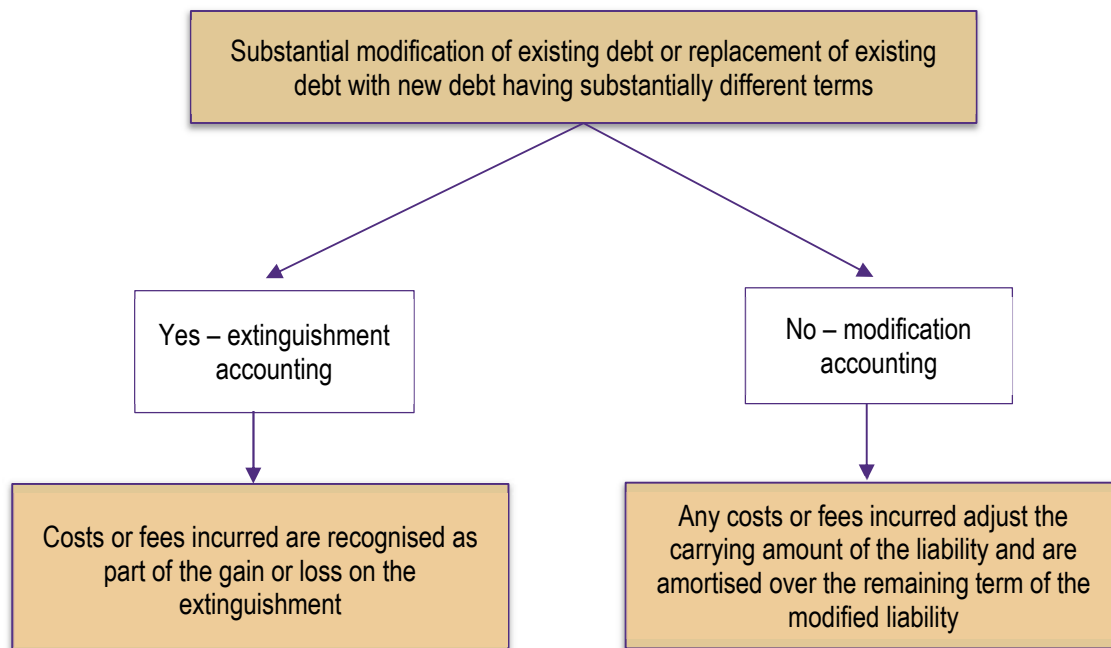


### 5.4.2.1 Accounting treatment

If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. In determining those fees paid net of any fees received, a borrower includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf.

If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of

the modified liability. It may be noted here that the costs or fees considered for this purpose differs from the costs or fees considered for the purpose of 10% test. In the case where modification does not result in derecognition, any costs or fees incurred is considered to adjust the effective interest rate whereas for the 10% test only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf are considered.



### 1. Extinguishment accounting

If the 10% test is passed, principle of “extinguishment accounting” are applied, that is:

- de-recognition of the existing liability
- recognition of the new or modified liability at its fair value (net of any fees incurred directly related to the new liability)
- recognition of a gain or loss equal to the difference between the carrying value of the old liability and the fair value of the new one
- recognising any incremental costs or fees incurred for modification (and not for the new liability), and any consideration paid or received, in profit or loss
- calculating a new effective interest rate for the modified liability, which is then used in future periods.

Fair value of the new or modified liability is estimated based on the expected future cash flows of the modified liability, discounted using the interest rate at which the entity could raise debt with similar terms and conditions in the market.

### Example 3: Extinguishment accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 10,00,000, bearing interest at 10% (payable annually on 31<sup>st</sup> December each year). The bonds are redeemable on 31 December 20X9 for ₹ 10,00,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- the term is extended to 31 December 20Y1;
- interest payments are reduced to 5% p.a.;
- the bonds are redeemable on 31 December 20Y1 for ₹ 15,00,000; and
- legal and other fees of ₹ 1,00,000 are incurred.

XYZ Ltd. determines that the market interest rate on 1 January 20X5 for borrowings on similar terms is 11%.

The repayment schedule for the original debt till the date of renegotiation is as below:

| Date / year ended | Opening balance | Interest accrual | Cash flows | Closing balance |
|-------------------|-----------------|------------------|------------|-----------------|
| 1 January 20X0    | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X0  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X1  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X2  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X3  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X4  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

- cash flows under the new terms – i.e. ₹ 15,00,000 payable on 31 December 20Y1 and ₹ 50,000 payable for each of the 7 years ending 31 December 20Y1.
- fees paid by the borrower to the lender – i.e. ₹ 1,00,000

using the original effective interest rate of 10%.

The total of these amounts to ₹ 11,13,158 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 11.32% i.e. by more than 10%. Hence, extinguishment accounting applies.

The next step is to estimate the fair value of the modified liability. This is determined as the present value of the future cash flows (interest and principal), using an interest rate of 11% (the market rate at which XYZ Ltd. could issue new bonds with similar terms). The estimated fair value on this basis is ₹ 958,097 (Refer Working Note). A gain or loss on modification is then determined as:

Gain (loss) = carrying value of existing liability - fair value of modified liability - fees and costs incurred i.e. ₹ 10,00,000 – ₹ 9,58,097 – ₹ 1,00,000 = Loss of ₹ 58,097

### Working Note:

| Year    | Discount factor @ 10% | Discount factor @ 11% |
|---------|-----------------------|-----------------------|
| 1       | 0.909091              | 0.900901              |
| 2       | 0.826446              | 0.811622              |
| 3       | 0.751315              | 0.731191              |
| 4       | 0.683013              | 0.658731              |
| 5       | 0.620921              | 0.593451              |
| 6       | 0.564474              | 0.534641              |
| 7       | <u>0.513158</u>       | <u>0.481658</u>       |
| Annuity | <u>4.868419</u>       | <u>4.712196</u>       |

| Amount                                   | Discounting factor @ 10% | Present value      | Discounting factor @ 11% | Present value   |
|------------------------------------------|--------------------------|--------------------|--------------------------|-----------------|
| 15,00,000                                | 0.513158                 | 7,69,737           | 0.481658                 | 7,22,487        |
| 1,00,000                                 |                          | 1,00,000           |                          |                 |
| 50,000 for 7 years                       | 4.868419                 | <u>2,43,421</u>    | 4.712196                 | <u>2,35,610</u> |
|                                          |                          | 11,13,158          |                          | <u>9,58,097</u> |
| PV of original cash flows @ original EIR |                          | <u>(10,00,000)</u> |                          |                 |
| Difference                               |                          | <u>1,13,158</u>    |                          |                 |
| Difference %                             |                          | 11.32%             |                          |                 |

### Modification accounting

Ind AS 109 is not clear as to the accounting treatment if the 10% test is failed. Two alternate approaches are therefore possible:

#### Amortisation of any cost or fees incurred on modification

Under this approach,

- the fees or costs incurred are netted against the existing liability;

- the effective interest rate is recalculated. This is the rate which discounts the future cash flows as per modified contractual terms to the adjusted carrying amount mentioned above
- the adjusted effective interest rate is used to determine the amortised cost and interest expense in future periods

#### Example 4: Modification accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 1,000,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 1,000,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- no further interest payments are made
- the bonds are redeemed on the original due date (31 December 20X9) for ₹ 1,600,000;
- fees paid by the borrower to lender ₹ 50,000
- .

The repayment schedule for the original debt till the date of renegotiation is as below:

| Date / year ended | Opening balance | Interest accrual | Cash flows | Closing balance |
|-------------------|-----------------|------------------|------------|-----------------|
| 1 January 20X0    | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X1  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X2  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X3  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X4  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |
| 31 December 20X5  | 10,00,000       | 1,00,000         | (1,00,000) | 10,00,000       |

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

- cash flows under the new terms – i.e. ₹ 16,00,000 payable on 31 December 20X9
- any fees paid (net of any fees received) – i.e. ₹ 50,000

using the original effective interest rate of 10%.

The total of these amounts to ₹ 10,43,474 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 4.35% i.e. by less than 10%. Hence, modification accounting applies.

On this basis:

- the fees paid of ₹ 50,000 are netted against the existing liability of ₹ 10,00,000, resulting in an adjusted carrying amount of ₹ 9,50,000;

- ii. the effective interest rate (EIR) is recalculated. This is the rate which discounts the future cash flows (₹ 16,00,000 in five years' time) to the adjusted carrying amount of ₹ 9,50,000. The adjusted EIR is 10.99%
- iii. the adjusted EIR is used to determine the amortised cost and interest expense in future periods.

### Working Note:

#### For testing extinguishment -

|                                          |                    |
|------------------------------------------|--------------------|
| Cash flows under new terms               | 16,00,000          |
| PV as at 01 January 20X5                 |                    |
| Revised cash flows@ original EIR         | 9,93,474           |
| Fees incurred                            | <u>50,000</u>      |
| PV of revised cash flows @ original EIR  | 10,43,474          |
| PV of original cash flows @ original EIR | <u>(10,00,000)</u> |
| Difference                               | <u>43,474</u>      |
| Difference %                             | 4%                 |
| Less than 10% - Indicates modification   |                    |

#### Accounting for revised cash flows @ original EIR

| Year                                 | Opening balance | Interest  | Payment    | Closing balance |
|--------------------------------------|-----------------|-----------|------------|-----------------|
| 0                                    | 10,00,000       | -         | -50,000    | 9,50,000        |
| 1                                    | 9,50,000        | 1,04,405  | 0          | 10,54,405       |
| 2                                    | 10,54,405       | 1,15,879  | 0          | 11,70,284       |
| 3                                    | 11,70,284       | 1,28,614  | 0          | 12,98,898       |
| 4                                    | 12,98,898       | 1,42,749  | 0          | 14,41,647       |
| 5                                    | 14,41,647       | 1,58,353* | -16,00,000 | -               |
| * Difference is due to approximation |                 |           |            |                 |

#### Illustration 13: Renegotiation of terms of (defaulted) borrowings subsequent to the year-end

Ind AS 109, Financial Instruments requires recognition of renegotiation gain/loss subject to fulfillment of certain conditions as mentioned in the standard. If there has been a renegotiation of terms of (defaulted) borrowings subsequent to the year end, but before the date of approval of financial statements, then should such modification gain/loss be recognised in the current year

*financial statements itself or in the next year when the terms of (defaulted) borrowings have been renegotiated in accordance with Ind AS 109?*

### Solution

As per paragraph 5.4.3 of Ind AS 109, Financial Instruments, whenever contractual cash flows of a financial instrument are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss.

In accordance with the above, modification gain or loss should be recognised in profit or loss in the period in which the renegotiation has contractually taken place. Accordingly, in the given case, if the terms of the (defaulted) borrowings have been renegotiated in the next year, then the related gain/loss should also be recognised in the next year.

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### 5.4.3 Debt for equity swaps

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A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'.

Appendix D to Ind AS 109, "Extinguishing Financial Liabilities with Equity Instruments" deals with accounting for such situations.

It must be noted that these accounting principles do not apply in following situations:

- the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder
- the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity
- extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability

The accounting principles are summarised below:

- An entity shall **remove a financial liability** (or part of a financial liability) from its balance sheet when, and only **when, it is extinguished** in accordance with derecognition principles mentioned above

- When **equity instruments issued to a creditor** to extinguish all or part of a financial liability are recognised initially, an entity shall **measure them at the fair value** of the equity instruments issued, unless that fair value cannot be reliably measured.
- **If the fair value of the equity instruments issued cannot be reliably measured** then the equity instruments shall be measured to reflect the **fair value of the financial liability** extinguished.
- **If only part of the financial liability is extinguished**, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid **does relate to a modification of the terms** of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding.
- The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. **If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability.**
- The **difference** between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be **recognised in profit or loss**.

**Example 5: Extinguishment of part of a financial liability through issue of equity instruments**

JK Ltd. has an outstanding unsecured loan of ₹ 90 crores to a bank. The effective interest rate (EIR) of this loan is 10%. Owing to financial difficulties, JK Ltd. is unable to service the debt and approaches the bank for a settlement.

The bank offers the following terms which are accepted by JK Ltd.:

- 2/3<sup>rd</sup> of the debt is unsustainable and hence will be converted into 70% equity interest in JK Ltd. The fair value of net assets of JK Ltd. is ₹ 80 crores.
- 1/3<sup>rd</sup> of the debt is sustainable and the bank agrees to certain moratorium period and decrease in interest rate in initial periods. The present value of cash flows as per these revised terms calculated using original EIR is ₹ 25 crores. The fair value of the cash flows as per these revised terms is ₹ 28 crores.

Fair value of the consideration paid is ₹ 56 crores (70% of ₹ 80 crores) plus ₹ 28 crores i.e. ₹ 84 crores.



Accordingly, 2/3<sup>rd</sup> of the original financial liability is extinguished through issue of equity shares and terms of 1/3<sup>rd</sup> of the original financial liability have been modified. JK Ltd. will need to evaluate if this modification tantamount to “substantial modification” or not.

Applying the guidance contained in Appendix D to Ind AS 109:

- Difference between the fair value of equity instruments (₹ 56 crores) and 2/3<sup>rd</sup> of the original financial liability (2/3<sup>rd</sup> of ₹ 90 crores = ₹ 60 crores) i.e. ₹ 4 crores will be recognised as a gain in the statement of profit and loss
- Carrying amount of original financial liability which is not extinguished (1/3<sup>rd</sup> of ₹ 90 crores = ₹ 30 crores) is compared with the present value of cash flows as per these revised terms (₹ 25 crores)
- As the difference is more than 10%, this results in substantial modification of the original financial liability. Resultantly, the existing financial liability (₹ 30 crores) will be extinguished and the new financial liability will be recognised at its fair value i.e. ₹ 28 crores.
- The difference i.e. ₹ 2 crores will be recognised as a gain in the statement of profit and loss.

## UNIT 6: HEDGE ACCOUNTING

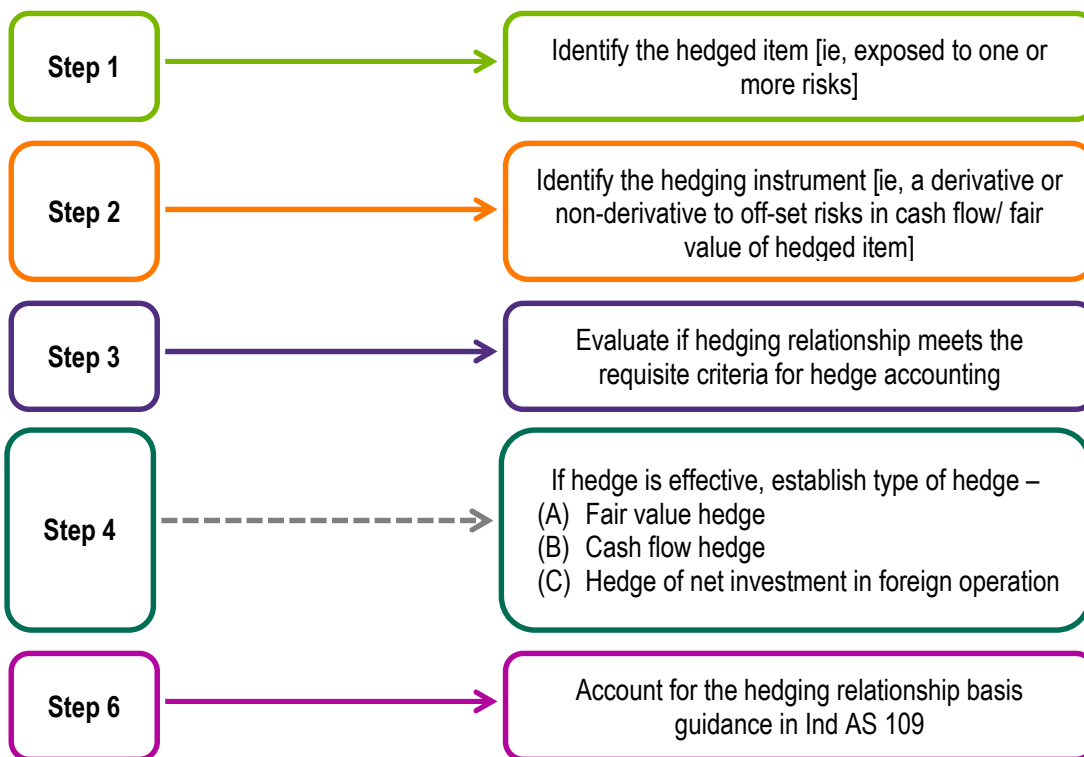


### 6.1 INTRODUCTION

The objective of hedge accounting is to **represent**, in the financial statements, **the effect of an entity's risk management activities that use financial instruments to manage exposures** arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item, i.e, hedge accounting is an option provided qualifying criteria are met. In such a case, accounting for gain / loss arising on the hedging relationship, ie, including hedging instrument and hedged item shall be accounted in a specific manner as detailed further in the unit in order to avoid measurement and recognition inconsistencies which may arise otherwise if the hedging instrument and hedged item were accounted separately.

A step wise analysis has been presented using the following diagrammatic presentation –



A hedge relationship can be evaluated for a single hedged item or group of items and the hedging instrument can also be a single instrument or multiple instruments hedging specific risk associated with the hedged item.



## 6.2 IDENTIFYING THE HEDGED ITEM AND DESIGNATION OF HEDGED ITEMS

- A hedged item can be a recognised **asset** or **liability**, an unrecognised **firm commitment**, a **forecast transaction** or a **net investment in a foreign operation**. The hedged item can be:

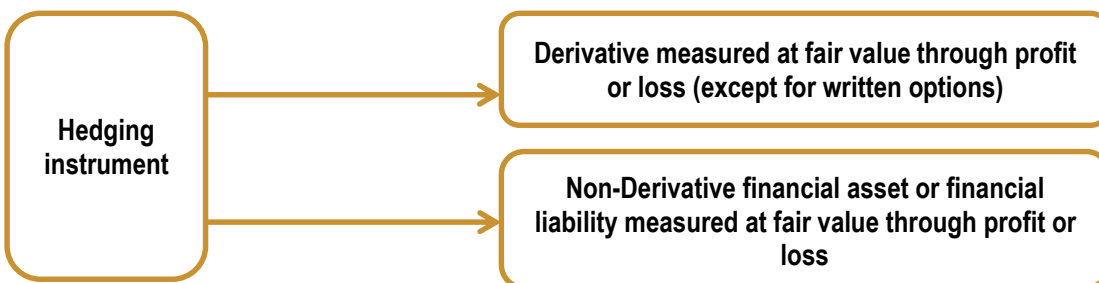
- (a) a single item; or
- (b) a group of items.

