Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 13

'Ind AS Transition Facilitation Group' (ITFG) of Ind AS Implementation Committee has been constituted for providing clarifications on timely basis on various issues related to the applicability and /or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015, raised by preparers, users and other stakeholders. Ind AS Transition Facilitation Group (ITFG) considered some issues received from members and decided to issue following clarifications[1] on January 16, 2018:

Issue 1: Can Dividend Distribution Tax (DDT) paid on distribution of dividend to preference shareholders (that are classified as liability as per Ind AS 32, *Financial Instruments: Presentation)*, be capitalised as borrowing costs with the qualifying asset in accordance with the principles of Ind AS 23, *Borrowing Costs*?

Response: Paragraphs 5 and 6 of Ind AS 23, *Borrowing Costs*, state as follows:

"5 Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

6 Borrowing costs may include:
(a) interest expense calculated using the effective interest method as described in Ind AS 109, Financial Instruments;
(b) …."

With regard to the recognition of dividend declared on financial instruments, paragraphs 35 and 36 of Ind AS 32 reproduced hereunder may be noted:

''35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.

36 The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in profit or loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.''

[1] Clarifications given or views expressed by the Ind AS Transition Facilitation Group (ITFG) represent the views of the members of the ITFG and are not necessarily the views of the Ind AS Implementation Committee or the Council of the Institute. The clarifications/views are based on the accounting principles as on the date the Group finalises the particular clarification. The date of finalisation of each clarification is indicated along with the clarification. The clarification must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of clarifications by the Group

In view of the above, if a financial instrument is classified as debt, the dividend or interest thereon is in the nature of interest which is charged to profit or loss.

Further, paragraph 8 of Ind AS 23 states that, *“An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.”*

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

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

The Guidance Note on Ind AS Schedule III provides following guidance in respect of dividend on redeemable preference shares:

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

In the given case, assuming that the requirements of paragraph 8 of Ind AS 23 for capitalisation are met then the dividend on the preference shares that are classified as a liability, in accordance with the principles of Ind AS 32, *Financial Instruments: Presentation* would be treated as interest and DDT paid thereon will be treated as cost eligible for capitalisation. Thus, in the given case, DDT is in the nature of incremental cost that an entity incurs in connection with obtaining the funds for qualifying asset. Hence DDT should be capitalised along with interest. Further, dividend distribution tax paid on such dividend will form part of the effective interest rate calculation (EIR) to compute the effective interest expense to be capitalised with the qualifying asset.

Issue 2: Company A Ltd., applied for a term loan from Bank B for business purposes. As per the loan agreement, the loan required a personal guarantee of one of the directors of A Ltd. to be executed. In case of default by A Ltd, the director will be required to compensate for the loss that Bank B incurs. Mr. P, one of the director had given guarantee to the bank pursuant to which the loan was sanctioned to Company A. Company A does not pay premium or fees to its director for providing this financial guarantee.

Whether Company A is required to account for the financial guarantee received from its director?

Response: Ind AS 109 *Financial Instruments*, defines a financial guarantee contract as *'a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.'*

Based on this definition, an evaluation is required to be done to ascertain whether the contract between director and Bank B qualifies as a financial guarantee contract as defined in Appendix A to Ind AS 109. In the given case, it does qualify as a financial guarantee contract as:

- the reference obligation is a debt instrument (term loan);
- the holder i.e. Bank B is compensated only for a loss that it incurs (arising on account of non-repayment); and
- the holder is not compensated for more than the actual loss incurred.

Ind AS 109 provides principles for accounting by the issuer of the guarantee. However, it does not specifically address the accounting for financial guarantees by the beneficiary. In an arm's length transaction between unrelated parties, the beneficiary of the financial guarantee would recognise the guarantee fee or premium paid as an expense.

It is also pertinent to note that the entity needs to exercise judgment in assessing the substance of the transaction taking into consideration relevant facts and circumstances, for example whether the director is being compensated otherwise for providing guarantee. Based on such an assessment, an appropriate accounting treatment based on the principles of Ind AS should be followed.

