

Chapter 2

# Deferred taxes - compound financial instruments

**This article aims to:**

Explain with examples calculation of  
deferred taxes for compound financial  
instruments



Ind AS 12, *Income Taxes* is the standard that prescribes accounting for income taxes. It follows a balance sheet approach to determine the amount of deferred taxes.

Deferred tax is the amount of income tax payable (recoverable) in future periods as a result of past transactions or events.

The objective of Ind AS 12 notes that it is inherent in the recognition of an asset or a liability that the 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, then the entity recognises a deferred tax liability (deferred tax asset), with certain limited exceptions.

To measure deferred tax liability or deferred tax asset, an entity needs to identify a tax base and accounting base of its assets and liabilities on its balance sheet. The tax base of an asset or a liability is the amount attributed to that asset or liability for tax purposes.

Determination of tax base of the balance sheet items may not be straight forward and it could involve complex computation in some situations e.g. where tax consequences depends upon how carrying amounts are recovered or settled, items with multiple tax consequences, or compound financial instruments.

### Compound financial instrument

An instrument may contain both a financial liability (e.g. an obligation to make interest and/or scheduled principal payments) and an equity component (e.g. a conversion feature in a convertible bond). Such an instrument is a compound instrument.

An entity that issues a compound instrument applies split accounting and classifies the liability and equity components of the instrument separately as a financial liability and equity.

To allocate the initial carrying amount of a compound instrument to the underlying financial liability and equity components, an entity would need to first determine the fair value of the liability component. This includes any embedded derivatives - whether or not they have to be accounted for separately. The fair value of the liability component is determined with reference to the fair value of a similar stand-alone debt instrument (including any embedded non-equity derivatives) that does not have an associated equity component. The amount allocated to the equity component is the residual amount after deducting the fair value of the financial liability component from the fair value of the entire compound instrument.

Compound financial instruments include many types of financial instruments and most common ones are 'compulsorily convertible debentures' and 'optionally convertible debentures'.

### Temporary difference

A temporary difference is the difference between the tax base of an asset or liability and its carrying amount in the financial statements. Such a temporary difference will result in taxable or deductible amounts in future periods when the carrying amount is recovered or settled.

When analysing compound financial instruments, if there is a temporary difference between the carrying amount of a financial liability component and its tax base on initial recognition, then an entity would need to recognise the corresponding deferred tax.

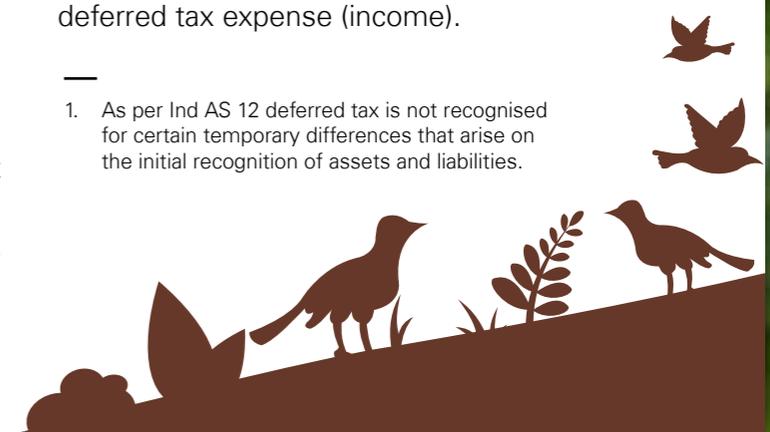
Ind AS 109, *Financial Instruments* requires on initial recognition a financial asset or financial liability is measured at fair value plus or minus directly attributable transaction costs, unless the instrument is classified as at fair value through profit or loss or is a trade receivable that does not have a significant financing component.

Normally, the fair value on initial recognition is the transaction price. However, on initial recognition of a compound financial instrument, Ind AS 32, *Financial Instruments: Presentation* requires an issuer to split compound financial instruments

(as mentioned above) into a financial liability and an equity component. Because of these requirements, the carrying amount of the financial liability component may not equal its par or nominal value.

Further, as per paragraph 23 of the Ind AS 12, in some jurisdictions, the tax base of the liability component on initial recognition is equal to the initial carrying amount of the sum of the liability and equity components. The resulting taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. Therefore, the initial recognition exemption<sup>1</sup> does not apply. Consequently, an entity recognises the resulting deferred tax liability and the deferred tax is charged directly to the carrying amount of the equity component. Subsequent changes in the deferred tax liability are recognised in profit or loss as deferred tax expense (income).