A hedged item can also be a component of such an item or group of items.

- The hedged item must be reliably measurable.
- If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.
- An entity may designate an item in its **entirety** or a **component of an item** as the hedged item in a hedging relationship.
  - ◆ An entire item comprises all changes in cash flows or fair value of an item.
  - ◆ A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:
    - (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable. Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).
    - (b) one or more selected contractual cash flows.
    - (c) components of a nominal amount, ie a specified part of the amount of an item



## 6.3 QUALIFYING INSTRUMENTS FOR HEDGE ACCOUNTING AND DESIGNATION OF HEDGING INSTRUMENTS

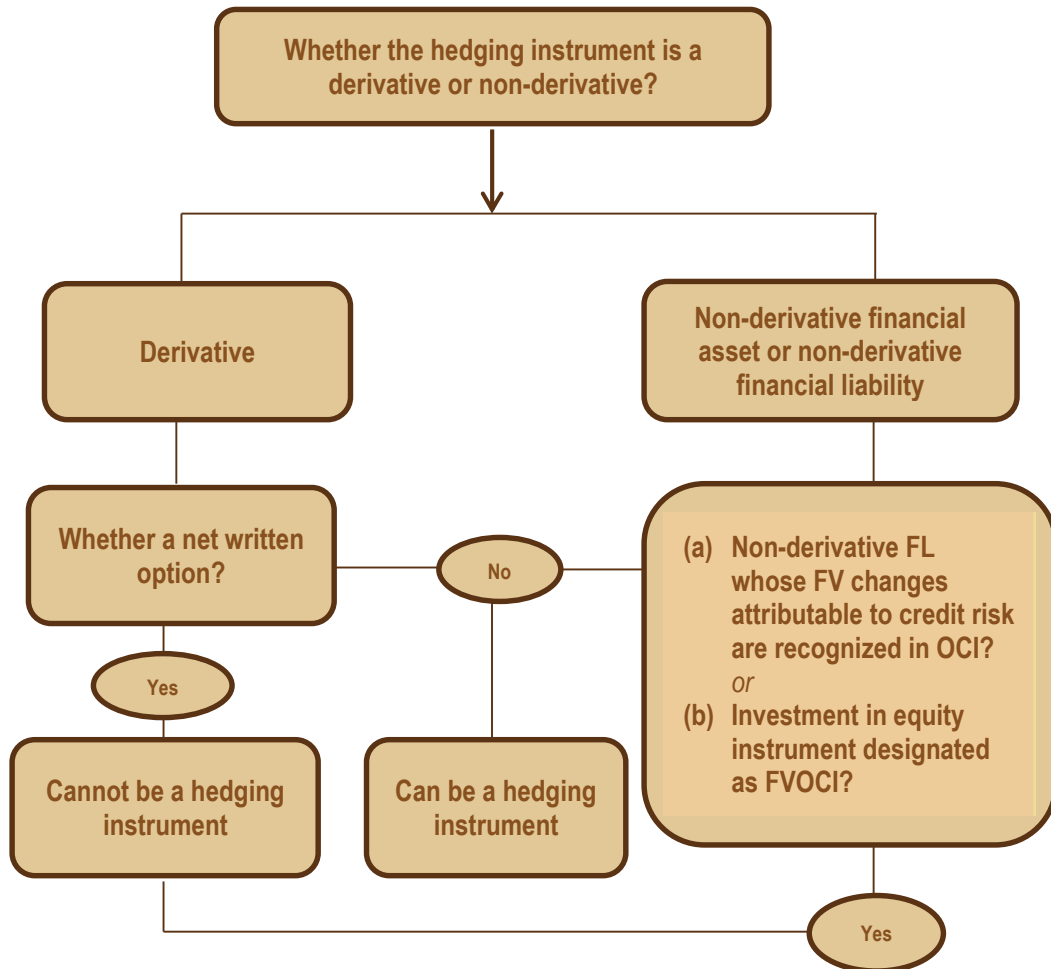


- **Exceptions to designating non-derivative financial asset or non-derivative financial liability as hedging instrument:**
  - ◆ A financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.
  - ◆ For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.
- For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments.
- **A qualifying instrument must be designated in its entirety as a hedging instrument.** The only **exceptions permitted** are:
  - (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value;
  - (b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; and
  - (c) a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair

value that results from only a portion of the time period during which the hedging instrument remains outstanding.

- **Written options are not hedging instruments:** A derivative instrument that combines a written option and a purchased option (for example, an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option at the date of designation.

The decision tree to determining if an instrument can be designated as a hedging instrument is as follows:



## 6.4 QUALIFYING CRITERIA FOR HEDGE ACCOUNTING

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

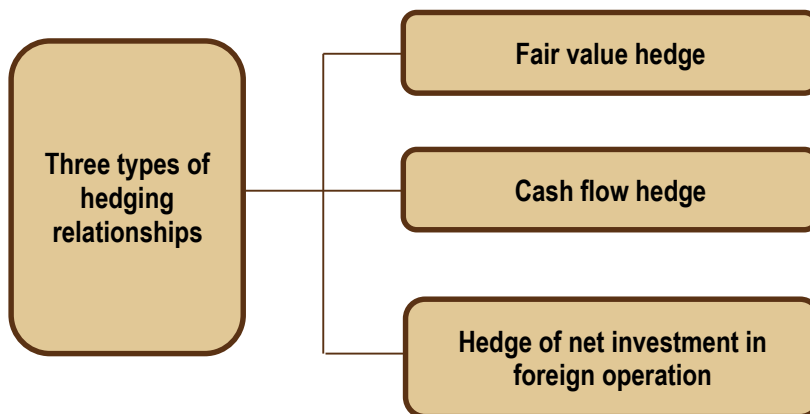
- Hedging relationship consists only of **eligible hedging instruments** and **eligible hedged items**.

- (b) At the inception of the hedging relationship, there is **formal designation and documentation of the hedging relationship** and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio)
- (c) Hedging relationship **meets all** of the following **hedge effectiveness requirements**:
- there is an **economic relationship** between the hedged item and the hedging instrument;
  - the effect of **credit risk does not dominate** the value changes that result from that economic relationship; and
  - the **hedge ratio** of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.



## 6.5 ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

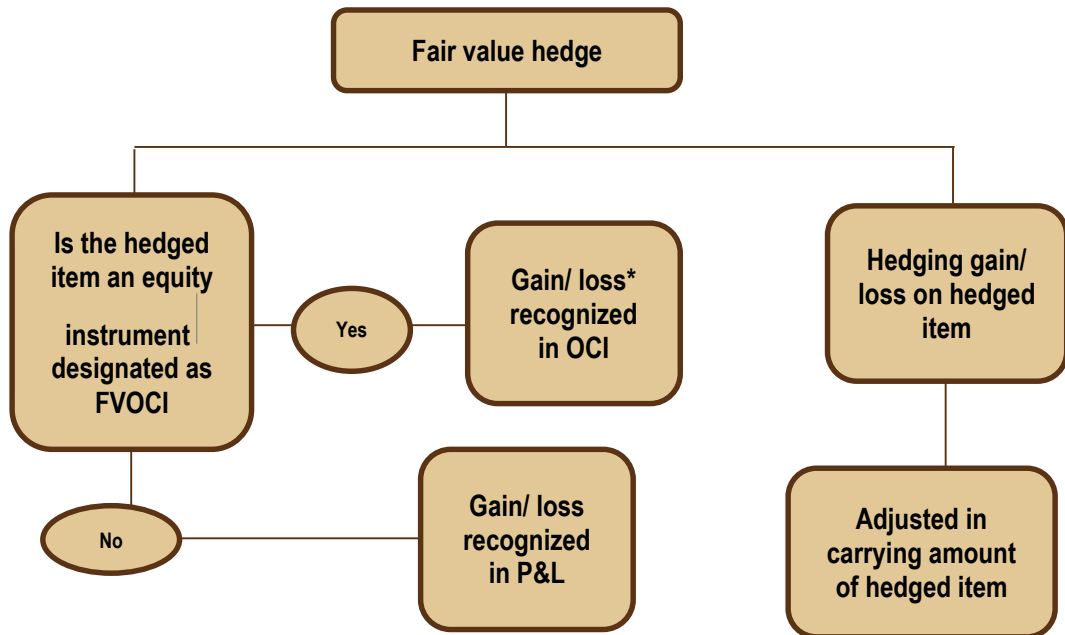
- An entity applies hedge accounting to hedging relationships that meet the qualifying criteria.
- Types of hedging relationships:**



- **Fair value hedge**

A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

Where a fair value hedge meets the qualifying criteria, fair value hedge shall be accounted as follows:



**\*Gain/ loss comprises both hedging instrument and hedged item**

- ◆ If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive income (FVOCI) other than equity instrument designated as FVOCI in accordance with Ind AS 109, the hedging gain or loss on the hedged item shall be recognised in profit or loss.
- ◆ When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

- **Cash flow hedge**

A cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable debt), or a highly probable forecast transaction, and could affect profit or loss.

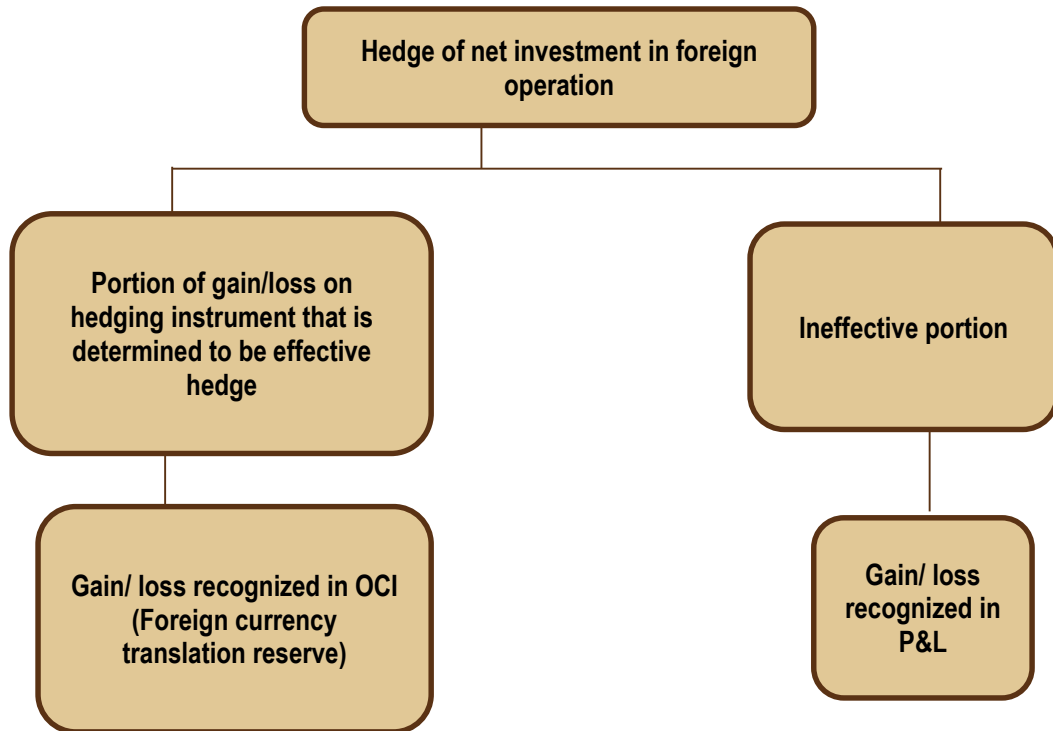
Where a cash flow hedge meets the qualifying criteria, it shall be accounted as follows:

- (a) the separate component of equity associated with the hedged item (**cash flow hedge reserve**) is adjusted to the lower of the following (in absolute amounts):
  - i. the cumulative gain or loss on the hedging instrument from inception of the hedge; and
  - ii. the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.
- (b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.
- (c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss
- (d) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:
  - i. If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment as defined in IAS 1 and hence it does not affect other comprehensive income.
  - ii. For cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).
  - iii. However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.



- **Hedge of net investment in foreign operation**

Hedge of a net investment in foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to cash flow hedges:



The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment on the disposal or partial disposal of the foreign operation.

## UNIT 7: DISCLOSURES



### 7.1 INTRODUCTION

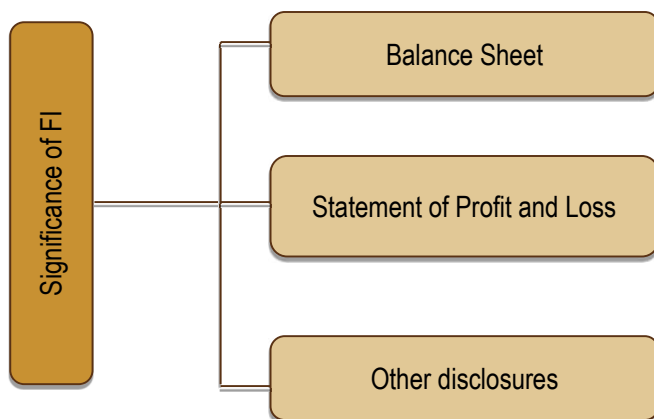
Ind AS 107 provides disclosures for financial instruments to be made in the financial statements that enable users to evaluate:

- (a) The significance of financial instruments for the entity's financial position and performance; and
- (b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period; and how the entity manages those risks.



### 7.2 SIGNIFICANCE OF FINANCIAL INSTRUMENTS

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.



### 7.3 BALANCE SHEET

- **Categories of financial assets and financial liabilities**

The carrying amounts of each of the following categories, as defined in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:

- (a) Financial assets measured at fair value through profit or loss, showing separately

- i. those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 (ie, financial asset whose credit risk exposure is managed through credit derivative that is measured at fair value through profit or loss and hence, such financial asset is also managed at fair value through profit or loss); and
  - ii. those mandatorily measured at fair value through profit or loss in accordance with Ind AS 109.
- (b) financial liabilities at fair value through profit or loss, showing separately –
  - i. those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 (ie, financial liability whose credit risk exposure is managed through credit derivative that is measured at fair value through profit or loss and hence, such financial liability is also managed at fair value through profit or loss; and
  - ii. those that meet the definition of held for trading in Ind AS 109.
- (c) financial assets measured at amortised cost.
- (d) financial liabilities measured at amortised cost.
- (e) financial assets measured at fair value through other comprehensive income, showing separately –
  - i. financial assets that are measured at fair value through other comprehensive income in accordance with Ind AS 109;
  - ii. investments in equity instruments designated as such upon initial recognition in accordance with Ind AS 109.
- **Financial assets or financial liabilities at fair value through profit or loss**
  - ◆ If the entity has designated as measured at fair value through profit or loss a financial asset (or group of financial assets) that would otherwise be measured at fair value through other comprehensive income or amortised cost, it shall disclose:
    - (a) the maximum exposure to credit risk of the financial asset (or group of financial assets) at the end of the reporting period.
    - (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
    - (c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:

- i. as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
- ii. using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

- (d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.
- ◆ If the entity has designated a financial liability as at fair value through profit or loss in accordance with Ind AS 109 and is required to present the effects of changes in that liability's credit risk in other comprehensive income, it shall disclose:
- (a) the amount of change, cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability
  - (b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
  - (c) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.
  - (d) if a liability is derecognised during the period, the amount (if any) presented in other comprehensive income that was realised at derecognition.
- ◆ If an entity has designated a financial liability as at fair value through profit or loss in accordance with Ind AS 109 and is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss, it shall disclose:
- (a) Amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability;  
and
  - (b) Difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

- **Investments in equity instruments designated at fair value through other comprehensive income**
  - ◆ If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income in accordance with Ind AS 109, it shall disclose:
    - (a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.
    - (b) the reasons for using this presentation alternative.
    - (c) the fair value of each such investment at the end of the reporting period.
    - (d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.
    - (e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.
  - ◆ If an entity derecognised investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:
    - (a) the reasons for disposing of the investments
    - (b) the fair value of the investments at the date of derecognition
    - (c) the cumulative gain or loss on disposal.
- **Reclassifications**
  - ◆ An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with Ind AS 109. For each such event, an entity shall disclose –
    - (a) the date of reclassification.
    - (b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.
    - (c) the amount reclassified into and out of each category.
  - ◆ For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income in accordance with Ind AS 109:
    - (a) the effective interest rate determined on the date of reclassification; and
    - (b) the interest revenue recognised.

- ◆ If, since its last annual reporting date, an entity has reclassified financial assets out of the fair value through other comprehensive income category so that they are measured at amortised cost; or out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income it shall disclose:
  - (a) the fair value of the financial assets at the end of the reporting period; and
  - (b) the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income during the reporting period if the financial assets had not been reclassified.
- **Off-setting financial assets and financial liabilities**
  - ◆ An entity shall disclose, at the end of the reporting period, the following quantitative information separately for recognised financial assets and recognised financial liabilities that have been off-set in accordance with Ind AS 32:
    - (a) the gross amounts of those recognised financial assets and recognised financial liabilities;
    - (b) the amounts that are set off in accordance with the criteria in Ind AS 32 when determining the net amounts presented in the balance sheet;
    - (c) the net amounts presented in the balance sheet;
    - (d) the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in the information disclosed for amounts set off in paragraph (b) above, including:
      - i. amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of Ind AS 32; and
      - ii. amounts related to financial collateral (including cash collateral); and
    - (e) the net amount after deducting the amounts in (d) from the amounts in (c) above.
- **Collateral**
  - ◆ An entity shall disclose:
    - (a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with Ind AS 109; and
    - (b) the terms and conditions relating to its pledge.
  - ◆ When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:

- (a) the fair value of the collateral held;
- (b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and
- (c) the terms and conditions associated with its use of the collateral.

- **Allowance for credit losses**

The carrying amount of financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109 is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the balance sheet as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

- **Compound financial instruments with multiple embedded derivatives**

If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

- **Defaults and breaches**

- ◆ For loans payable recognised at the end of the reporting period, an entity shall disclose:
  - (a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
  - (b) the carrying amount of the loans payable in default at the end of the reporting period; and
  - (c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.
- ◆ If, during the period, there were breaches of loan agreement terms other than those that are existing at the year end and covered by year-end disclosure above, an entity shall disclose the same information as required by paragraph above, if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the end of the reporting period).