In the given case, Company A Ltd, is the beneficiary of the financial guarantee and it does not pay a premium or fees to its director for providing this financial guarantee (subject to discussion above). Accordingly, Company A will not be required to account for such financial guarantee in its financial statements considering the unit of account as being the guaranteed loan, in which case the fair value would be expected to be the face value of the loan proceeds that the Company A received. Nonetheless, the above transaction needs to be evaluated for disclosure under paragraph 18 of Ind AS 24, *Related Party Disclosures*, which states as follows:

"If an entity has 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. These disclosure requirements are in addition to those in paragraph 17. At a minimum, disclosures shall include:

(a) the amount of the transactions;

(b) the amount of outstanding balances, including commitments, and:

(i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and

(ii) details of any guarantees given or received;

(c) provisions for doubtful debts related to the amount of outstanding balances; and

(d) the expense recognised during the period in respect of bad or doubtful debts due from related parties."

In the given case based on the limited facts provided, Company A will be required to make necessary disclosures of such financial guarantee in accordance with Ind AS 24.

Issue 3: Paragraph 34 of Ind AS 108, *Operating Segments* requires entities to disclose information about its major customers i.e. those contributing 10% or more of its total amount of revenue. Whether such disclosure is required even in case where the company operates into only one segment?

Response: The scope paragraph of Ind AS 108, *Operating Segments*, *inter alia*, states that this Accounting Standard shall apply to companies to which Indian Accounting Standards (Ind ASs) notified under the Companies Act apply.

Further, paragraphs 32-35 of Ind AS 108 provide the entity-wide disclosures that an entity is required to disclose.

Paragraph 31 of Ind AS 108 states as follows:

"***Paragraphs 32–34 apply to all entities subject to this Ind AS including those entities that have a single reportable segment***. *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. Information required by paragraphs 32–34 shall be provided only if it is not provided as part of the reportable segment information required by this Ind AS."*

In accordance with the above, it may be noted that disclosure requirements as specified in paragraphs 32-34 of Ind AS 108 apply to all entities to which Ind AS applies including entities that have a single reportable segment.

Paragraph 34 of Ind AS 108 states as follows:

"***Information about major customers***

34 ***An entity shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10 per cent or more of an entity's revenues, the entity shall 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 this Ind AS, a group of entities known to a reporting entity to be under common control shall 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 shall consider the extent of economic integration between those entities."

Accordingly, in the given case information regarding customers contributing to more than 10% of total revenue will be required to be disclosed by the company even though it is operating into a single operating segment. The entity need not disclose the identity of a major customer or customers, or the amount of revenues that each segment reports from that customer or those customers.

Issue 4: A Company ABC Ltd. performs role of NBFC and has applied for the registration as NBFC which is awaited from the Reserve Bank of India (RBI).

Whether roadmap for the applicability of Ind AS as applicable to NBFCs also applies to the Company ABC Ltd., which performs role of NBFC however, it is not registered with the RBI?

Response: Rule 4(1)(iii) of the Companies (Indian Accounting Standards) (Amendments) Rules, 2016 lays down the roadmap for the applicability of Ind AS to NBFCs. As per the said rules, "Non-Banking Financial Company" means a Non-Banking Financial Company as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934 and includes Housing Finance Companies, Merchant Banking companies, Micro Finance Companies, Mutual Benefit Companies, Venture Capital Fund Companies, Stock Broker or Sub-Broker Companies, Nidhi Companies, Chit Companies, Securitisation and Reconstruction Companies, Mortgage Guarantee Companies, Pension Fund Companies, Asset Management Companies and Core Investment Companies."

In view of the above, it is pertinent to note that the above definition covers a company which is carrying on the activity of Non Banking Financial Company. The definition of NBFC is given under the RBI Act, 1934. Hence the company which is carrying on the activity of NBFC but not registered with RBI will also be subject to the roadmap for the applicability of Ind AS as applicable to any other NBFC. However, the requirements with regard to registration, eligibility of a company to operate as NBFC (pending registration) etc. are governed by the Reserve Bank of India Act, 1934 and Rules laid down thereon and should be evaluated by the entity based on its own facts and circumstances separately.

Issue 5: Can a company disclose operating profit on the face of Statement of Profit and Loss in accordance with Ind AS based Schedule III?