1. As per Ind AS 12 deferred tax is not recognised for certain temporary differences that arise on the initial recognition of assets and liabilities.



### Example 1 – Compulsorily convertible debentures

Company A issued compulsorily convertible debentures of INR1,000 to a third party investor and would be paying non-discretionary interest at 10 per cent in cash for 5 years. The debenture is mandatorily convertible into fixed number of equity shares at the end of 5 years. This instrument is a compound financial instrument and would need to be separated at inception between financial liability (interest strip) and an equity component (as a residual).

The following is the break-up of the compulsorily convertible debentures (before calculation of deferred tax:

Components	Amount (INR)
Liability (present value of INR500)	379
Equity	621
Interest cash outflows over the life of compulsorily convertible debenture, which will be tax-deductible when paid	500

(Source: KPMG in India's analysis, 2022)

As the instrument is compulsorily convertible into equity shares, nothing will be repaid on maturity. The cash outflow will be relating to interest component to the holders of this instrument. Therefore, the cash flow accounts both for the repayment of principal and for the interest on the liability recognised by company A. All of these cash flows are deductible for tax purposes in A's tax jurisdiction, where tax rate is 30 per cent.

The tax base of the liability component of the compulsorily convertible debenture would be zero. This is the difference between the carrying amount of the liability component (i.e. INR379), and all repayments deductible for tax purposes (i.e. INR500, which actually exceeds the carrying amount of INR379). INRIN379). This will result in deductible temporary difference of INR379 from initial recognition of the mandatorily convertible debenture. This difference will result in a deferred tax asset of INR 114 (379\*30 per cent) which would be recognised subject to recoverability in equity<sup>2</sup>.

Balance sheet item	Accounting base	Tax base	Deductible temporary difference	Deferred tax asset @30 per cent
Liability	379	0	379	114

(Source: KPMG in India's analysis, 2022)

2. In this case specific requirements on compound financial instruments override the initial recognition exemption.

Company A would recognise following accounting entry at the time of initial recognition of compulsorily convertible debenture:

	Debit (INR)	Credit (INR)
Bank	1,000	
Deferred tax asset	114	
Liability		379
Equity (balancing figure)		735

(Source: KPMG in India's analysis, 2022)



### Example 2 – Optionally convertible debentures

Company B issued optionally convertible debentures for proceeds of INR1,000 to a third party investor and would be paying non-discretionary interest at 10 per cent in cash. The term of the debentures is 5 years. They are convertible at the option of the holder into fixed number of equity shares at the end of 5 years. If not converted, they would be redeemed for INR 1,000 at the end of 5 years. This instrument is a compound financial instrument and would need to be separated at inception between financial liability and an equity component (as a residual).

The following is the break-up of the optionally convertible debentures (before calculation of deferred tax):

Components	Amount (INR)
Liability (present value of INR1,500)	832
Equity	168

(Source: KPMG in India’s analysis, 2022)

The tax base of the liability component of the optionally convertible debenture would be INR1,000. This will result in taxable temporary difference of INR168 from initial recognition of the optionally convertible debenture. This difference will result in a deferred tax liability of INR 50 (168\*30 per cent) which would be recognised in equity.

Balance sheet item	Accounting base	Tax base	Taxable temporary difference	Deferred tax liability @30 per cent
Liability	832	1,000	168	50

(Source: KPMG in India’s analysis, 2022)

Company A would recognise following accounting entry at the time of initial recognition of compulsorily convertible debenture:

	Debit	Credit
Bank	1,000	
Deferred tax liability		50
Liability		832
Equity (balancing figure)		118

(Source: KPMG in India’s analysis, 2022)

### Key consideration

Accounting for deferred taxes for compound financial instruments is a complex topic as it requires separation of components into financial liability and equity. Further, application of Ind AS 12 requires careful analysis to determine the tax base and accounting base of the liability component. This article shares only two examples to showcase the complexity in this area.

The types and features of compound financial instruments could vary and would require a detailed analysis for splitting the equity and financial liability components and corresponding tax base e.g. additional complexities may arise in relation to the accounting for deferred taxes on a convertible debenture issued by a subsidiary to an external party to the group and its accounting impact on the consolidated financial statements.