## 7.4 STATEMENT OF PROFIT AND LOSS

An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

- (a) net gains or net losses on:
- i. financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (eg financial liabilities that meet the definition of held for trading in Ind AS 109).  
  
For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.
  - ii. financial liabilities measured at amortised cost
  - iii. financial assets measured at amortised cost
  - iv. investments in equity instruments designated at fair value through other comprehensive income in accordance with Ind AS 109
  - v. financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period.
- (b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss
- (c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:
- i. financial assets and financial liabilities that are not at fair value through profit or loss; and
  - ii. trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.



## 7.5 OTHER DISCLOSURES

- **Accounting policies**

An entity discloses its significant accounting policies comprising the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.



- **Hedge accounting**

An entity shall apply these disclosure requirements for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:

- (a) an entity's risk management strategy and how it is applied to manage risk;
- (b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- (c) the effect that hedge accounting has had on the entity's balance sheet, statement of comprehensive income and statement of changes in equity.

- **Fair value**

- ◆ For each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount. In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the balance sheet.
- ◆ In some cases, an entity does not recognise a gain or loss on initial recognition of a financial asset or financial liability because the fair value is neither evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) nor based on a valuation technique that uses only data from observable markets. In such cases, the entity shall disclose by class of financial asset or financial liability:
  - (a) its accounting policy for recognising in profit or loss the difference between the fair value at initial recognition and the transaction price to reflect a change in factors (including time) that market participants would take into account when pricing the asset or liability
  - (b) aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.
  - (c) why the entity concluded that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value.
- ◆ Disclosures of fair value are not required:
  - (a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;
  - (b) for a contract containing a discretionary participation feature (as described in Ind AS 104) if the fair value of that feature cannot be measured reliably; or
  - (c) for lease liabilities.

- ◆ In case of contracts with discretionary participation feature, where fair value cannot be determined reliably, an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts and their fair value, including:
  - (a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
  - (b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
  - (c) information about the market for the instruments;
  - (d) information about whether and how the entity intends to dispose of the financial instruments; and
  - (e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.
- **Nature and extent of risks arising from financial instruments**
  - ◆ An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.
  - ◆ The disclosures described below focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, **credit risk, liquidity risk and market risk**.
  - ◆ **Qualitative disclosures**

For each type of risk arising from financial instruments, an entity shall disclose:

    - (a) the exposures to risk and how they arise;
    - (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
    - (c) any changes in (a) or (b) from the previous period.
  - ◆ **Quantitative disclosures –**

For each type of risk arising from financial instruments, including – credit risk, liquidity risk and market risk, an entity shall disclose:

    - (a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided

internally to key management personnel of the entity, for example the entity's board of directors or chief executive officer

- (b) certain detailed disclosures required for each type of risk mentioned above, to the extent not provided in accordance with (a).
- (c) concentration of risk if not apparent from the disclosures made in accordance with (a) and (b).

If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

◆ **Credit risk:**

An entity shall apply the disclosure requirements in paragraphs 35F–35N of Ind AS 107 (as described below) to financial instruments to which the impairment requirements in Ind AS 109 are applied. However:

- (a) For trade receivables, contract assets and lease receivables, **paragraph 35J(a)** applies to those trade receivables, contract assets or lease receivables on which lifetime expected credit losses are recognised in accordance with Ind AS 109, if those financial assets are modified while more than 30 days past due; and
  - (b) paragraph 35K(b) does not apply to lease receivables.
- ◆ The credit risk disclosures described below shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, credit risk disclosures shall provide:
- (a) information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses
  - (b) quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes; and
  - (c) information about an entity's credit risk exposure (ie the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

◆ **The credit risk management practices**

An entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective an

entity shall disclose information that enables users of financial statements to understand and evaluate:

- (a) how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:
    - ii. financial instruments are considered to have low credit risk in accordance with Ind AS 109, including the classes of financial instruments to which it applies; and
    - iii. the presumption of Ind AS 109, that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted;
  - (b) an entity's definitions of default, including the reasons for selecting those definitions;
  - (c) how the instruments were grouped if expected credit losses were measured on a collective basis;
  - (d) how an entity determined that financial assets are credit-impaired financial assets;
  - (e) an entity's write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity; and
  - (f) how the requirements in Ind AS 109 for the modification of contractual cash flows of financial assets have been applied, including how an entity:
    - i. determines whether the credit risk on a financial asset that has been modified while the loss allowance was measured at an amount equal to lifetime expected credit losses, has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month expected credit losses in accordance with Ind AS 109; and
    - ii. monitors the extent to which the loss allowance on financial assets meeting the criteria in (i) is subsequently remeasured at an amount equal to lifetime expected credit losses in accordance with Ind AS 109.
- ◆ An entity shall explain the inputs, assumptions and estimation techniques used to apply the impairment requirements in Ind AS 109. For this purpose, an entity shall disclose:
- (a) the basis of inputs and assumptions and the estimation techniques used to:
    - i. measure the 12-month and lifetime expected credit losses;

- ii. determine whether the credit risk of financial instruments has increased significantly since initial recognition; and
    - iii. determine whether a financial asset is a credit-impaired financial asset.
  - (b) how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and
  - (c) changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.
- ◆ Quantitative and qualitative information about amounts arising from expected credit losses

To explain the changes in the loss allowance and the reasons for those changes, an entity shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for:

- (a) the loss allowance measured at an amount equal to 12-month expected credit losses;
- (b) the loss allowance measured at an amount equal to lifetime expected credit losses for:
  - i. financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;
  - ii. financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and
  - iii. trade receivables, contract assets or lease receivables for which the loss allowances are measured in accordance with Ind AS 109
- (c) financial assets that are purchased or originated credit-impaired. In addition to the reconciliation, an entity shall disclose the total amount of undiscounted expected credit losses at initial recognition on financial assets initially recognised during the reporting period.

◆ **Credit risk exposure**

To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity shall disclose, by credit risk rating grades, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information shall be provided separately for financial instruments:

- (a) for which the loss allowance is measured at an amount equal to 12-month expected credit losses;

- (b) for which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:
  - i. financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;
  - ii. financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and
  - iii. trade receivables, contract assets or lease receivables for which the loss allowances are measured at life-time expected credit losses as an option provided in Ind AS 109.
- ◆ For all financial instruments to which the impairment requirements in Ind AS 109 are not applied, an entity shall disclose by class of financial instrument:
  - (a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with Ind AS 32); this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk.
  - (b) a description of collateral held as security and other credit enhancements, and their financial effect (eg quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk (whether disclosed in accordance with (a) or represented by the carrying amount of a financial instrument).
- **Liquidity risk**

An entity shall disclose:

  - (a) a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.
  - (b) a maturity analysis for derivative financial liabilities.

The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows.
  - (c) a description of how it manages the liquidity risk inherent in (a) and (b).

- **Market risk**

- ◆ An entity shall disclose:
  - (a) a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
  - (b) the methods and assumptions used in preparing the sensitivity analysis; and
  - (c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.
- ◆ If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity shall also disclose:
  - (a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
  - (b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

**Note:** Students are advised to read the application guidance to Ind AS 107 for better understanding of the disclosure requirements related to financial instruments.

## COMPREHENSIVE ILLUSTRATIONS

### Illustration 1

*A Ltd. issued redeemable preference shares to a Holding Company – Z Ltd. The terms of the instrument have been summarized below. Account for this in the books of Z Ltd.*

| <b>Nature</b>                             | <b>Non-cumulative redeemable preference shares</b> |
|-------------------------------------------|----------------------------------------------------|
| <i>Repayment:</i>                         | <i>Redeemable after 5 years</i>                    |
| <i>Date of Allotment:</i>                 | <i>1-Apr-20X1</i>                                  |
| <i>Date of repayment:</i>                 | <i>31-Mar-20X6</i>                                 |
| <i>Total period:</i>                      | <i>5.00 years</i>                                  |
| <i>Value of preference shares issued:</i> | <i>100,000,000</i>                                 |
| <i>Dividend rate</i>                      | <i>0.0001%</i>                                     |
| <i>Market rate of interest</i>            | <i>12% per annum</i>                               |
| <i>Present value factor</i>               | <i>0.56743</i>                                     |

### Solution

Applying the guidance in Ind AS 109, a 'financial asset' shall be recorded at its fair value upon initial recognition. Fair value is normally the transaction price. However, sometimes certain type of instruments may be exchanged at off market terms (ie, different from market terms for a similar instrument if exchanged between market participants).

For example, a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. In such cases where part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

In the above case, since A Ltd has issued preference shares to its Holding Company – Z Ltd, the relationship between the parties indicates that the difference in transaction price and fair value is akin to investment made by Z Ltd. in its subsidiary.

Following is the table summarising the computations on initial recognition:

|                          |            |
|--------------------------|------------|
| Market rate of interest  | 12%        |
| Present value factor     | 0.56743    |
| Present value            | 56,742,686 |
| Loan component           | 56,742,686 |
| Investment in subsidiary | 43,257,314 |



Subsequently, such preference shares shall be carried at amortised cost at each reporting date. The computation of amortised cost at each reporting date has been done as follows:

| Year | Date        | Opening Asset | Days | Interest @ 12% | Closing balance |
|------|-------------|---------------|------|----------------|-----------------|
|      | 1-Apr-20X1  |               |      |                | 56,742,686      |
| 1    | 31-Mar-20X2 | 56,742,686    | 365  | 6,809,122      | 63,551,808      |
| 2    | 31-Mar-20X3 | 63,551,808    | 365  | 76,26,217      | 71,178,025      |
| 3    | 31-Mar-20X4 | 71,178,025    | 365  | 85,41,363      | 79,719,388      |
| 4    | 31-Mar-20X5 | 79,719,388    | 365  | 95,66,327      | 89,285,715      |
| 5    | 31-Mar-20X6 | 89,285,715    | 365  | 10,714,285     | 100,000,000     |

**Journal Entries to be done at every reporting date**

| Particulars                             |     | Amount     | Amount      |
|-----------------------------------------|-----|------------|-------------|
| <b>Date of transaction</b>              |     |            |             |
| Investment - Equity portion             | Dr. | 43,257,314 |             |
| Loan receivable                         | Dr. | 56,742,686 |             |
| To Bank                                 |     |            | 100,000,000 |
| <b>Interest income - March 31, 20X2</b> |     |            |             |
| Loan receivable                         | Dr. | 6,809,122  |             |
| To Interest income                      |     |            | 6,809,122   |
| <b>Interest income - March 31, 20X3</b> |     |            |             |
| Loan receivable                         | Dr. | 76,26,217  |             |
| To Interest income                      |     |            | 76,26,217   |
| <b>Interest income - March 31, 20X4</b> |     |            |             |
| Loan receivable                         | Dr. | 85,41,363  |             |
| To Interest income                      |     |            | 85,41,363   |
| <b>Interest income - March 31, 20X5</b> |     |            |             |
| Loan receivable                         | Dr. | 95,66,327  |             |
| To Interest income                      |     |            | 95,66,327   |
| <b>Interest income - March 31, 20X6</b> |     |            |             |
| Loan receivable                         | Dr. | 10,714,285 |             |
| To Interest income                      |     |            | 10,714,285  |

| Settlement of transaction |     |             |             |
|---------------------------|-----|-------------|-------------|
| Bank                      | Dr. | 100,000,000 |             |
| To Loan receivable        |     |             | 100,000,000 |

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**Illustration 2**

A Limited issues ₹ 1 crore optionally convertible bonds on 1 April 20X1. The bonds have a life of eight years and a face value of ₹ 10 each, and they offer interest, payable at the end of each financial year, at a rate of 6 per cent annum. The bonds are issued at their face value and each bond can be converted into one ordinary share in A Limited at any time in the next eight years. Companies of a similar risk profile have recently issued debt with similar terms, without the option for conversion, at a rate of 8 per cent per annum.

**Required:**

- Provide the appropriate accounting entries for initial recognition.
- Calculate the stream of interest expenses across the eight years of the life of the bonds.
- Provide the accounting entries if the holders of the bonds elect to convert the bonds to ordinary shares at the end of the third year (after receiving interest for the third year).

**Solution**

- Applying the guidance for compound instruments, the present value of the bond is computed to identify the liability component and then difference between the present value of these bonds & the issue price of ₹ 1 crore shall be allocated to the equity component. In determining the present value, the rate of 8 per cent will be used, which is the interest rate paid on debt of a similar nature and risk that does not provide an option to convert the liability to ordinary shares.

Present value of bonds at the market rate of debt

Present value of principal to be received in eight years discounted at 8%

$$(10,000,000 \times 0.5403) = 5,403,000$$

Present value of interest stream discounted at 8% for 8 years

$$(6,00,000 \times 5.7466) = 3,447,960$$

$$\text{Total present value} = 8,850,960$$

$$\text{Equity component} = 1,149,040$$

$$\text{Total face value of convertible bonds} = 10,000,000$$

The accounting entries will be as follows:

|                                                                                                                                                              | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| <b>1 April, 20X1</b>                                                                                                                                         |                   |                   |
| Bank Dr.                                                                                                                                                     | 10,000,000        |                   |
| To Convertible bonds (liability)                                                                                                                             |                   | 8,850,960         |
| To Convertible bonds (equity component)                                                                                                                      |                   | 1,149,040         |
| (Being entry to record the convertible bonds and the recognition of the liability and equity components)                                                     |                   |                   |
| <b>31<sup>st</sup> March, 20X2</b>                                                                                                                           |                   |                   |
| Interest expense Dr.                                                                                                                                         | 708,077           |                   |
| To Bank                                                                                                                                                      |                   | 600,000           |
| To Convertible bonds (liability)                                                                                                                             |                   | 108,077           |
| (Being entry to record the interest expense, where the expense equals the present value of the opening liability multiplied by the market rate of interest). |                   |                   |

- (b) The stream of interest expense is summarised below, where interest for a given year is calculated by multiplying the present value of the liability at the beginning of the period by the market rate of interest, this is being 8 per cent.

| Date          | Payment | Interest expense at 8% | Increase in bond liability | Total bond liability |
|---------------|---------|------------------------|----------------------------|----------------------|
| 1 April, 20X1 |         |                        |                            | 8,850,960            |
| 31 March 20X2 | 600,000 | 708,077                | 108,077                    | 8,959,037            |
| 31 March 20X3 | 600,000 | 716,723                | 116,723                    | 9,075,760            |
| 31 March 20X4 | 600,000 | 726,061                | 126,061                    | 9,201,821            |
| 31 March 20X5 | 600,000 | 736,146                | 136,146                    | 9,337,967            |
| 31 March 20X6 | 600,000 | 747,037                | 147,037                    | 9,485,004            |
| 31 March 20X7 | 600,000 | 758,800                | 158,800                    | 9,643,804            |
| 31 March 20X8 | 600,000 | 771,504                | 171,504                    | 9,815,308            |
| 31 March 20X9 | 600,000 | 784,692*               | 184,692                    | 10,000,000           |

\*difference is due to rounding off

- (c) If the holders of the bonds elect to convert the bonds to ordinary shares at the end of the third year (after receiving their interest payments), the entries in the third year would be:

|                                                                                                                                                                                                                                                     | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| <b>31 March 20X4</b>                                                                                                                                                                                                                                |                   |                   |
| Interest expense Dr.                                                                                                                                                                                                                                | 726,061           |                   |
| To Bank                                                                                                                                                                                                                                             |                   | 600,000           |
| To Convertible bonds (liability)                                                                                                                                                                                                                    |                   | 126,061           |
| (Being entry to record interest expense for the period)                                                                                                                                                                                             |                   |                   |
| <b>31 March 20X4</b>                                                                                                                                                                                                                                |                   |                   |
| Convertible bonds (liability) Dr.                                                                                                                                                                                                                   | 9,201,821         |                   |
| Convertible bonds (equity component) Dr.                                                                                                                                                                                                            | 1,149,040         |                   |
| To Ordinary share capital A/c                                                                                                                                                                                                                       |                   | 10,000,000        |
| To Securities Premium A/c                                                                                                                                                                                                                           |                   | 350,861           |
| (Being entry to record the conversion of bonds into shares of A Limited recognised in equity share capital account at face value of the shares and there being no premium on equity shares, the balance has been transferred to retained earnings.) |                   |                   |

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### Illustration 3

On 1st January 20X1, SamCo. Ltd. agreed to purchase USD (\$) 20,000 from JT Bank in future on 31st December 20X1 for a rate equal to ₹ 68 per USD. SamCo. Ltd. did not pay any amount upon entering into the contract. SamCo Ltd. is a listed company in India and prepares its financial statements on a quarterly basis.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for each quarter ended till the date of actual purchase of USD.

For the purposes of accounting, please use the following information representing marked to market fair value of forward contracts at each reporting date:

As at 31st March 20X1 – ₹ (25,000)

As at 30th June 20X1 - ₹ (15,000)

As at 30th September 20X1 - ₹ 12,000

Spot rate of USD on 31st December 20X1 - ₹ 66 per USD

**Solution****(i) Assessment of the arrangement using the definition of derivative included under Ind AS 109**

Derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

- a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
- b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c) it is settled at a future date.

**Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:**

- a) the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.
- b) the initial amount paid to enter into the contract is zero. A contract which would give the holder a similar response to foreign exchange rate changes would have required an investment of USD 20,000 on inception.
- c) the contract is settled in future

The derivative is a forward exchange contract.

As per Ind AS 109, derivatives are measured at fair value upon initial recognition and are subsequently measured at fair value through profit and loss.

**(ii) Accounting on 1st January 20X1:**

As there was no consideration paid and without evidence to the contrary the fair value of the contract on the date of inception is considered to be zero. Accordingly, no accounting entries shall be recorded on the date of entering into the contract.