Response: As per Ind AS based Schedule III, aggregate of 'Revenue from operations' and 'Other income' is to be disclosed on face of the Statement of Profit and Loss. Revenue from operations is to be separately disclosed in the notes, showing revenue from:
(a) Sale of products (including Excise Duty);
(b) Sale of services; and
(c) Other operating revenues

The aggregate of 'Other income' is to be disclosed on face of the Statement of Profit and Loss. As per Note 5 of General Instructions for the Preparation of Statement of Profit and Loss 'Other Income' shall be classified as:
(a) interest Income;
(b) dividend Income; and
(c) other non-operating income (net of expenses directly attributable to such income).

Paragraph 9.1.8 of the Guidance Note on Ind AS based Schedule III, states that, "*The term "other operating revenue" is not defined. This would include Revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities.*"

Accordingly, disclosure of income shall be governed as stated above. Further it is also pertinent to note that Ind AS Schedule III sets out the minimum requirements for disclosure in the financial statements including notes. It states that line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the financial statements when such presentation is relevant to the understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements, apart from, when required for compliance with amendments to the Act or Ind AS.

As per the Guidance Note on Ind AS based Schedule III, the application of the above requirement is a matter of professional judgement. The following examples illustrate this requirement. Earnings before Interest, Tax, Depreciation and Amortisation is often an important measure of financial performance of the company relevant to the various users of financial statements and stakeholders of the company. Hence, a company may choose to present the same as an additional line item on the face of the Statement of Profit and Loss. The method of computation adopted by companies for presenting such measures should be followed consistently over the years. Further, companies should also disclose the policy followed in the measurement of such line items.

In respect of operating profit disclosure, certain items which are credited to profit and loss account may not form part of operating profit measure and therefore giving a separate line item for disclosure of the operating profit may not be appropriate and would result in change in the format of Statement of Profit and Loss as prescribed by Schedule III applicable to Ind

AS companies. It is also to be noted that Ind AS Schedule III and Ind AS requires classification of expense by nature and not function. The operating profit measure sub-total would result in a more appropriate presentation of performance for entities classifying expenses by function. Since classification of expenses by function is not permitted under Ind AS and Ind AS Schedule III, it may not be appropriate to present an operating profit measure sub-total as part of the statement of profit and loss. However, the entity may provide such additional information in the financial statements.

Issue 6: 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?

Response: 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.

Issue 7: Parent had 70% stake in subsidiary. The other investor invested additional funds in the subsidiary reducing the parent's stake to 60%. However, there was no loss of control by the Parent. How this partial deemed disposal should be accounted in the separate financial statements of the Parent assuming that investment in subsidiary is measured at cost. Also, state the accounting treatment in the consolidated financial statements?

Response: **Treatment in Separate Financial Statements of the Parent entity**

In the given case, in the separate financial statements of the parent entity there will not be any impact and investment in the subsidiary will continue to be recognised at its carrying amount. However, the fact that its shareholding has been reduced from 70% to 60% should be disclosed appropriately in the financial statements.

Treatment in Consolidated Financial Statements

As per paragraph 23 of Ind AS 110 *Consolidated Financial Statements*, changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners).

Thus, such transactions have no impact on goodwill or the statement of profit and loss.

Paragraph B96 of Appendix B to Ind AS 110 further provides that, when the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Non-controlling interests (NCI) are recorded at fair value (or proportionate share in the recognized amounts of the acquiree's identifiable net assets, if chosen) only at the date of the business combination. Subsequent purchases or sales of ownership interests when control is maintained are recorded at the non-controlling interest's proportionate share of the net assets.

As per paragraph 18 of Ind AS 112, *Disclosure of Interests in Other Entities*, an entity is required to present a schedule that shows the effects on the equity attributable to owners of the parent of any changes in its ownership interest in a subsidiary that do not result in a loss of control.

Issue 8: If a company has availed the option available under paragraph D13AA of Ind AS 101, i.e., to continue the policy adopted for accounting for exchange difference arising from translation of long-term foreign currency monetary items recognised in the previous GAAP financial statements, then will the foreign currency risk disclosure of Ind AS 107, *Financial Instruments: Disclosures* apply to such exchange differences so capitalised?

Response: As per paragraph 40(a) of Ind AS 107, *Financial Instruments: Disclosures*, amongst other disclosures, an entity is required to disclose a sensitivity analysis for each type of market risk, (which includes foreign exchange risk) as 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. If the company capitalises the exchange differences in the cost of asset, then too the company is exposed to foreign currency risk exposure and there could be an indirect impact in the profit and loss or equity, for example through depreciation. Accordingly, the company should provide appropriate disclosures where applicable under Ind AS 107 even though the company has availed the option under paragraph D13AA of Ind AS 101.

Issue 9: What will be the accounting treatment of dividend distribution tax in the consolidated financial statements in case of partly-owned subsidiary in the following scenarios:

Scenario 1: H Limited (holding company) holds 12,000 equity shares in S Limited (Subsidiary of H Limited) with 60% holding. Accordingly, S Limited is a partly-owned

subsidiary of H Limited. During the year 2017, S Limited paid a dividend @ ₹ 10 per share, amounting to ₹ 200,000 and DDT @ 20% amounting to ₹ 40,000.

Should the share of H Limited in DDT paid by S Limited amounting to ₹ 24,000 (60% ₹ 40,000) be charged as expense in the consolidated profit and loss of H Limited?

Response: Since H Limited is holding 12,000 shares it has got ₹ 1, 20,000 as dividend from S Limited. In the consolidated financial statements of H Ltd., dividend income earned by H Ltd. and dividend recorded by S Ltd. in its equity will both get eliminated as a result of consolidation adjustments. Dividend paid by S Ltd. to the 40% non- controlling interest (NCI) shareholders will be recorded in the Statement of Changes in Equity as reduction of NCI balance (as shares are classified as equity as per Ind AS 32)

DDT of ₹ 40,000 paid to tax authorities has two components- One ₹ 24,000 (related to H Limited's shareholding and other ₹ 16,000 belong to non- controlling interest (NCI) shareholders of S Limited). DDT of ₹ 16,000 (pertaining to non- controlling interest (NCI) shareholders) will be recorded in the Statement of Changes in Equity along with dividend. DDT of ₹ 24,000 paid outside the consolidated Group shall be charged as tax expense in the consolidated Statement of Profit and Loss of H Ltd.

It may be noted that Issue 1 of ITFG Clarification Bulletin 9 provides that-

"In the consolidated financial statements of P Ltd., the dividend income earned by P Ltd. from S Ltd. and dividend recorded by S Ltd. in its equity will both get eliminated as a result of consolidation adjustments. DDT of INR 20,000 paid outside the consolidated Group i.e. to the tax authorities should be charged as expense in the consolidated statement of Profit and Loss of P Ltd."

The similar accounting treatment would be done in case of the partly-owned subsidiary:

In accordance with the above, in the given case CFS of H limited will be as under:

Transactions	**H Ltd.**	**S Ltd.**	**Consol Adjustments**	**CFS H Ltd**
Dividend Income (P&L)	120,000	-	(120,000)	-
Dividend (in Statement of Changes in Equity by way of reduction of NCI)	-	(200,000)	120,000	(80,000)
DDT (in Statement of Changes in Equity by way of reduction of NCI)	-	(40,000)	24,000	(16,000)
DDT (in Statement of P&L)	-	-	(24,000)	(24,000)

Scenario 2 (A): Extending the situation given in scenario 1, H Limited also pays dividend of ₹ 300,000 to its shareholders and DDT liability @ 20% thereon amounts to ₹ 60,000. As per the tax laws, DDT paid by S Ltd. of ₹ 24,000 is allowed as set off against the DDT liability of H Ltd., resulting in H Ltd. paying ₹ 36,000 (₹ 60,000 – ₹ 24,000) as DDT to tax authorities.

Response: If DDT paid by the subsidiary S Ltd. is allowed as a set off against the DDT liability of its parent H Ltd. (as per the tax laws), then the amount of such DDT should be recognised in the consolidated statement of changes in equity of parent H Ltd.