**(iii) Accounting on 31st March 20X1:**

| Particulars                                                                                                              | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|--------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Profit and loss A/c Dr.<br>To derivative financial liability<br>(Being mark to market loss on forward contract recorded) | 25,000            | 25,000            |

**(iv) Accounting on 30th June 20X1:**

The change in value of the derivative forward contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

| Particulars                                                                                                                                      | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|--------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Derivative financial liability A/c Dr.<br>To Profit and loss A/c<br>(being partial reversal of mark to market loss on forward contract recorded) | 10,000            | 10,000            |

**(v) Accounting on 30th September 20X1:**

The value of the derivative forward contract shall be recorded as a derivative financial asset in the books of SamCo Ltd. by recording the following journal entry:

| Particulars                                                                                                                                                                                                                                      | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Derivative financial liability A/c Dr.<br>Derivative financial asset A/c Dr.<br>To Profit and loss A/c<br>(being gain on mark to market of forward contract booked as derivative financial asset and reversal of derivative financial liability) | 15,000<br>12,000  | 27,000            |

**(vi) Accounting on 31st December 20X1:**

The settlement of the derivative forward contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. by recording the following journal entry:

| Particulars                                                                                                                                                                                                      | Dr. Amount<br>(₹)   | Cr. Amount<br>(₹)   |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|---------------------|
| Bank (USD Account) @ 20,000 x 66 Dr.<br>Profit and loss A/c Dr.<br>To Bank @ 20,000 x 68<br>To Derivative financial asset A/c<br>(being loss on settlement of forward contract booked on actual purchase of USD) | 13,20,000<br>52,000 | 13,60,000<br>12,000 |

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**Illustration 4**

Entity A (an ₹ functional currency entity) enters into a USD 1,000,000 sale contract on 1 January 20X1 with Entity B (an ₹ functional currency entity) to sell equipment on 30 June 20X1.

|                                                   |    |
|---------------------------------------------------|----|
| Spot rate on 1 January 20X1: ₹/ USD               | 45 |
| Spot rate on 31 March 20X1: ₹/ USD                | 57 |
| Three-month forward rate on 31 March 20X1: ₹/ USD | 45 |
| Six-month forward rate on 1 January 20X1: ₹/ USD  | 55 |
| Spot rate on 30 June 20X1: ₹/ USD                 | 60 |

Assume that this contract has an embedded derivative that is not closely related and requires separation. Please provide detailed journal entries in the books of Entity A for accounting of such embedded derivative until sale is actually made.

**Solution**

The contract should be separated using the 6 month USD / ₹ forward exchange rate, as at the date of the contract (₹/USD = 55). The two components of the contract are therefore:

- A sale contract for ₹ 55 Million
- A six-month currency forward to purchase USD 1 Million at 55
- This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery

1. Entity A records the sales at the amount of the host contract = ₹ 55 Million
2. The embedded derivative is considered to expire.
3. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial asset on delivery.
4. In this case the carrying value of the currency forward at 30 June 20X1 on maturity is = ₹ (1,000,000 x 60 – 55 x 1,000,000) = ₹ 5,000,000 (profit/asset)

The table summarising the computation of gain/ loss to be recorded at every period end -

| Date        | Transaction                                                          | Sales     | Debtors | Derivative Asset (Liability) | (Profit) Loss |
|-------------|----------------------------------------------------------------------|-----------|---------|------------------------------|---------------|
|             |                                                                      | ₹         | ₹       | ₹                            | ₹             |
| 1-Jan-20X1  | Embedded Derivative                                                  | Nil Value |         |                              |               |
| 31-Mar-20X1 | Change in Fair Value of Embedded Derivatives MTM (55-45) x 1 Million |           |         | (10,000,000)                 | 10,000,000    |

|             |                                                                  |              |            |             |              |
|-------------|------------------------------------------------------------------|--------------|------------|-------------|--------------|
| 30-Jun-20X1 | Change in Fair Value of Embedded Derivatives (60-45) x 1 Million |              |            | 15,000,000  | (15,000,000) |
| 30-Jun-20X1 | Recording sales at forward rate                                  | (55,000,000) | 55,000,000 |             |              |
| 30-Jun-20X1 | Embedded derivative-settled against debtors                      |              | 5,000,000  | (5,000,000) |              |

**Journal Entries to be recorded at every period end**

a. 01 January 20X1 – No entry to be made

b. 31 March 20X1 –

| Particulars                                                                                                                      | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|----------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Profit and loss A/c Dr.<br>To Derivative financial liability A/c<br>(being loss on mark to market of embedded derivative booked) | 10,000,000        | 10,000,000        |

c. 30 June 20X1 –

| Particulars                                                                                                       | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Derivative financial asset A/c Dr.                                                                                | 5,000,000         |                   |
| Derivative financial liability A/c Dr.                                                                            | 10,000,000        |                   |
| To Profit and loss A/c<br>(being gain on embedded derivative based on spot rate at the date of settlement booked) |                   | 15,000,000        |

d. 30 June 20X1 –

| Particulars                                                                    | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|--------------------------------------------------------------------------------|-------------------|-------------------|
| Trade receivable A/c Dr.                                                       | 55,000,000        |                   |
| To Sales A/c<br>(being sale booked at forward rate on the date of transaction) |                   | 55,000,000        |



## e. 30 June 20X1 –

| Particulars                                                                                                                                                                         | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Trade receivable A/c Dr<br>To Derivative financial asset A/c<br>(being derivative asset re-classified as a part of trade receivables, bringing it to spot rate on the date of sale) | 5,000,000         | 5,000,000         |

\*\*\*\*\*

**Illustration 5**

On 1st January 20X1, SamCo. Ltd. entered into a written put option for USD (\$) 20,000 with JT Corp to be settled in future on 31<sup>st</sup> December 20X1 for a rate equal to ₹ 68 per USD at the option of JT Corp. SamCo. Ltd. did not receive any amount upon entering into the contract. SamCo Ltd. is a listed company in India and prepares its financial statements on a quarterly basis.

Following the classification principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for each quarter ended till the date of actual purchase of USD.

For the purposes of accounting, please use the following information representing marked to market fair value of put option contracts at each reporting date:

As at 31st March 20X1 – ₹ (25,000)

As at 30th June 20X1 - ₹ (15,000)

As at 30th September 20X1 - ₹ NIL

Spot rate of USD on 31st December 20X1 - ₹ 66 per USD

**Solution**i. Assessment of the arrangement using the definition of derivative included under Ind AS 109

Derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- it is settled at a future date.

Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:

- a) the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.
- d) the initial amount received to enter into the contract is zero. A contract which would give the holder a similar response to foreign exchange rate changes would have required an investment of USD 20,000 on inception.
- e) the contract is settled in future

The derivative liability is a written put option contract.

As per Ind AS 109, derivatives are measured at fair value upon initial recognition and are subsequently measured at fair value through profit and loss.

ii. **Accounting on 1st January 20X1**

As there was no consideration paid and without evidence to the contrary the fair value of the contract on the date of inception is considered to be zero. Accordingly, no accounting entries shall be recorded on the date of entering into the contract.

iii. **Accounting on 31<sup>st</sup> March 20X1**

The value of the derivative put option contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

| Particulars                                                                                                                     | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|---------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Profit and loss A/c Dr.<br>To derivative financial liability<br>(Being mark to market loss on the put option contract recorded) | 25,000            | 25,000            |

iv. **Accounting on 30<sup>th</sup> June 20X1**

The change in value of the derivative put option contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

| Particulars                                                                                                                                             | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Derivative financial liability A/c Dr.<br>To Profit and loss A/c<br>(Being partial reversal of mark to market loss on the put option contract recorded) | 10,000            | 10,000            |

**v. Accounting on 30<sup>th</sup> September 20X1**

The change in value of the derivative option contract shall be recorded as a zero in the books of SamCo Ltd. by recording the following journal entry:

| Particulars                                                                                                                                                                         | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Derivative financial liability A/c Dr.<br>To Profit and loss A/c<br>(Being gain on mark to market of put option contract booked to make the value the derivative liability as zero) | 15,000            | 15,000            |

**vi. Accounting on 31<sup>st</sup> December 20X1**

The settlement of the derivative put option contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. upon exercise by JT Corp. by recording the following journal entry:

| Particulars                                                                                                                                                                    | Dr. Amount<br>(₹)   | Cr. Amount<br>(₹) |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|-------------------|
| Bank (USD Account) @ 20,000 x 66 Dr.<br>Profit and loss A/c Dr.<br>To Bank @ 20,000 x 68<br>(being loss on settlement of put option contract booked on actual purchase of USD) | 13,20,000<br>40,000 | 13,60,000         |

\*\*\*\*\*

**Illustration 6**

ABC Company issued 10,000 compulsory cumulative convertible preference shares (CCCPS) as on 1 April 20X1 @ ₹ 150 each. The rate of dividend is 10% payable every year. The preference shares are convertible into 5,000 equity shares of the company at the end of 5<sup>th</sup> year from the date of allotment. When the CCCPS are issued, the prevailing market interest rate for similar debt without conversion options is 15% per annum. Transaction cost on the date of issuance is 2% of the value of the proceeds.

**Key terms:**

|                                 |             |
|---------------------------------|-------------|
| Date of Allotment               | 01-Apr-20X1 |
| Date of Conversion              | 01-Apr-20X6 |
| Number of Preference Shares     | 10,000      |
| Face Value of Preference Shares | 150         |
| Total Proceeds                  | 15,00,000   |

|                                             |        |
|---------------------------------------------|--------|
| Rate of dividend                            | 10%    |
| Market Rate for Similar Instrument          | 15%    |
| Transaction Cost                            | 30,000 |
| Face value of equity share after conversion | 10     |
| Number of equity shares to be issued        | 5,000  |
| Effective interest rate                     | 15.86% |

You are required to compute the liability and equity component and pass journal entries for entire term of arrangement i.e. from the issue of preference shares till their conversion into equity shares keeping in view the provisions of relevant Ind AS.

### Solution

This is a compound financial instrument with two components – liability representing present value of future cash outflows and balance represents equity component.

#### a. Computation of Liability & Equity Component

| Date                             | Particulars | Cash Flow | Discount Factor | Net present Value   |
|----------------------------------|-------------|-----------|-----------------|---------------------|
| 01-Apr-20X1                      |             | 0         | 1               | 0.00                |
| 31-Mar-20X2                      | Dividend    | 150,000   | 0.869565        | 130,434.75          |
| 31-Mar-20X3                      | Dividend    | 150,000   | 0.756144        | 113,421.6           |
| 31-Mar-20X4                      | Dividend    | 150,000   | 0.657516        | 98,627.4            |
| 31-Mar-20X5                      | Dividend    | 150,000   | 0.571753        | 85,762.95           |
| 31-Mar-20X6                      | Dividend    | 150,000   | 0.497177        | <u>74,576.55</u>    |
| Total Liability Component        |             |           |                 | 502,823.25          |
| Total Proceeds                   |             |           |                 | <u>1,500,000.00</u> |
| Total Equity Component (Bal fig) |             |           |                 | <u>997,176.75</u>   |

#### b. Allocation of transaction costs

| Particulars         | Amount           | Allocation    | Net Amount       |
|---------------------|------------------|---------------|------------------|
| Liability Component | 502,823          | 10,056        | 492,767          |
| Equity Component    | <u>997,177</u>   | <u>19,944</u> | <u>977,233</u>   |
| Total Proceeds      | <u>1,500,000</u> | <u>30,000</u> | <u>1,470,000</u> |

#### c. Accounting for liability at amortised cost:

- Initial accounting = Present value of cash outflows less transaction costs

- Subsequent accounting = At amortised cost, ie, initial fair value adjusted for interest and repayments of the liability.

|             | Opening<br>Financial Liability<br>A | Interest<br>B | Cash Flow<br>C | Closing Financial<br>Liability<br>A+B-C |
|-------------|-------------------------------------|---------------|----------------|-----------------------------------------|
| 01-Apr-20X1 | 492,767                             | -             | -              | 4,92,767                                |
| 31-Mar-20X2 | 492,767                             | 78,153        | 150,000        | 4,20,920                                |
| 31-Mar-20X3 | 420,920                             | 66,758        | 150,000        | 3,37,678                                |
| 31-Mar-20X4 | 337,678                             | 53,556        | 150,000        | 2,41,234                                |
| 31-Mar-20X5 | 241,234                             | 38,260        | 150,000        | 1,29,494                                |
| 31-Mar-20X6 | 129,494                             | 20,506        | 150,000        | -                                       |

d. Journal Entries to be recorded for entire term of arrangement are as follows:

| Date        | Particulars                                                                                                                                                                                                                                                | Debit     | Credit             |
|-------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|--------------------|
| 01-Apr-20X1 | Bank A/c Dr.<br>To Preference Shares Liability A/c<br>To Equity Component of Preference shares A/c<br>(Being compulsorily convertible preference shares issued. The same are divided into equity component and liability component as per the calculation) | 1,470,000 | 492,767<br>977,233 |
| 31-Mar-20X2 | Preference shares Liability A/c Dr.<br>To Bank A/c<br>(Being Dividend at the coupon rate of 10% paid to the shareholders)                                                                                                                                  | 150,000   | 150,000            |
| 31-Mar-20X2 | Finance cost A/c Dr.<br>To Preference Shares Liability A/c<br>(Being interest as per EIR method recorded)                                                                                                                                                  | 78,153    | 78,153             |
| 31-Mar-20X3 | Preference shares Liability A/c Dr.<br>To Bank A/c<br>(Being Dividend at the coupon rate of 10% paid to the shareholders)                                                                                                                                  | 150,000   | 150,000            |

|             |                                                                                                                                                                                                                                      |         |                   |
|-------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------|-------------------|
| 31-Mar-20X3 | Finance cost A/c Dr.<br>To Preference Shares Liability A/c<br>(Being interest as per EIR method recorded)                                                                                                                            | 66,758  | 66,758            |
| 31-Mar-20X4 | Preference shares Liability A/c Dr.<br>To Bank A/c<br>(Being Dividend at the coupon rate of 10% paid to the shareholders)                                                                                                            | 150,000 | 150,000           |
| 31-Mar-20X4 | Finance cost A/c Dr.<br>To Preference Shares Liability A/c<br>(Being interest as per EIR method recorded)                                                                                                                            | 53,556  | 53,556            |
| 31-Mar-20X5 | Preference shares Liability A/c Dr.<br>To Bank A/c<br>(Being Dividend at the coupon rate of 10% paid to the shareholders)                                                                                                            | 150,000 | 150,000           |
| 31-Mar-20X5 | Finance cost A/c Dr.<br>To Preference Shares Liability A/c<br>(Being interest as per EIR method recorded)                                                                                                                            | 38,260  | 38,260            |
| 31-Mar-20X6 | Preference shares Liability A/c Dr.<br>To Bank A/c<br>(Being Dividend at the coupon rate of 10% paid to the shareholders)                                                                                                            | 150,000 | 150,000           |
| 31-Mar-20X6 | Finance cost A/c Dr.<br>To Preference Shares Liability A/c<br>(Being interest as per EIR method recorded)                                                                                                                            | 20,506  | 20,506            |
| 31-Mar-20X6 | Equity Component of Preference shares A/c Dr.<br>To Equity Share Capital A/c<br>To Securities Premium A/c<br>(Being Preference shares converted in equity shares and remaining equity component is recognised as securities premium) | 977,233 | 50,000<br>927,233 |

\*\*\*\*\*

## EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

**A. Disclosure of Preference Shares under Liabilities (and not Shareholders' Funds) in the Annual Report of Tata Capital Ltd. For the year 2022-2023:**



Annual Report 2022-23

### NOTES FORMING PART OF STANDALONE FINANCIAL STATEMENTS

NOTE "14"

(₹ in lakh)

| SUBORDINATED LIABILITIES                                                                                           | As at<br>March 31, 2023 | As at<br>March 31, 2022 |
|--------------------------------------------------------------------------------------------------------------------|-------------------------|-------------------------|
| <b>At Amortised cost</b>                                                                                           |                         |                         |
| <b>UNSECURED</b>                                                                                                   |                         |                         |
| (a) Preference Shares other than those that qualify as equity                                                      |                         |                         |
| (i) Cumulative Redeemable Preference Shares [Face Value<br>₹ 1,06,972 lakh (As at March 31, 2022 ₹ 1,10,992 lakh)] | <b>1,07,013</b>         | 1,10,983                |
| <b>Total (A)</b>                                                                                                   | <b>1,07,013</b>         | <b>1,10,983</b>         |
| Subordinated Liabilities in India                                                                                  | <b>1,07,013</b>         | 1,10,983                |
| Subordinated Liabilities outside India                                                                             | -                       | -                       |
| <b>Total (B)</b>                                                                                                   | <b>1,07,013</b>         | <b>1,10,983</b>         |

No default has been made in repayment of any Debt securities, Subordinated liabilities and interest thereon for the year ended March 31, 2023 and March 31, 2022.

(Source: Annual reports for 2022-2023 of Tata capital Ltd.)

**B. Accounting Policy and OCI Extracts from the annual reports of Reliance Industries Ltd. For the year 2021-2022-Presentation of movements in Fair Values of Financial Instruments through OCI**

## Notes

to the Standalone Financial Statements for the year ended 31<sup>st</sup> March, 2022

(₹ in crore)

|                                                                                                 | 2021-22    | 2020-21    |
|-------------------------------------------------------------------------------------------------|------------|------------|
| <b>27.1 Other Comprehensive Income - Items that will not be Reclassified to Profit and Loss</b> |            |            |
| Remeasurement gain / (loss) of Defined Benefit Plan                                             | (42)       | 21         |
| Equity instruments through OCI                                                                  | 283        | 329        |
| <b>Total</b>                                                                                    | <b>241</b> | <b>350</b> |

(₹ in crore)

|                                                                                             | 2021-22        | 2020-21      |
|---------------------------------------------------------------------------------------------|----------------|--------------|
| <b>27.2 Other Comprehensive Income - Items that will be reclassified to Profit and Loss</b> |                |              |
| Government Securities                                                                       | (121)          | (152)        |
| Debenture or Bonds                                                                          | (146)          | 83           |
| Debt Income Fund                                                                            | (686)          | (491)        |
| Fixed Maturity Plan                                                                         | (344)          | 84           |
| Commodity Hedge                                                                             | 91             | 504          |
| Cash flow Hedge                                                                             | (1,499)        | 2,727        |
| <b>Total</b>                                                                                | <b>(2,705)</b> | <b>2,755</b> |



## 38. Financial Instruments

## A. Fair Value Measurement Hierarchy

(₹ in crore)

| Particulars                  | As at 31st March, 2022 |                        |         |         | As at 31st March, 2021 |                        |         |         |
|------------------------------|------------------------|------------------------|---------|---------|------------------------|------------------------|---------|---------|
|                              | Carrying Amount        | Level of input used in |         |         | Carrying Amount        | Level of input used in |         |         |
|                              |                        | Level 1                | Level 2 | Level 3 |                        | Level 1                | Level 2 | Level 3 |
| <b>Financial Assets</b>      |                        |                        |         |         |                        |                        |         |         |
| <b>At Amortised Cost</b>     |                        |                        |         |         |                        |                        |         |         |
| Investments *                | 30,874                 | -                      | -       | -       | 38,222                 | -                      | -       | -       |
| Trade Receivables            | 14,394                 | -                      | -       | -       | 4,159                  | -                      | -       | -       |
| Cash and Cash Equivalents    | 21,714                 | -                      | -       | -       | 5,573                  | -                      | -       | -       |
| Loans                        | 42,112                 | -                      | -       | -       | 65,066                 | -                      | -       | -       |
| Other Financial Assets       | 55,428                 | -                      | -       | -       | 58,933                 | -                      | -       | -       |
| <b>At FVTPL</b>              |                        |                        |         |         |                        |                        |         |         |
| Investments                  | 28,098                 | 24,825                 | 3,023   | 250     | 31,810                 | 27,235                 | 4,325   | 250     |
| Other Financial Assets       | 1,720                  | -                      | 1,720   | -       | 2,245                  | -                      | 2,245   | -       |
| <b>At FVTOCI</b>             |                        |                        |         |         |                        |                        |         |         |
| Investments                  | 1,80,655               | 68,724                 | 33,191  | 78,740  | 1,45,484               | 64,944                 | 2,268   | 78,272  |
| Other Financial Assets       | -                      | -                      | -       | -       | 7                      | -                      | 7       | -       |
| <b>Financial Liabilities</b> |                        |                        |         |         |                        |                        |         |         |
| <b>At Amortised Cost</b>     |                        |                        |         |         |                        |                        |         |         |
| Borrowings                   | 1,94,563               | -                      | -       | -       | 2,21,698               | -                      | -       | -       |
| Trade Payables               | 1,34,005               | -                      | -       | -       | 86,999                 | -                      | -       | -       |
| Lease Liabilities            | 2,876                  |                        |         |         | 2,985                  |                        |         |         |
| Other Financial Liabilities  | 31,034                 | -                      | -       | -       | 30,790                 | -                      | -       | -       |
| <b>At FVTPL</b>              |                        |                        |         |         |                        |                        |         |         |
| Other Financial Liabilities  | 4,951                  | -                      | 4,951   | -       | 3,463                  | -                      | 3,463   | -       |
| <b>At FVTOCI</b>             |                        |                        |         |         |                        |                        |         |         |
| Other Financial Liabilities  | 450                    | -                      | 450     | -       | -                      | -                      | -       | -       |

\* Exclude Group Company investments ₹ 1,69,170 crore (Previous Year ₹1,31,769 crore) measured at cost (Refer Note 2.1).

## A.1 Reconciliation of fair value measurement of the investment categorised at level 3:

(₹ in crore)

| Particulars                               | As at 31st March, 2022                                                            |           | As at 31st March, 2021                                                           |           |
|-------------------------------------------|-----------------------------------------------------------------------------------|-----------|----------------------------------------------------------------------------------|-----------|
|                                           | At FVTPL                                                                          | At FVTOCI | At FVTPL                                                                         | At FVTOCI |
| Opening Balance                           | 250                                                                               | 78,272    | 965                                                                              | 77,910    |
| Addition during the year                  | -                                                                                 | 232       | -                                                                                | 84        |
| Sale/Reduction during the year            | -                                                                                 | 94        | 715                                                                              | -         |
| Total Gain/(Loss)                         | -                                                                                 | 330       | -                                                                                | 278       |
| Closing Balance                           | 250                                                                               | 78,740    | 250                                                                              | 78,272    |
| Line item in which gain/(loss) recognised | Other Comprehensive Income- Items that will not be reclassified to Profit or Loss |           | Other Comprehensive Income-Items that will not be reclassified to Profit or Loss |           |

## A.2 Sensitivity of level 3 financial instrument's fair value to changes in significant unobservable inputs used in their fair valuation:

(₹ in crore)

| Particulars                 | Valuation Technique   | Significant Unobservable Input                    | Change in % | Sensitivity of the fair value to change in input |                  |
|-----------------------------|-----------------------|---------------------------------------------------|-------------|--------------------------------------------------|------------------|
|                             |                       |                                                   |             | 31st March, 2022                                 | 31st March, 2021 |
| Investment in OCPS (FVTOCI) | Discounting Cash Flow | Discounting rate - 14.51% (Previous Year -13.12%) | +0.10%      | (1,547)                                          | (1,436)          |
|                             |                       |                                                   | -0.10%      | 1,573                                            | 1,463            |

## A.3 The below table summarises the fair value of borrowings which are carried at amortised cost:

(₹ in crore)

| Particulars                                           | Level   | 31st March, 2022 | 31st March, 2021 |
|-------------------------------------------------------|---------|------------------|------------------|
| Non-current borrowings (including current maturities) | Level 1 | 1,03,546         | 1,11,025         |
|                                                       | Level 2 | 79,857           | 82,180           |
|                                                       | Level 3 | 3,137            | 3,796            |

For current borrowings, the carrying amounts approximates fair value due to the short maturity of these instruments.

**The financial instruments are categorised into three levels based on the inputs used to arrive at fair value measurements as described below**

**Level 1:** Quoted prices (unadjusted) in active markets for identical assets or liabilities;

**Level 2:** Inputs other than the quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and

**Level 3:** Inputs based on unobservable market data.

### **Valuation Methodology**

All financial instruments are initially recognised and subsequently re-measured at fair value as described below:

- a) The fair value of investment in quoted Equity Shares, Bonds, Government Securities, Treasury Bills, Certificate of Deposit and Mutual Funds is measured at quoted price or NAV.
- b) The fair value of Interest Rate Swaps is calculated as the present value of the estimated future cash flows based on observable yield curves.
- c) The fair value of Forward Foreign Exchange contracts and Currency Swaps is determined using observable forward exchange rates and yield curves at the balance sheet date.
- d) The fair value of over-the-counter Foreign Currency Option contracts is determined using the Black Scholes valuation model.
- e) Commodity derivative contracts are valued using available information in markets and quotations from exchange, brokers and price index developers.
- f) The fair value for level 3 instruments is valued using inputs based on information about market participants assumptions and other data that are available.
- g) The fair value of the remaining financial instruments is determined using discounted cash flow analysis.
- h) All foreign currency denominated assets and liabilities are translated using exchange rate at reporting date.

## B. Financial Risk Management

The company's activities expose it to variety of financial risks: market risk, credit risk, interest rate risk and liquidity risk. Within the boundaries of approved Risk Management Policy framework The Company uses derivative instruments to manage the volatility of financial markets and minimize the adverse impact on its financial performance.

### i) Market Risk

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: interest rate risk, currency risk and other price risk, such as equity price risk and commodity risk.

#### a) Foreign Currency Risk

Foreign currency risk is the risk that the Fair Value or Future Cash Flows of an exposure will fluctuate because of changes in foreign currency rates. Exposures can arise on account of the various assets and liabilities which are denominated in currencies other than Indian Rupee.

The following table shows foreign currency exposures in US Dollar, Euro and Japanese Yen on financial instruments at the end of the reporting period. The exposure to all other foreign currencies are not material.

(₹ In crore)

| Particulars                 | Foreign Currency Exposure |            |              |                        |            |            |
|-----------------------------|---------------------------|------------|--------------|------------------------|------------|------------|
|                             | As at 31st March, 2022    |            |              | As at 31st March, 2021 |            |            |
|                             | USD                       | EUR        | JPY          | USD                    | EUR        | JPY        |
| Borrowings                  | 1,15,850                  | 11,993     | 10,731       | 96,823                 | 12,634     | 11,555     |
| Trade and Other Payables    | 1,30,415                  | 1,154      | -            | 81,227                 | 2,528      | -          |
| Trade and Other Receivables | (13,639)                  | (244)      | (13)         | (3,692)                | (110)      | (13)       |
| <b>Derivatives</b>          |                           |            |              |                        |            |            |
| - Forwards & Futures        | (54,958)                  | (12,500)   | (10,927)     | (55,461)               | (13,970)   | (11,528)   |
| - Currency Swap             | -                         | -          | -            | 2,655                  | -          | -          |
| - Options                   | (2,877)                   | 126        | (319)        | (19,347)               | (472)      | 727        |
| <b>Exposure</b>             | <b>1,74,791</b>           | <b>529</b> | <b>(528)</b> | <b>1,02,205</b>        | <b>610</b> | <b>741</b> |

Sensitivity analysis of 1% change in exchange rate at the end of reporting period net of hedges \*

(₹ in crore)

| Particulars                   | Foreign Currency Sensitivity |            |            |                        |          |          |
|-------------------------------|------------------------------|------------|------------|------------------------|----------|----------|
|                               | As at 31st March, 2022       |            |            | As at 31st March, 2021 |          |          |
|                               | USD                          | EUR        | JPY        | USD                    | EUR      | JPY      |
| <b>1% Depreciation in INR</b> |                              |            |            |                        |          |          |
| Impact on Equity              | (165)                        | -          | -          | (260)                  | (11)     | (28)     |
| Impact on P&L                 | (114)                        | (5)        | 5          | (240)                  | 11       | 28       |
| <b>Total</b>                  | <b>(279)</b>                 | <b>(5)</b> | <b>5</b>   | <b>(500)</b>           | <b>-</b> | <b>-</b> |
| <b>1% Appreciation in INR</b> |                              |            |            |                        |          |          |
| Impact on Equity              | 165                          | -          | -          | 260                    | 11       | 28       |
| Impact on P&L                 | 114                          | 5          | (5)        | 240                    | (11)     | (28)     |
| <b>Total</b>                  | <b>279</b>                   | <b>5</b>   | <b>(5)</b> | <b>500</b>             | <b>-</b> | <b>-</b> |

\* Includes natural hedges arising from foreign currency denominated earnings, for which hedge accounting may be implemented.

#### b) Interest Rate Risk

The Company is also exposed to interest rate risk, changes in interest rates will affect future cash flows or the fair values of its financial instruments, principally debt. The Company issues debt in a variety of currencies based on market opportunities and it uses derivatives to hedge interest rate exposures.



The exposure of the company's borrowings and derivatives to interest rate changes at the end of the reporting period are as follows:

(₹ in crore)

| Interest Rate Exposure                                |                           |                           |
|-------------------------------------------------------|---------------------------|---------------------------|
| Particulars                                           | As at<br>31st March, 2022 | As at<br>31st March, 2021 |
| <b>Borrowings</b>                                     |                           |                           |
| Non-Current - Floating (includes Current Maturities)* | 86,216                    | 88,618                    |
| Non-Current - Fixed (includes Current Maturities)*    | 99,978                    | 1,00,721                  |
| Current #                                             | 9,418                     | 33,301                    |
| <b>Total</b>                                          | <b>1,95,612</b>           | <b>2,22,640</b>           |
| <b>Derivatives</b>                                    |                           |                           |
| <b>Foreign Currency Interest Rate Swaps</b>           |                           |                           |
| - Receive Fix                                         | 5,647                     | 2,924                     |
| - Pay Fix                                             | 1,516                     | 29,606                    |
| <b>Rupees Interest Rate Swaps</b>                     |                           |                           |
| - Receive Fix                                         | 32,495                    | 7,975                     |
| - Pay Fix                                             | 14,525                    | 11,475                    |
| <b>Currency Swaps</b>                                 |                           |                           |
| - INR to USD Swap ^                                   | -                         | 2,655                     |

\* Include ₹ 1,029 crore (Previous Year ₹ 793 crore) as Prepaid Finance Charges.

# Include ₹ 20 crore (Previous Year ₹ 149 crore) as Commercial Paper Discount.

^ Receive fix in INR and pay floating in USD

Sensitivity analysis of 1% change in Interest rate

(₹ in crore)

| Particulars         | Interest rate Sensitivity |              |                        |            |
|---------------------|---------------------------|--------------|------------------------|------------|
|                     | As at 31st March, 2022    |              | As at 31st March, 2021 |            |
|                     | Up Move                   | Down Move    | Up Move                | Down Move  |
| Impact on Equity    | (187)                     | 182          | (123)                  | 123        |
| Impact on P&L       | (976)                     | 920          | (665)                  | 665        |
| <b>Total Impact</b> | <b>(1,163)</b>            | <b>1,102</b> | <b>(788)</b>           | <b>788</b> |

## ii) Commodity Price Risk

Commodity price risk arises due to fluctuation in prices of crude oil, other feed stock and products. The company has a risk management framework aimed at prudently managing the risk arising from the volatility in commodity prices and freight costs.

The Company's commodity risk is managed centrally through well-established trading operations and control processes. In accordance with the risk management policy, the Company enters into various transactions using derivatives and uses over-the-counter as well as Exchange Traded Futures, Options and Swap contracts to hedge its commodity and freight exposure.

## iii) Credit Risk

Credit risk is the risk that a customer or counterparty to a financial instrument fails to perform or pay the amounts due causing financial loss to the company. Credit risk arises from company's activities in investments, dealing in derivatives and receivables from customers. The Company ensure that sales of products are made to customers with appropriate creditworthiness. Investment and other market exposures are managed against counterparty exposure limits. Credit information is regularly shared between businesses and finance function, with a framework in place to quickly identify and respond to cases of credit deterioration.

The company has a prudent and conservative process for managing its credit risk arising in the course of its business activities. Credit risk is actively managed through Letters of Credit, Bank Guarantees, Parent Company Guarantees, advance payments and factoring & forfaiting without recourse to the company to avoid concentration of risk. The company restricts its fixed income investments to liquid securities carrying high credit rating.

## iv) Liquidity Risk

Liquidity risk arises from the Company's inability to meet its cash flow commitments on the due date. The company maintains sufficient stock of cash, marketable securities and committed credit facilities. The company accesses global and local financial markets to meet its liquidity requirements. It uses a range of products and a mix of currencies to ensure efficient funding from across well-diversified markets and investor pools. Treasury monitors rolling forecasts of the company's cash flow position and ensures that the company is able to meet its financial obligation at all times including contingencies.

The company's liquidity is managed centrally with operating units forecasting their cash and liquidity requirements. Treasury pools the cash surpluses from across the different operating units and then arranges to either fund the net deficit or invest the net surplus in a range of short-dated, secure and liquid instruments including short-term bank deposits, money market funds, reverse repos and similar instruments. The portfolio of these investments is diversified to avoid concentration risk in any one instrument or counterparty.

(₹ in crore)

| Particulars <sup>^</sup>         | Maturity Profile as at 31st March, 2022 |              |              |               |               |               |                 |
|----------------------------------|-----------------------------------------|--------------|--------------|---------------|---------------|---------------|-----------------|
|                                  | Below 3 Months                          | 3-6 Months   | 6-12 Months  | 1-3 Years     | 3-5 Years     | Above 5 Years | Total           |
| <b>Borrowings</b>                |                                         |              |              |               |               |               |                 |
| Non-Current <sup>*@</sup>        | 2,169                                   | 6,416        | 9,517        | 74,969        | 32,724        | 60,399        | 1,86,194        |
| Current <sup>**</sup>            | 9,328                                   | 90           | -            | -             | -             | -             | 9,418           |
| <b>Total</b>                     | <b>11,497</b>                           | <b>6,506</b> | <b>9,517</b> | <b>74,969</b> | <b>32,724</b> | <b>60,399</b> | <b>1,95,612</b> |
| <b>Lease Liabilities (Gross)</b> | <b>85</b>                               | <b>79</b>    | <b>148</b>   | <b>552</b>    | <b>552</b>    | <b>4,577</b>  | <b>5,993</b>    |
| <b>Derivative Liabilities</b>    |                                         |              |              |               |               |               |                 |
| Forwards                         | 3,033                                   | 601          | 677          | 390           | -             | -             | 4,701           |
| Options                          | 151                                     | 2            | 20           | -             | -             | -             | 173             |
| Interest Rate Swaps              | -                                       | -            | 4            | 43            | 30            | -             | 77              |
| <b>Total</b>                     | <b>3,184</b>                            | <b>603</b>   | <b>701</b>   | <b>433</b>    | <b>30</b>     | <b>-</b>      | <b>4,951</b>    |

<sup>^</sup> Does not include Trade Payables (Current) ₹ 1,34,005 crore.

<sup>\*</sup> Include ₹ 1,029 crore as Prepaid Financial Charges.

<sup>@</sup> Does not include interest thereon (For Interest rate refer Note 16.2).

<sup>\*\*</sup> Include ₹ 20 crore of Commercial Paper Discount.

<sup>‡</sup> Interest rate on current borrowings ranges from 2.5% to 8.6%.

(₹ in crore)

| Particulars <sup>^</sup>         | Maturity Profile as at 31st March, 2021 |              |               |               |               |               |                 |
|----------------------------------|-----------------------------------------|--------------|---------------|---------------|---------------|---------------|-----------------|
|                                  | Below 3 Months                          | 3-6 Months   | 6-12 Months   | 1-3 Years     | 3-5 Years     | Above 5 Years | Total           |
| <b>Borrowings</b>                |                                         |              |               |               |               |               |                 |
| Non-Current <sup>*@</sup>        | 3,048                                   | 4,606        | 20,447        | 65,641        | 61,593        | 34,004        | 1,89,339        |
| Current <sup>**</sup>            | 30,638                                  | 2,663        | -             | -             | -             | -             | 33,301          |
| <b>Total</b>                     | <b>33,686</b>                           | <b>7,269</b> | <b>20,447</b> | <b>65,641</b> | <b>61,593</b> | <b>34,004</b> | <b>2,22,640</b> |
| <b>Lease Liabilities (Gross)</b> | <b>88</b>                               | <b>88</b>    | <b>175</b>    | <b>587</b>    | <b>552</b>    | <b>4,853</b>  | <b>6,343</b>    |
| <b>Derivative Liabilities</b>    |                                         |              |               |               |               |               |                 |
| Forwards                         | 1,476                                   | 349          | 176           | 1,097         | -             | -             | 3,098           |
| Options                          | 178                                     | -            | 33            | -             | -             | -             | 211             |
| Interest Rate Swaps              | 10                                      | 1            | 22            | 45            | 76            | -             | 154             |
| <b>Total</b>                     | <b>1,664</b>                            | <b>350</b>   | <b>231</b>    | <b>1,142</b>  | <b>76</b>     | <b>-</b>      | <b>3,463</b>    |

<sup>^</sup> Does not include Trade Payables (Current) ₹ 86,999 crore.