In the given case, share of H Limited in DDT paid by S Limited is ₹ 24,000 and entire ₹ 24,000 was utilised by H Limited while paying dividend to its own shareholders. Accordingly, DDT of ₹ 76,000 (₹ 40,000 of DDT paid by S Ltd. (of which ₹ 16,000 is attributable to NCI) and ₹ 36,000 of DDT paid by H Ltd.) should be recognised in the consolidated statement of changes in equity of parent H Ltd. No amount will be charged to consolidated Statement of profit and loss. The basis for such accounting would be that due to Parent H Ltd's transaction of distributing dividend to its shareholders (a transaction recorded in Parent H Ltd's equity) and the related DDT set-off, this DDT paid by the subsidiary is effectively a tax on distribution of dividend to the shareholders of the Parent company.

In accordance with the above, in the given case CFS of H limited will be as under:

Transactions	**H Ltd**	**S Ltd**	**Consol Adjustments**	**CFS H Ltd**
Dividend Income (P&L)	120,000	-	(120,000)	-
Dividend (in Statement of Changes in Equity)	(300,000)	(200,000)	120,000	(380,000)*
DDT (in Statement of Changes in Equity)	(36,000)	(40,000)	-	(76,000)*

*Dividend of ₹ 80,000 and DDT of ₹ 16,000 will be reflected as reduction from non-controlling interest.

(B) If in (A) above, H Limited pays dividend amounting to ₹ 100,000 with DDT liability @ 20% amounting to ₹ 20,000.

Response: In the given case, share of H Limited in DDT paid by S Limited is ₹ 24,000 out of which only ₹ 20,000 was utilised by H Limited while paying dividend by its own. Therefore balance ₹ 4,000 should be charged in the consolidated Statement of profit and loss.

In accordance with the above, in the given case CFS of H limited will be as under:

Transactions	H Ltd	S Ltd	Consol Adjustments	CFS H Ltd
Dividend Income (P&L)	120,000	-	(120,000)	-
Dividend (in Statement of Changes in Equity)	(100,000)	(200,000)	120,000	(180,000)*
DDT (in Statement of Changes in Equity)	-	(40,000)	4,000	(36,000)*
DDT (in Statement of P&L)	-	-	(4,000)	(4,000)

*Dividend of ₹ 80,000 and DDT of ₹ 16,000 will be reflected as reduction from non-controlling interest.

Scenario (3): Will the answer be different for the treatment of dividend distribution tax paid by associate in the consolidated financial statement of investor, if as per tax laws the DDT paid by associate is not allowed set-off against the DDT liability of the investor?

Response: Considering that as per tax laws, DDT paid by associate is not allowed set off against the DDT liability of the investor, the investor's share of DDT would be accounted by the investor company by crediting its investment account in the associate and recording a corresponding debit adjustment towards its share of profit or loss of the associate.

Issue 10: A company ABC Limited has issued compulsorily convertible debentures at 14.5 % coupon rate which will be converted at the end of 10 years. The unsecured loan market rate of interest is 14.5% (Assuming this rate can be considered as the appropriate market rate for the given purpose). Coupon rate on debentures is same as that of the market rate of interest although coupon rate on instruments with conversion feature is generally lower than market rate of interest on unsecured loans. How the financial liability (debt portion) would be computed in such situation. (It is assumed that the equity conversion option requires the company to deliver a fixed number of its own shares for a fixed amount of another financial asset indicating that it meets the 'fixed for fixed' criterion under Ind AS 32).

Response: As per Ind AS 32, *Financial Instruments: Presentation*, in case of compound financial instruments, it is required to separate it into two components, i.e., financial liability (debt) and equity component. When allocating the initial carrying amount of the compound instrument to the underlying financial liability and equity component, an entity first determine the fair value of the liability component (assuming there is no embedded derivative). The fair value of the liability component is determined with reference to the fair value of a similar stand-alone debt instrument. The amount allocated to the equity component

is residual amount after deducting the fair value of the financial liability component from the fair value of the entire compound instrument.

The application guidance of Ind AS 32 provides additional guidance on compound financial instruments from issuers' point of view.

AG31 A common form of compound financial instrument 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 derivative features. Paragraph 28 requires the issuer of such a financial instrument to present the liability component and the equity component separately in the balance sheet, as follows:

(a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. On initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into equity of the issuer. This option has value on initial recognition even when it is out of the money.

Basis above guidance, the fair value of the liability shall be the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option. The amount allocated to the equity component will be the residual amount after deducting the fair value of the financial liability component as determined above from the fair value of the entire compound instrument (for purpose of this issue, transaction costs have been ignored).

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