<sup>\*</sup> Include ₹ 793 crore as Prepaid Financial Charges.

<sup>@</sup> Does not include interest thereon.

<sup>\*\*</sup> Include ₹ 149 crore as Commercial Paper Discount.

<sup>‡</sup> Interest rate on current borrowings ranges from 3.4% to 8.6%.



### C. Hedge Accounting

The Company's business objective includes safe-guarding its earnings against adverse price movements of crude oil and other feedstock, refined products, freight costs as well as foreign exchange and interest rates. The Company has adopted a structured risk management policy to hedge all these risks within an acceptable risk limit and an approved hedge accounting framework which allows for Fair Value and Cash Flow hedges. Hedging instruments include exchange traded futures and options, over-the-counter swaps, forwards and options as well as non-derivative instruments to achieve this objective.

There is an economic relationship between the hedged items and the hedging instruments. The Company has established a hedge ratio of 1:1 for the hedging relationships. To test the hedge effectiveness, the Company uses the hypothetical derivative method and Dollar offset method.

The hedge ineffectiveness can arise from:

- Differences in the timing of the cash flows.
- Different indexes (and accordingly different curves).
- The counterparties' credit risk differently impacting the fair value movements.

The table below shows the position of hedging instruments and hedged items as on the balance sheet date:

#### Disclosure of effects of hedge accounting

##### A. Fair Value Hedge

###### Hedging Instrument

|                                    |               |                 |                 |             |                       |                             | (₹ in crore)                         |
|------------------------------------|---------------|-----------------|-----------------|-------------|-----------------------|-----------------------------|--------------------------------------|
| Particulars                        | Nominal Value | Quantity (Kbbl) | Carrying Amount |             | Changes in Fair Value | Hedge Maturity              | Line Item in Balance Sheet           |
|                                    |               |                 | Assets          | Liabilities |                       |                             |                                      |
| As on 31 <sup>st</sup> March, 2022 |               |                 |                 |             |                       |                             |                                      |
| Foreign Currency Risk              |               |                 |                 |             |                       |                             |                                      |
| Derivative Contracts               | -             | -               | -               | -           | -                     | -                           | -                                    |
| Commodity Price Risk               |               |                 |                 |             |                       |                             |                                      |
| Derivative Contracts               | 33,663        | 1,58,884        | 1,274           | 2,114       | (1,094)               | April 2022 to December 2023 | Other Financial Assets / Liabilities |
|                                    |               |                 |                 |             |                       |                             |                                      |
| As on 31 <sup>st</sup> March, 2021 |               |                 |                 |             |                       |                             |                                      |
| Foreign Currency Risk              |               |                 |                 |             |                       |                             |                                      |
| Derivative Contracts               | 2,557         | -               | -               | 86          | (72)                  | April 2021 to May 2021      | Other Financial Liabilities          |
| Commodity Price Risk               |               |                 |                 |             |                       |                             |                                      |
| Derivative Contracts               | 30,478        | 3,85,566        | 1,524           | 597         | 20                    | April 2021 to December 2023 | Other Financial Assets / Liabilities |

###### Hedged Items

(₹ in crore)

| Particulars                                            | Carrying Amount |             | Changes in Fair Value | Line Item in Balance Sheet         |
|--------------------------------------------------------|-----------------|-------------|-----------------------|------------------------------------|
|                                                        | Assets          | Liabilities |                       |                                    |
| As on 31 <sup>st</sup> March, 2022                     |                 |             |                       |                                    |
| Foreign Currency Risk                                  |                 |             |                       |                                    |
| Import Firm Commitments                                | -               | -           | -                     |                                    |
| Commodity Price Risk                                   |                 |             |                       |                                    |
| Firm Commitments for purchase of feedstock and freight | -               | 1,010       | (943)                 | Other Current Assets / Liabilities |
| Firm Commitments for sale of products                  | 2,114           | -           | 2,301                 | Other Current Assets               |
| Inventories                                            | 3807            | -           | (264)                 | Inventories                        |
| As on 31 <sup>st</sup> March, 2021                     |                 |             |                       |                                    |
| Foreign Currency Risk                                  |                 |             |                       |                                    |
| Import Firm Commitments                                | 86              | -           | 72                    | Other Financial Assets             |
| Commodity Price Risk                                   |                 |             |                       |                                    |
| Firm Commitments for purchase of feedstock and freight | -               | 306         | (656)                 | Other Current Assets / Liabilities |
| Firm Commitments for sale of products                  | -               | 1,218       | (446)                 | Other Current Assets               |

## B. Cash Flow Hedge

## Hedging Instruments

(` in crore)

| Particulars                                      | Nominal Value | Carrying amount |             | Changes in Fair Value | Hedge Maturity                                                       | Line Item in Balance Sheet                               |
|--------------------------------------------------|---------------|-----------------|-------------|-----------------------|----------------------------------------------------------------------|----------------------------------------------------------|
|                                                  |               | Assets          | Liabilities |                       |                                                                      |                                                          |
| <b>As on 31<sup>st</sup> March, 2022</b>         |               |                 |             |                       |                                                                      |                                                          |
| <b>Foreign Currency Risk</b>                     |               |                 |             |                       |                                                                      |                                                          |
| Foreign Currency Risk Component - Trade Payables | 22,301        | -               | 22,738      | (437)                 | 1 <sup>st</sup> April, 2022 to 31 <sup>st</sup> March, 2025          | Trade Payables                                           |
| Foreign Currency Risk Component-Borrowings       | 1,20,017      | -               | 1,23,697    | (3,685)               | 30 <sup>th</sup> September, 2022 to 30 <sup>th</sup> September, 2033 | Non-Current Liabilities-Financial Liabilities-Borrowings |
| <b>Interest Rate Risk</b>                        |               |                 |             |                       |                                                                      |                                                          |
| Interest Rate Swaps                              | -             | -               | -           | -                     | -                                                                    | -                                                        |
| <b>As on 31<sup>st</sup> March, 2021</b>         |               |                 |             |                       |                                                                      |                                                          |
| <b>Foreign Currency Risk</b>                     |               |                 |             |                       |                                                                      |                                                          |
| Foreign Currency Risk Component - Trade Payables | -             | -               | -           | -                     | -                                                                    | -                                                        |
| Foreign Currency Risk Component-Borrowings       | 7,218         | -               | 7,311       | 256                   | June 2022                                                            | Non-Current Liabilities-Financial Liabilities-Borrowings |
| <b>Interest Rate Risk</b>                        |               |                 |             |                       |                                                                      |                                                          |
| Interest Rate Swaps                              | 33,590        | 82              | -           | 141                   | April 2021 to March 2025                                             | Other Financial Assets                                   |

## Hedged Items

(` in crore)

| Particulars                              | Nominal Value | Changes in Fair Value | Hedge Reserve | Line Item in Balance Sheet |
|------------------------------------------|---------------|-----------------------|---------------|----------------------------|
|                                          |               |                       |               |                            |
| <b>As on 31<sup>st</sup> March, 2022</b> |               |                       |               |                            |
| <b>Foreign Currency Risk</b>             |               |                       |               |                            |
| Highly Probable Forecasted Exports       | 1,42,318      | 4,122                 | (4,810)       | Other Equity               |
| <b>Interest Rate Risk</b>                |               |                       |               |                            |
| Borrowings                               | -             | -                     | -             | -                          |
| <b>As on 31<sup>st</sup> March, 2021</b> |               |                       |               |                            |
| <b>Foreign Currency Risk</b>             |               |                       |               |                            |
| Highly Probable Forecasted Exports       | 7,218         | (256)                 | (3,059)       | Other Equity               |
| <b>Interest Rate Risk</b>                |               |                       |               |                            |
| Borrowings                               | 33,590        | (141)                 | (97)          | Other Equity               |

## C. Movement in Cash Flow Hedge

(₹ in crore)

| Sr. No. | Particulars                                                            | 2021-22 | 2020-21 | Line Item in Balance Sheet / Statement of Profit and Loss |
|---------|------------------------------------------------------------------------|---------|---------|-----------------------------------------------------------|
| 1       | At the beginning of the year                                           | (3,156) | (5,883) |                                                           |
| 2       | Gain/ (loss) recognised in other comprehensive income during the year. | (4,334) | 914     | Items that will be reclassified to Profit & Loss          |
| 3       | Amount reclassified to Profit and Loss during the year                 | 2,835   | 1,813   | Value of Sale                                             |
| 4       | At the end of the year                                                 | (4,655) | (3,156) | Other Comprehensive Income                                |

Extract of Accounting Policy in respect of Financial Instruments: Page 319-320

**(q) Financial Instruments****i. Financial Assets****A. Initial Recognition and Measurement**

All Financial Assets are initially recognised at fair value. Transaction costs that are directly attributable to the acquisition or issue of Financial Assets, which are not at Fair Value Through Profit or Loss, are adjusted to the fair

value on initial recognition. Purchase and sale of Financial Assets are recognised using trade date accounting.

## **B. Subsequent Measurement**

### **a) Financial Assets measured at Amortised Cost (AC)**

A Financial Asset is measured at Amortised Cost if it is held within a business model whose objective is to hold the asset in order to collect contractual cash flows and the contractual terms of the Financial Asset give rise to cash flows on specified dates that represent solely payments of principal and interest on the principal amount outstanding.

### **b) Financial Assets measured at Fair Value Through Other Comprehensive Income (FVTOCI)**

A Financial Asset is measured at FVTOCI if it is held within a business model whose objective is achieved by both collecting contractual cash flows and selling Financial Assets and the contractual terms of the Financial Asset give rise on specified dates to cash flows that represents solely payments of principal and interest on the principal amount outstanding.

### **c) Financial Assets measured at Fair Value Through Profit or Loss (FVTPL)**

A Financial Asset which is not classified in any of the above categories are measured at FVTPL. Financial assets are reclassified subsequent to their recognition, if the Company changes its business model for managing those financial assets. Changes in business model are made and applied prospectively from the reclassification date which is the first day of immediately next reporting period following the changes in business model in accordance with principles laid down under Ind AS 109 – Financial Instruments.

## **C. Investment in Subsidiaries, Associates and Joint Ventures**

The Company has accounted for its investments in Subsidiaries, associates and joint venture at cost less impairment loss (if any). The investments in preference shares with the right of surplus assets which are in nature of equity in accordance with Ind AS 32 are treated as separate category of investment and measured at FVTOCI.

## **D. Other Equity Investments**

All other equity investments are measured at fair value, with value changes recognised in Statement of Profit and Loss, except for those equity investments for which the Company

has elected to present the value changes in 'Other Comprehensive Income'. However, dividend on such equity investments are recognised in Statement of Profit and Loss when the Company's right to receive payment is established.

## **E. Impairment of Financial Assets**

In accordance with Ind AS 109, the Company uses 'Expected Credit Loss' (ECL) model, for evaluating impairment of Financial Assets other than those measured at Fair Value Through Profit and Loss (FVTPL).

Expected Credit Losses are measured through a loss allowance at an amount equal to:

- The 12-months expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or
- Full lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

For Trade Receivables the Company applies 'simplified approach' which requires expected lifetime losses to be recognised from initial recognition of the receivables.

The Company uses historical default rates to determine impairment loss on the portfolio of trade receivables. At every reporting date these historical default rates are reviewed and changes in the forward-looking estimates are analysed.

For other assets, the Company uses 12 month ECL to provide for impairment loss where there is no significant increase in credit risk. If there is significant increase in credit risk full lifetime ECL is used.

## **ii. Financial Liabilities**

### **A. Initial Recognition and Measurement**

All Financial Liabilities are recognised at fair value and in case of borrowings, net of directly attributable cost. Fees of recurring nature are directly recognised in the Statement of Profit and Loss as finance cost.

### **B. Subsequent Measurement**

Financial Liabilities are carried at amortised cost using the effective interest method. For trade and other payables maturing within one year from the balance sheet date, the carrying amounts approximate fair value due to the short maturity of these instruments.



### iii. Derivative Financial Instruments and Hedge Accounting

The Company uses various derivative financial instruments such as interest rate swaps, currency swaps, forwards & options and commodity contracts to mitigate the risk of changes in interest rates, exchange rates and commodity prices. At the inception of a hedge relationship, the Company formally designates and documents the hedge relationship to which the Company wishes to apply hedge accounting and the risk management objective and strategy for undertaking the hedge. Such derivative financial instruments are initially recognised at fair value on the date on which a derivative contract is entered into and are also subsequently measured at fair value.

Derivatives are carried as Financial Assets when the fair value is positive and as Financial Liabilities when the fair value is negative. Any gains or losses arising from changes in the fair value of derivatives are taken directly to Statement of Profit and Loss, except for the effective portion of cash flow hedge which is recognised in Other Comprehensive Income and later to Statement of Profit and Loss when the hedged item affects profit or loss or is treated as basis adjustment if a hedged forecast transaction subsequently results in the recognition of a Non-Financial Assets or Non-Financial liability.

Hedges that meet the criteria for hedge accounting are accounted for as follows:

#### A. Cash Flow Hedge

The Company designates derivative contracts or non-derivative Financial Assets/ Liabilities as hedging instruments to mitigate the risk of movement in interest rates and foreign exchange rates for foreign exchange exposure on highly probable future cash flows attributable to a recognised asset or liability or forecast cash transactions.

When a derivative is designated as a cash flow hedging instrument, the effective portion of changes in the fair value of the derivative is recognised in the cash flow hedging reserve being part of Other Comprehensive Income. Any ineffective portion of changes in the fair value of the derivative is recognised immediately in the Statement of Profit and Loss. If the hedging relationship no longer meets the criteria for hedge accounting, then hedge accounting is discontinued prospectively. If the hedging instrument expires or is sold or terminated or exercised, the cumulative gain or loss on the hedging instrument recognised in cash flow hedging reserve till the period

the hedge was effective remains in cash flow hedging reserve until the underlying transaction occurs. The cumulative gain or loss previously recognised in the cash flow hedging reserve is transferred to the Statement of Profit and Loss upon the occurrence of the underlying transaction. If the forecasted transaction is no longer expected to occur, then the amount accumulated in cash flow hedging reserve is reclassified in the Statement of Profit and Loss.

#### B. Fair Value Hedge

The Company designates derivative contracts or non-derivative Financial Assets/Liabilities as hedging instruments to mitigate the risk of change in fair value of hedged item due to movement in interest rates, foreign exchange rates and commodity prices.

Changes in the fair value of hedging instruments and hedged items that are designated and qualify as fair value hedges are recorded in the Statement of Profit and Loss. If the hedging relationship no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised to Statement of Profit and Loss over the period of maturity.

#### iv. Derecognition of Financial Instruments

The Company derecognises a Financial Asset when the contractual rights to the cash flows from the Financial Asset expire or it transfers the Financial Asset and the transfer qualifies for derecognition under Ind AS 109. A Financial liability (or a part of a Financial liability) is derecognised from the Company's Balance Sheet when the obligation specified in the contract is discharged or cancelled or expires.

#### v. Offsetting

Financial Assets and Financial Liabilities are offset and the net amount is presented in the balance sheet when, and only when, the Company has a legally enforceable right to set off the amount and it intends, either to settle them on a net basis or to realise the asset and settle the liability simultaneously.

#### (r) Non-current Assets Held for Sale

Non-current assets are classified as held for sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use and sale is considered highly probable.

A sale is considered as highly probable when decision has been made to sell, assets are available for immediate sale in its present condition, assets

(Source: Annual reports for 2022-2023 of Reliance Industries Ltd.)

**FOR SHORTCUT TO IND AS WISDOM: SCAN ME!**



**IND AS 32**



**IND AS 109**

## TEST YOUR KNOWLEDGE

### Questions

- As part of staff welfare measures, Y Co Ltd. has contracted to lend to its employees sums of money at 5% per annum rate of interest. The amounts lent are to be repaid in five equal instalments for principle along with the interest. The market rate of interest is 10% per annum for comparable loans. Y lent ₹ 1,600,000 to its employees on 1<sup>st</sup> January 20X1.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for the year ended 31 December 20X1, for the transaction and also compute the value of loan initially to be recognised and amortised cost for all subsequent years.

For the purpose of calculation, following discount factors at interest rate of 10% per annum may be adopted –

At the end of year –

| Year | Present value factor |
|------|----------------------|
| 1    | .909                 |
| 2    | .827                 |
| 3    | .751                 |
| 4    | .683                 |
| 5    | .620                 |

- Wheel Co. Limited has a policy of providing subsidized loans to its employees for the purpose of buying or building houses. Mr. X, who's executive assistant to the CEO of Wheel Co. Limited, took a loan from the Company on the following terms:

- Interest rate: 4% for the first 400,000 and 7% for the next 600,000
- Start date: 1 January 20X1
- Tenure: 5 years
- Pre-payment: Full or partial pre-payment at the option of the employee
- The principal amount of loan shall be recovered in 5 equal annual instalments and will be first applied to 7% interest bearing principal
- The accrued interest shall be paid on an annual basis
- Mr. X must remain in service till the term of the loan ends

The market rate of a comparable loan available to Mr. X, is 12% per annum.

Following table shows the contractually expected cash flows from the loan given to Mr. X:

(amount in ₹)

| Date        | Outflows    | Inflows   |                    |                    | Principal outstanding |
|-------------|-------------|-----------|--------------------|--------------------|-----------------------|
|             |             | Principal | Interest income 7% | Interest income 4% |                       |
| 1-Jan-20X1  | (1,000,000) |           |                    |                    | 1,000,000             |
| 31-Dec-20X1 |             | 200,000   | 42,000             | 16,000             | 800,000               |
| 31-Dec-20X2 |             | 200,000   | 28,000             | 16,000             | 600,000               |
| 31-Dec-20X3 |             | 200,000   | 14,000             | 16,000             | 400,000               |
| 31-Dec-20X4 |             | 200,000   | -                  | 16,000             | 200,000               |
| 31-Dec-20X5 |             | 200,000   | -                  | 8,000              | -                     |

Mr. S, pre-pays ₹ 200,000 on 31 December 20X2, reducing the outstanding principal as at that date to ₹ 400,000.

Following table shows the actual cash flows from the loan given to Mr. X, considering the pre-payment event on 31 December 20X2:

(amount in ₹)

| Date        | Outflows    | Inflows   |                    |                    | Principal outstanding |
|-------------|-------------|-----------|--------------------|--------------------|-----------------------|
|             |             | Principal | Interest income 7% | Interest income 4% |                       |
| 1-Jan-20X1  | (1,000,000) |           |                    |                    | 1,000,000             |
| 31-Dec-20X1 |             | 200,000   | 42,000             | 16,000             | 800,000               |
| 31-Dec-20X2 |             | 400,000   | 28,000             | 16,000             | 400,000               |
| 31-Dec-20X3 |             | 200,000   | -                  | 16,000             | 200,000               |
| 31-Dec-20X4 |             | 200,000   | -                  | 8,000              | -                     |
| 31-Dec-20X5 |             | -         | -                  | -                  | -                     |

Record journal entries in the books of Wheel Co. Limited considering the requirements of Ind AS 109.

3. Wheel Co. Limited borrowed ₹ 500,000,000 from a bank on 1 January 20X1. The original terms of the loan were as follows:

- Interest rate: 11%
- Repayment of principal in 5 equal instalments
- Payment of interest annually on accrual basis
- Upfront processing fee: ₹ 5,870,096

Effective interest rate on loan: 11.50%

On 31 December 20X2, Wheel Co. Limited approached the bank citing liquidity issues in meeting the cash flows required for immediate instalments and re-negotiated the terms of the loan with banks as follows:

- Interest rate 15%
- Repayment of outstanding principal in 10 equal instalments starting 31 December 20X3
- Payment of interest on an annual basis

Record journal entries in the books of Wheel Co. Limited till 31 December 20X3, after giving effect of the changes in the terms of the loan on 31 December 20X2

4. K Ltd. issued 500,000, 6% convertible debentures @ ₹ 10 each on 01 April 20X1. The debentures are due for redemption on 31 March 20X5 at a premium of 10%, convertible into 2,50,000 equity shares of Rs. 10 each i.e. to the extent of 50% and balance to be settled in cash to the debenture holders. The interest rate on equivalent debentures without conversion rights was 10%.

You are required to separate the debt and equity components at the time of issue and show the accounting entries in Company's books at initial recognition. The following present values of Re 1 at 6% and at 10% are provided:

| Interest rate | Year 1 | Year 2 | Year 3 | Year 4 |
|---------------|--------|--------|--------|--------|
| 6%            | 0.94   | 0.89   | 0.84   | 0.79   |
| 10%           | 0.91   | 0.83   | 0.75   | 0.68   |

5. On 1 April 20X1, an 8% convertible loan with a nominal value of ₹ 6,00,000 was issued at par. It is redeemable on 31 March 20X5 also at par. Alternatively, it may be converted into equity shares on the basis of 100 new shares for each ₹ 200 worth of loan.



An equivalent loan without the conversion option would have carried interest at 10%. Interest of ₹ 48,000 has already been paid and included as a finance cost.

Present value rates are as follows:

| Year End | @ 8% | @ 10% |
|----------|------|-------|
| 1        | 0.93 | 0.91  |
| 2        | 0.86 | 0.83  |
| 3        | 0.79 | 0.75  |
| 4        | 0.73 | 0.68  |

Explain how will the Company account for the above loan notes in the financial statements for the year ended 31 March 20X2?

6. On 1 April 20X1, Sun Limited guarantees a ₹ 10,00,000 loan of Subsidiary – Moon Limited, which Bank STDK has provided to Moon Limited for three years at 8%.

Interest payments are made at the end of each year and the principal is repaid at the end of the loan term.

If Sun Limited had not issued a guarantee, Bank STDK would have charged Moon Limited an interest rate of 11%. Sun Limited does not charge Moon Limited for providing the guarantee.

On 31 March 20X2, there is 1% probability that Moon Limited may default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited.

On 31 March 20X3, there is 3% probability that Moon Limited may default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited.

Provide the accounting treatment of financial guarantee as per Ind AS 109 in the books of Sun Ltd., on initial recognition and in subsequent periods till 31 March 20X3.

## Answers

1. (i) Calculation of initial measurement amount of loan to its employees:

| Year end | Cash flow |               | Total   | PV factor | Present value    |
|----------|-----------|---------------|---------|-----------|------------------|
|          | Principal | Interest @ 5% |         |           |                  |
| 20X1     | 320,000   | 80,000        | 400,000 | .909      | 363,600          |
| 20X2     | 320,000   | 64,000        | 384,000 | .827      | 317,568          |
| 20X3     | 320,000   | 48,000        | 368,000 | .751      | 276,368          |
| 20X4     | 320,000   | 32,000        | 352,000 | .683      | 240,416          |
| 20X5     | 320,000   | 16,000        | 336,000 | .620      | <u>208,320</u>   |
|          |           |               |         |           | <u>1,406,272</u> |

- (ii) Calculation of amortised cost of loan to employees

| Year end | Amortised cost (opening balance) | Interest to be recognised | Repayment (including interest) | Amortised cost (closing balance) |
|----------|----------------------------------|---------------------------|--------------------------------|----------------------------------|
| 20X1     | 1,406,272                        | 140,627                   | 400,000                        | 1,146,899                        |
| 20X2     | 1,146,899                        | 114,690                   | 384,000                        | 877,589                          |
| 20X3     | 877,589                          | 87,759                    | 368,000                        | 597,348                          |
| 20X4     | 597,348                          | 59,735                    | 352,000                        | 305,083                          |
| 20X5     | 305,083                          | 30,917*                   | 336,000                        | -                                |

\* $305,083 \times 10\% = 30,508$ . Difference of ₹ 409 is due to approximation in computation.

- (iii) Journal Entries to be recorded of Y Ltd. for the year ended 31 December 20X1

| Date       | Particulars                                                                                                                                                              | Debit     | Credit    |
|------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|-----------|
| 1 Jan 20X1 | Staff loan A/c Dr.                                                                                                                                                       | 14,06,272 |           |
|            | Prepaid staff cost A/c* Dr.                                                                                                                                              | 1,93,728  |           |
|            | [(1,600,000 – 1,406,272), Refer part (ii)]                                                                                                                               |           |           |
|            | To Bank A/c                                                                                                                                                              |           | 16,00,000 |
|            | (Being disbursement of loans to staff and excess loan balance over present value thereof in order to reflect the loan at its present value booked as prepaid staff cost) |           |           |

|             |                                                                 |     |          |          |
|-------------|-----------------------------------------------------------------|-----|----------|----------|
| 31 Dec 20X1 | Staff loan A/c                                                  | Dr. | 1,40,627 |          |
|             | To Interest expense A/c                                         |     |          | 1,40,627 |
|             | (Being interest accrued on loans to staff)                      |     |          |          |
| 31 Dec 20X1 | Staff cost A/c                                                  | Dr. | 38,746   |          |
|             | To Prepaid expense A/c                                          |     |          | 38,746   |
|             | (Being prepaid expense charged for the year against staff cost) |     |          |          |

\* Where the difference between the amount given by the Company to its employees and its fair value represents another asset, then such asset shall be recognised. Accordingly, such difference is recognised as prepaid employee cost and amortised over the period of loan.

2. As per requirement of Ind AS 109, a financial instrument is initially measured and recorded at its fair value. Therefore, considering the market rate of interest of similar loan available to Mr. X is 12%, the fair value of the contractual cash flows shall be as follows:

|                    | Inflows   |                    |                    |                      |                 |
|--------------------|-----------|--------------------|--------------------|----------------------|-----------------|
| Date               | Principal | Interest income 7% | Interest income 4% | Discount factor @12% | PV              |
| 31-Dec-20X1        | 200,000   | 42,000             | 16,000             | 0.8929               | 2,30,357        |
| 31-Dec-20X2        | 200,000   | 28,000             | 16,000             | 0.7972               | 1,94,515        |
| 31-Dec-20X3        | 200,000   | 14,000             | 16,000             | 0.7118               | 1,63,709        |
| 31-Dec-20X4        | 200,000   | -                  | 16,000             | 0.6355               | 1,37,272        |
| 31-Dec-20X5        | 200,000   | -                  | 8,000              | 0.5674               | <u>1,18,025</u> |
| Total (fair value) |           |                    |                    |                      | <u>8,43,878</u> |

Benefit to Mr. X, to be considered a part of employee cost for Wheel Co. ₹ 1,56,121.

The deemed employee cost is to be amortised over the period of loan i.e. the minimum period that Mr. X must remain in service.

The amortization schedule of the ₹ 843,878 loan is shown in the following table:

| Date        | Loan outstanding | Total cash inflows (principal repayment + interest) | Interest @ 12% |
|-------------|------------------|-----------------------------------------------------|----------------|
| 1-Jan-20X1  | 843,878          |                                                     |                |
| 31-Dec-20X1 | 687,143          | 258,000                                             | 101,265        |
| 31-Dec-20X2 | 525,600          | 244,000                                             | 82,457         |

|             |         |         |         |
|-------------|---------|---------|---------|
| 31-Dec-20X3 | 358,672 | 230,000 | 63,072  |
| 31-Dec-20X4 | 185,713 | 216,000 | 43,041  |
| 31-Dec-20X5 | (0)     | 208,000 | 22,287* |

\* Difference is due to approximation.

**Journal Entries to be recorded at every period end:**

**a. 1 January 20X1 –**

| Particulars                                       |     | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|---------------------------------------------------|-----|-------------------|-------------------|
| Loan to employee A/c                              | Dr. | 843,879           |                   |
| Pre-paid employee cost A/c                        | Dr. | 156,121           |                   |
| To Bank A/c                                       |     |                   | 1,000,000         |
| (Being loan asset recorded at initial fair value) |     |                   |                   |

**b. 31 December 20X1 –**

| Particulars                                                                                                             |     | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------------|-----|-------------------|-------------------|
| Bank A/c                                                                                                                | Dr. | 258,000           |                   |
| To Interest income (profit and loss) @12% A/c                                                                           |     |                   | 101,265           |
| To Loan to employee A/c                                                                                                 |     |                   | 156,735           |
| (Being first instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%) |     |                   |                   |
| Employee benefit (profit and loss) A/c                                                                                  | Dr. | 31,224            |                   |
| To Pre-paid employee cost A/c                                                                                           |     |                   | 31,224            |
| (Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)                      |     |                   |                   |

On 31 December 20X2, due to pre-payment of a part of loan by Mr. X, the carrying value of the loan shall be re-computed by discounting the future remaining cash flows by the original effective interest rate.

There shall be two sets of accounting entries on 31 December 20X2, first the realisation of the contractual cash flow as shown in (c) below and then the accounting for the pre-payment of ₹ 200,000 included in (d) below:

## c. 31 December 20X2 –

| Particulars                                                                                                                                                                                                          | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Bank A/c Dr.<br>To Interest income (profit and loss) @12% A/c<br>To Loan to employee A/c<br>(Being second instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%) | 244,000           | 82,457<br>161,543 |
| Employee benefit (profit and loss) A/c Dr.<br>To Pre-paid employee cost A/c<br>(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)                                    | 31,224            | 31,224            |

Computation of new carrying value of loan to employee:

|                                | Inflows   |                    |                    |                      |         |
|--------------------------------|-----------|--------------------|--------------------|----------------------|---------|
| Date                           | Principal | Interest income 7% | Interest income 4% | Discount factor @12% | PV      |
| 31-Dec-20X3                    | 200,000   | -                  | 16,000             | 0.8929               | 192,857 |
| 31-Dec-20X4                    | 200,000   | -                  | 8,000              | 0.7972               | 165,816 |
| Total (revised carrying value) |           |                    |                    |                      | 358,673 |
| Less: Current carrying value   |           |                    |                    |                      | 525,601 |
| Adjustment required            |           |                    |                    |                      | 166,928 |

The difference between the amount of pre-payment and adjustment to loan shall be considered a gain, though will be recorded as an adjustment to pre-paid employee cost, which shall be amortised over the remaining tenure of the loan.

## d. 31 December 20X2 prepayment–

| Particulars                                                                                                                                                       | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Bank A/c Dr.<br>To Pre-paid employee cost A/c<br>To Loan to employee A/c<br>(Being gain to Wheel Co. Limited recorded as an adjustment to pre-paid employee cost) | 200,000           | 33,072<br>166,928 |

The amortisation schedule of the new carrying amount of loan shall be as follows:

| Date        | Loan outstanding | Total cash inflows (principal repayment + interest) | Interest @ 12% |
|-------------|------------------|-----------------------------------------------------|----------------|
| 31-Dec-20X2 | 358,673          |                                                     |                |
| 31-Dec-20X3 | 185,714          | 216,000                                             | 43,041         |
| 31-Dec-20X4 | -                | 208,000                                             | 22,286         |

Amortisation of employee benefit cost shall be as follows:

| Date        | Balance | Amortised to P&L | Adjustment |
|-------------|---------|------------------|------------|
| 1-Jan-20X1  | 156,121 |                  |            |
| 31-Dec-20X1 | 124,897 | 31,224           |            |
| 31-Dec-20X2 | 60,601  | 31,224           | 33,072     |
| 31-Dec-20X3 | 30,300  | 30,300           |            |
| 31-Dec-20X4 | -       | 30,300           |            |

**e. 31 December 20X3 –**

| Particulars                                                                                                                                                                                                         | Dr. Amount (₹) | Cr. Amount (₹)    |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------|-------------------|
| Bank A/c Dr.<br>To Interest income (profit and loss) @12% A/c<br>To Loan to employee A/c<br>(Being third instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%) | 216,000        | 43,041<br>172,959 |
| Employee benefit (profit and loss) A/c Dr.<br>To Pre-paid employee cost A/c<br>(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)                                   | 30,300         | 30,300            |

**f. 31 December 20X4 –**

| Particulars                                                                                                                                                                                                        | Dr. Amount (₹) | Cr. Amount (₹)    |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------|-------------------|
| Bank A/c Dr.<br>To Interest income (profit and loss) @12% A/c<br>To Loan to employee A/c<br>(Being last instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%) | 208,000        | 22,286<br>185,714 |

|                                                                                                    |     |        |        |
|----------------------------------------------------------------------------------------------------|-----|--------|--------|
| Employee benefit (profit and loss) A/c                                                             | Dr. | 30,300 |        |
| To Pre-paid employee cost A/c                                                                      |     |        | 30,300 |
| (Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost) |     |        |        |

3. On the date of initial recognition, the effective interest rate of the loan shall be computed keeping in view the contractual cash flows and upfront processing fee paid. The following table shows the amortisation of loan based on effective interest rate:

| Date        | Cash flows<br>(principal) | Cash flows<br>(interest and<br>fee) | Amortised cost<br>(opening +<br>interest – cash<br>flows) | Interest @<br>EIR<br>(11.50%) |
|-------------|---------------------------|-------------------------------------|-----------------------------------------------------------|-------------------------------|
| 1-Jan-20X1  | (500,000,000)             | 5,870,096                           | 494,129,904                                               |                               |
| 31-Dec-20X1 | 100,000,000               | 55,000,000                          | 395,954,843                                               | 56,824,939                    |
| 31-Dec-20X2 | 100,000,000               | 44,000,000                          | 297,489,650                                               | 45,534,807                    |
| 31-Dec-20X3 | 100,000,000               | 33,000,000                          | 198,700,959                                               | 34,211,310                    |
| 31-Dec-20X4 | 100,000,000               | 22,000,000                          | 99,551,570                                                | 22,850,610                    |
| 31-Dec-20X5 | 100,000,000               | 11,000,000                          | (0)                                                       | 11,448,430                    |

a. 1 January 20X1 –

| Particulars                                                                                    | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Bank A/c                                                                                       | Dr.               | 494,129,904       |
| To Loan from bank A/c                                                                          |                   | 494,129,904       |
| (Being loan recorded at its fair value less transaction costs on the initial recognition date) |                   |                   |

b. 31 December 20X1 –

| Particulars                                                                                                           | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-----------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Loan from bank A/c                                                                                                    | Dr.               | 98,175,061        |
| Interest expense (profit and loss)                                                                                    | Dr.               | 56,824,939        |
| To Bank A/c                                                                                                           |                   | 155,000,000       |
| (Being first instalment of loan and payment of interest accounted for as an adjustment to the amortised cost of loan) |                   |                   |

## c. 31 December 20X2 – Before Wheel Co. Limited approached the bank –

| Particulars                                                                                                       | Dr. Amount<br>(₹) | Cr.<br>Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------|-------------------|----------------------|
| Interest expense (profit and loss) Dr.                                                                            | 45,534,807        |                      |
| To Loan from bank A/c                                                                                             |                   | 1,534,807            |
| To Bank A/c                                                                                                       |                   | 44,000,000           |
| (Being loan payment of interest recorded by the Company before it approached the Bank for deferment of principal) |                   |                      |

Upon receiving the new terms of the loan, Wheel Co. Limited, re-computed the carrying value of the loan by discounting the new cash flows with the original effective interest rate and comparing the same with the current carrying value of the loan. As per requirements of Ind AS 109, any change of more than 10% shall be considered a substantial modification, resulting in fresh accounting for the new loan:

| Date                                                  | Cash flows<br>(principal) | Interest outflow<br>@15% | Discount<br>factor | PV of cash<br>flows |
|-------------------------------------------------------|---------------------------|--------------------------|--------------------|---------------------|
| 31-Dec-20X2                                           | (400,000,000)             |                          |                    |                     |
| 31-Dec-20X3                                           | 40,000,000                | 60,000,000               | 0.8969             | 89,686,099          |
| 31-Dec-20X4                                           | 40,000,000                | 54,000,000               | 0.8044             | 75,609,805          |
| 31-Dec-20X5                                           | 40,000,000                | 48,000,000               | 0.7214             | 63,483,092          |
| 31-Dec-20X6                                           | 40,000,000                | 42,000,000               | 0.6470             | 53,053,542          |
| 31-Dec-20X7                                           | 40,000,000                | 36,000,000               | 0.5803             | 44,100,068          |
| 31-Dec-20X8                                           | 40,000,000                | 30,000,000               | 0.5204             | 36,429,133          |
| 31-Dec-20X9                                           | 40,000,000                | 24,000,000               | 0.4667             | 29,871,422          |
| 31-Dec-20Y0                                           | 40,000,000                | 18,000,000               | 0.4186             | 24,278,903          |
| 31-Dec-20Y1                                           | 40,000,000                | 12,000,000               | 0.3754             | 19,522,235          |
| 31-Dec-20Y3                                           | 40,000,000                | 6,000,000                | 0.3367             | 15,488,493          |
| PV of new contractual cash flows discounted at 11.50% |                           |                          |                    | 451,522,791         |
| Carrying amount of loan                               |                           |                          |                    | 397,489,650         |
| Difference                                            |                           |                          |                    | 54,033,141          |
| Percentage of carrying amount                         |                           |                          |                    | 13.59%              |

**Note:** Calculation done above is on full decimal, though in the table discount factor is limited to 4 decimals.



Considering a more than 10% change in PV of cash flows compared to the carrying value of the loan, the existing loan shall be considered to have been extinguished and the new loan shall be accounted for as a separate financial liability. The accounting entries for the same are included below:

**d. 31 December 20X2 – accounting for extinguishment**

| Particulars                                                                                                                                                                    | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Loan from bank (old) A/c Dr.                                                                                                                                                   | 397,489,650       |                   |
| Loss on modification of loan (profit and loss) Dr.                                                                                                                             | 2,510,350         |                   |
| To Loan from bank (new) A/c                                                                                                                                                    |                   | 400,000,000       |
| (Being new loan accounted for at its principal amount in absence of any transaction costs directly related to such loan and correspondingly a de-recognition of existing loan) |                   |                   |

**e. 31 December 20X3**

| Particulars                                                                                                                   | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Loan from bank A/c Dr.                                                                                                        | 40,000,000        |                   |
| Interest expense (profit and loss) Dr.                                                                                        | 60,000,000        |                   |
| To Bank A/c                                                                                                                   |                   | 100,000,000       |
| (Being first instalment of the new loan and payment of interest accounted for as an adjustment to the amortised cost of loan) |                   |                   |

**4. Computation of debt component of convertible debentures on 01 April 20X1**

| Particulars                                                                                    | Amount    |
|------------------------------------------------------------------------------------------------|-----------|
| Present value of principal amount repayable after 4 years                                      |           |
| (A) $5,000,000 \times 50\% \times 1.10 \times 0.68$ (10% discount factor)                      | 1,870,000 |
| (B) Present value of interest $[300,000 \times 3.17]$ (4 years cumulative 10% discount factor) | 951,000   |
| Total present value of debt component (A) + (B)                                                | 2,821,000 |
| Issue proceeds from convertible debentures                                                     | 5,000,000 |
| Value of equity component                                                                      | 2,179,000 |

## Journal entry at initial recognition

| Particulars                                 | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|---------------------------------------------|-------------------|-------------------|
| Bank A/c Dr.                                | 5,000,000         |                   |
| To 6% debenture A/c (liability component)   |                   | 2,821,000         |
| To 6% debenture A/c (equity component)      |                   | 2,179,000         |
| (Being disbursement recorded at fair value) |                   |                   |

5. **Step 1** There is an 'option' to convert the loans into equity i.e. the loan note holders do not have to accept equity shares; they could demand repayment in the form of cash.

Ind AS 32 states that where there is an obligation to transfer economic benefits there should be a liability recognised. On the other hand, where there is not an obligation to transfer economic benefits, a financial instrument should be recognised as equity.

In the above illustration we have both – 'equity' and 'debt' features in the instrument. There is an obligation to pay cash – i.e. interest at 8% per annum and a redemption amount – this is 'financial liability' or 'debt component'. The 'equity' part of the transaction is the option to convert. So it is a compound financial instrument.

**Step 2** Debt element of the financial instrument so as to recognise the liability is the present value of interest and principal

The rate at which the same is to be discounted, is the rate of *equivalent* loan note *without* the conversion option would have carried interest at 10%, therefore this is the rate to be used for discounting

**Step 3** Calculation of the debt element of the loan note as follows:

8% Interest discounted at a rate of 10% Present Value (6,00,000 x 8%)

| S. No                                  | Year | Interest amount | PVF  | Amount          |
|----------------------------------------|------|-----------------|------|-----------------|
| Year 1                                 | 20X2 | 48,000          | 0.91 | 43,680          |
| Year 2                                 | 20X3 | 48,000          | 0.83 | 39,840          |
| Year 3                                 | 20X4 | 48,000          | 0.75 | <u>36,063</u>   |
|                                        |      |                 |      | 1,19,583        |
| Year 4                                 | 20X5 | 648,000         | 0.68 | <u>4,40,640</u> |
| Amount to be recognised as a liability |      |                 |      | 5,60,223        |

Initial proceeds (6,00,000)

Amount to be recognised as equity 39,777

\* In year 4, the loan note is redeemed therefore ₹ 6,00,000 + ₹ 48,000 = ₹ 6,48,000.

**Step 4** The next step is to recognise the interest component equivalent to the loan that would carry if there was no option to cover. Therefore, the interest should be recognised at 10%. As on date ₹ 48,000 has been recognised in the statement of profit and loss i.e.  $6,00,000 \times 8\%$  but we have discounted the present value of future interest payments and redemption amount using discount factors of 10%, so the finance charge in the statement of profit and loss must also be recognised at the same rate i.e. for the purpose of consistency.

The additional charge to be recognised in the income statement is calculated as:

Debt component of the financial instrument ₹ 5,60,000

|                                            |                   |
|--------------------------------------------|-------------------|
| Interest charge ( $5,60,000 \times 10\%$ ) | ₹ 56,000          |
| Already charged to the income statement    | <u>(₹ 48,000)</u> |
| Additional charge required                 | <u>₹ 8,000</u>    |

**Journal Entries for recording additional finance cost for year ended 31 March 20X2**

| Particulars                                                                                                                                                       | Dr. Amount<br>(₹) | Cr. Amount<br>(₹) |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Finance cost A/c<br>To Debt component A/c<br>(Being interest recorded for difference between<br>amount recorded earlier and that to be recorded per<br>Ind AS 32) | Dr.<br>8,000      | 8,000             |

**6. 1 April 20X1**

A financial guarantee contract is initially recognised at fair value. The fair value of the guarantee will be the present value of the difference between the net contractual cash flows required under the loan, and the net contractual cash flows that would have been required without the guarantee.

| Particulars                                                          | Year 1<br>(₹) | Year 2<br>(₹) | Year 3<br>(₹) | Total<br>(₹)         |
|----------------------------------------------------------------------|---------------|---------------|---------------|----------------------|
| Cash flows based on interest rate of 11% (A)                         | 1,10,000      | 1,10,000      | 1,10,000      | 3,30,000             |
| Cash flows based on interest rate of 8% (B)                          | 80,000        | 80,000        | 80,000        | 2,40,000             |
| Interest rate differential (A-B)                                     | 30,000        | 30,000        | 30,000        | 90,000               |
| Discount factor @ 11%                                                | 0.901         | 0.812         | 0.731         |                      |
| Interest rate differential discounted at 11%                         | 27,030        | 24,360        | 21,930        | <u>73,320</u>        |
| <b>Fair value of financial guarantee contract<br/>(at inception)</b> |               |               |               | <u><b>73,320</b></u> |

## Journal Entry

| Particulars                                                                                                          | Debit (₹) | Credit (₹) |
|----------------------------------------------------------------------------------------------------------------------|-----------|------------|
| Investment in subsidiary Dr.<br>To Financial guarantee (liability)<br>(Being financial guarantee initially recorded) | 73,320    | 73,320     |

**31 March 20X2**

Subsequently at the end of the reporting period, financial guarantee is measured at the higher of:

- the amount of loss allowance; and
- the amount initially recognised less cumulative amortization, where appropriate.

At 31 March 20X2, there is 1% probability that Moon Limited may default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited. The 12-month expected credit losses are therefore ₹ 10,000 (Rs.10,00,000 x 1%).

The initial amount recognised less amortisation is ₹ 51,385 (₹ 73,320 + ₹ 8,065 (interest accrued based on EIR)) – ₹ 30,000 (benefit of the guarantee in year 1) Refer table below. The unwound amount is recognised as income in the books of Sun Limited, being the benefit derived by Moon Limited not defaulting on the loan during the period.

| Year | Opening balance<br>₹ | EIR @ 11% | Benefits provided<br>₹ | Closing balance<br>₹ |
|------|----------------------|-----------|------------------------|----------------------|
| 1    | 73,320               | 8,065     | (30,000)               | 51,385               |
| 2    | 51,385               | 5,652     | (30,000)               | 27,037               |
| 3    | 27,037               | 2,963*    | (30,000)               | -                    |

\* Difference is due to approximation

The carrying amount of the financial guarantee liability after amortisation is therefore ₹ 51,385, which is higher than the 12-month expected credit losses of ₹ 10,000. The liability is therefore adjusted to ₹ 51,385 (the higher of the two amounts) as follows:

| Particulars                                                                                                   | Debit (₹) | Credit (₹) |
|---------------------------------------------------------------------------------------------------------------|-----------|------------|
| Financial guarantee (liability) Dr.<br>To Profit or loss<br>(Being financial guarantee subsequently adjusted) | 21,935    | 21,935     |

**31 March 20X3**

At 31 March 20X3, there is 3% probability that Moon Limited will default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited. The 12-month expected credit losses are therefore ₹ 30,000 (₹ 10,00,000 x 3%).

The initial amount recognised less accumulated amortisation is ₹ 27,037, which is lower than the 12-month expected credit losses (₹ 30,000). The liability is therefore adjusted to ₹ 30,000 (the higher of the two amounts) as follows:

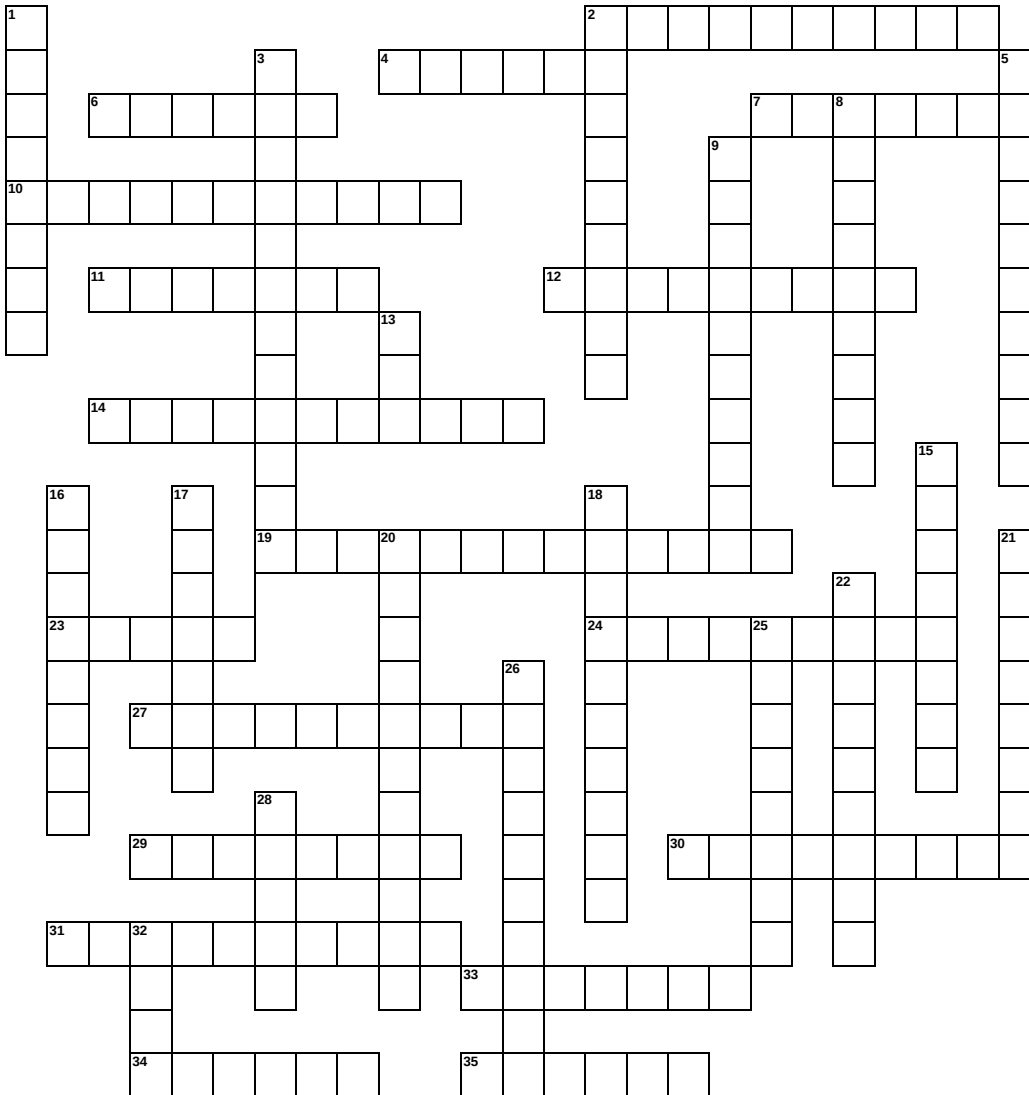
| Particulars                                       | Debit (₹) | Credit (₹) |
|---------------------------------------------------|-----------|------------|
| Financial guarantee (liability) Dr.               | 21,385*   |            |
| To Profit or loss (Note)                          |           | 21,385     |
| (Being financial guarantee subsequently adjusted) |           |            |

\* The carrying amount at the end of 31 March 20X2 = ₹ 51,385 less 12-month expected credit losses of ₹ 30,000.

[illegible]

[illegible]

## IND AS PUZZLERS: TEST YOUR ACCOUNTING ACUMEN\*



### **ACROSS:**

2. Operating segments not meeting any of the quantitative thresholds may be considered \_\_\_\_\_, and separately disclosed, if management believes that information about it would be useful to users of the financial statements. (10)

\_\_\_\_\_

\*Related to Chapters of Module 3 only



4. Short-term employee benefits are expected to be settled wholly \_\_\_\_\_ twelve months after the end of the annual reporting period in which the employees render the related service. (6)
6. If it is probable that future taxable profit will be available, a deferred tax asset shall be recognised for the carryforward of \_\_\_\_\_ tax losses. (6)
7. As per Ind AS 109, a financial asset is \_\_\_\_\_ when a counterparty has failed to make a contractually due payment. (4,3)
10. As per Ind AS 21, exchange difference is the difference resulting from \_\_\_\_\_ a given number of units of one currency into another currency at different exchange rates. (11)
11. Objective of Ind AS 21 is to prescribe how to include \_\_\_\_\_ currency transactions and operations in the financial statements of an entity. (7)
12. As per Ind AS 12, unpaid current tax for current and prior periods shall be recognised as a \_\_\_\_\_. (9)
14. Ind 32 states that the \_\_\_\_\_ costs of an equity transaction shall be accounted for as a deduction from equity. (11)
19. In case of change in an entity's functional currency, the translation procedures are applicable to the new functional currency \_\_\_\_\_ from the date of the change. (13)
23. \_\_\_\_\_ earnings per share is calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity by the weighted average number of ordinary shares outstanding during the period. (5)
24. 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 \_\_\_\_\_. (9)
27. A deferred tax asset shall be recognised for all \_\_\_\_\_ temporary differences, if it is probable that taxable profit will be available against it. (10)
29. A financial instrument is a \_\_\_\_\_ that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. (8)

30. An entity shall not reclassify any financial \_\_\_\_\_. (9)
31. \_\_\_\_\_ on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period. (3,7)
33. Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of \_\_\_\_\_ temporary differences. (7)
34. A contract is not an \_\_\_\_\_ instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. (6)
35. An entity shall \_\_\_\_\_ a financial liability from its balance sheet when the obligation specified in the contract is discharged. (6)

**DOWN:**

1. On issuance of a contract that may be settled in ordinary shares or cash at the entity's option, it is presumed by an entity that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is \_\_\_\_\_. (8)
2. A related party transaction is a transfer of resources, services or obligations between a \_\_\_\_\_ entity and a related party, regardless of whether a price is charged. (9)
3. \_\_\_\_\_ between a parent and its subsidiaries shall be disclosed irrespective of any transaction between them. (12)
5. The gross carrying amount of a financial asset shall be reduced when the entity has no \_\_\_\_\_ expectations of recovering it in its entirety or a portion thereof. (10)
8. A financial instrument shall be classified on initial recognition as a financial liability, a financial asset or an equity instrument as per the \_\_\_\_\_ of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. (9)
9. If the total external revenue reported by operating segments constitutes less than 75 per cent of the entity's revenue, \_\_\_\_\_ operating segments shall be identified as

reportable segments (even if they do not meet the specified criteria) until at least 75 per cent of the entity's revenue is included in reportable segments. (10)

13. Purchased put or call options held by the entity on its own ordinary shares are \_\_\_\_\_ included in the calculation of diluted earnings per share. (3)
15. The term 'Chief Operating Decision Maker' identifies a \_\_\_\_\_, not necessarily a manager with a specific title. (8)
16. Information about other business activities and operating segments that are not reportable shall be \_\_\_\_\_ and disclosed in an 'all other segments' category. (8)
17. Post-employment benefit plans are classified as either \_\_\_\_\_ contribution plans or \_\_\_\_\_ benefit plans, depending on the economic substance of the plan. (7)
18. Ind AS 24 requires \_\_\_\_\_ of related party relationships, transactions and outstanding balances, including commitments, in the financial statements. (10)
20. The objective of the impairment requirements in Ind AS 109 is to recognize lifetime expected credit losses for all financial instruments for which there have been \_\_\_\_\_ increases in credit risk since initial recognition. (11)
21. \_\_\_\_\_ items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. (8)
22. An entity shall \_\_\_\_\_ a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument. (9)
25. An \_\_\_\_\_ share is an equity instrument that is subordinate to all other classes of equity instruments. (8)
26. Contracts that require the entity to \_\_\_\_\_ its own shares are reflected in the calculation of diluted earnings per share, if the effect is dilutive. (10)
28. An entity shall account for a \_\_\_\_\_ plan in the same way as for a multi-employer plan. (5)

32. Net interest on the net defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of \_\_\_\_\_.  
(4)

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**To know the answer of the above Ind AS Puzzle, scan the QR Code**

