Comments on Exposure Draft of Annual Improvements to IFRS Standards 2015-2017 Cycle

- Amendments proposed to clarify Income Tax consequences of payments on financial instruments classified as equity:

  We welcome and agree with the amendments proposed to clarify Income Tax consequences of payments on financial instruments classified as equity. The clarification that tax consequences of distribution of profits should be recognised in profit or loss for the period will make financial statements comparable across entities in a jurisdiction and across entities in different jurisdiction.

  In this regard, we draw attention to the recent FAQ issued by ASB of ICAI which clarified that the tax on distribution of profits should be recognised in equity based on recognition of dividends in equity and the tax mechanism in India. It may be noted that the Exposure Draft of IASB is based on recognition of items of income and expense that gives rise to profits and hence dividends and not recognition of dividends itself. Further, it specifically states that what is relevant is the tax effect and not tax mechanism. Our comments on that FAQ, are given below:

  1. Companies Act, 2013, requires dividends to be distributed only from profits. A company having accumulated losses cannot declare dividends. Therefore, in India, the basis for conclusions of IASB holds valid. Let us take a case of companies A Ltd. and B Ltd. Both have recognised profit after tax of Rs.100 crores. To keep things simple, it is assumed that there is no deferred tax as the carrying amount in balance sheet is equal to tax base. Further, the accounting profit is same as taxable profit. For this analysis, the requirement of transfer of profits to reserves rules have been ignored. A Ltd. distributes entire profit after tax of Rs.100 crores whereas B Ltd. does not distribute any dividends. In such a case, the total tax outgo of A Ltd. will be the regular corporate tax and dividend distribution tax. Assuming the corporate tax rate to be 35% and dividend distribution tax to be 15%, the total cash outflow due to tax is Rs.50 crores (Rs.35 crores being corporate tax and Rs.15 crores being Dividend Distribution Tax). Thus, effectively the company A Ltd. pays tax at 50% of the profits on transactions recognised in profit or loss whereas company B Ltd. is paying tax at 35% of the profits on transactions recognised in profit or loss. Thus, in India, income taxes are payable effectively at a higher or lower rate if part or all of the net profit or retained earnings is paid out as dividend to shareholders to the entity. As can be seen from the above analysis, the effective tax rate changes depending on whether a company distributes its profits. Therefore, the conclusion arrived at by ASB of ICAI as stated in point 3 above that the rate of income tax for company on taxable income does not change if a company distributes dividends is not proper.

2. One of the conclusion of ASB of ICAI is that, in India, the dividend distribution tax is a tax that is computed on the basis of the amount of dividends distributed to shareholders and it arises at the point of time when dividends are distributed. However, dividends can be distributed only out of realized profits. Therefore, as per paragraph 52B, proposed to be replaced by paragraph 58A, the tax consequences of distribution of profits should also be recognized in profit or loss. Further, ASB has concluded that, in India, dividends are not taxable in the hands of shareholders considering that DDT is paid by the company that paid the dividend which itself signifies that the dividend distribution tax should be recognised in profit or loss. The conclusion that had there been no DDT mechanism, dividend would have been taxable in the hands of recipients, though recently it has been made taxable if the amount of dividend exceeds a specific limit corroborates what paragraph 52A states. Because of DDT, a company's total tax outflow has increased. This also indicates that DDT should be recognised in profit or loss. The issue of DDT has arisen because of there being a mechanism of DDT. If there had been no such mechanism, the companies would have paid tax at 35% rather than 50%. Therefore, the argument of ASB of ICAI that DDT mechanism being brought into income tax act later than corporate tax cannot be considered to be a reason for recognising DDT in equity.

3. ASB of ICAI is of the view that DDT is, in substance, of the nature of withholding tax. For DDT to be withholding tax, the tax paid by the company should be refundable to shareholders. Tax deducted at source is an example of withholding tax. The DDT paid by the company is not refundable to all shareholders. The refund happens in case of holding - subsidiary relationship only. To that extent, the DDT may be considered as withholding tax. However, that too, needs some research to verify that if a subsidiary pays dividend, whether the holding company receives credit of the DDT paid by the subsidiary company in all cases or only in some specific circumstances. If the refund of DDT paid by the subsidiary is allowed only in specific circumstances then unless such conditions are existing as at the end of the reporting period, the DDT paid by the subsidiary should be recognised in profit or loss of the subsidiary.

4. On one hand, ASB of ICAI has concluded that the presentation of DDT paid on the dividends should be consistent with the presentation of the transaction that creates those income tax consequences and on the other hand it concludes that if the dividend is recognised in equity, the presentation of DDT should be consistent with the presentation of the dividend, i.e., to be recognised in equity. The transactions that create income tax consequences are recognised in profit or loss and dividend is paid out of profits of the company. Therefore, the conclusion that if dividend is recognised in equity, the presentation of DDT should be in equity is not proper. DDT creates tax outflow to the entity. DDT simply postpones the further tax liability on profits till the point of declaration to distribute. As explained above, if a company distributes entire profits, it will be paying

tax at a higher rate to the taxation authorities. The conclusion of ASB is based on form rather than on substance. Dividends are distributions to owners. Distributions to owners are always recognised in equity. A financial instrument when classified as financial liability, any contractual payments made on that financial instrument is, in substance, a payment of either principal or interest. The contract may term the payment as dividend but the payment is, in substance, interest payment. Interest payments are recognised in profit or loss and tax paid on the same results in increase of interest payments. Payments made on a financial instrument classified as equity can either be dividends or redemptions of equity. Dividends are not an expense and hence always recognised in equity. However, dividends are paid out of profits and the transactions giving rise to profits are recognised in the Statement of Profit or Loss. Therefore, the tax on dividends is, in substance, a further tax on profits that arises on distribution.

In view of the above, it can be concluded that DDT should be recognised in the Statement of Profit or Loss and not in Equity. DDT can be recognised in equity when the dividend is paid out of capital or when refund is available. What is worrying is whether such FAQs will result in further departures from IFRS and one day Ind AS will be transformed to Indian GAAP rather than being converged with IFRS. Drop by drop an ocean is filled. The mechanism of issuing FAQs is extremely opaque as the same is not put to the same rigours as exposure draft. Further, an issue arises that if an entity departs from FAQ would that result in departure from Ind AS. Would an entity to depart from FAQ, require to go through the rigours of paragraph 19 to 24 of Ind AS 1? FAQs are not authoritative in nature and therefore an entity may depart from an FAQ without going through the rigours of paragraph 19 to 24 of Ind AS 1. However, having said that, one becomes worried on the comparability and relevance of financial statements. The ICAI should address this at the earliest before issuing further FAQs. Further the paragraphs in FAQ should be serially numbered to provide ease of reference.

- Amendments proposed to clarify the inclusion of outstanding specific borrowing as general borrowings:
  We do not agree with the amendments proposed to clarify inclusion of borrowings made specifically to obtain a qualifying asset in general borrowings when that qualifying asset is ready for its intended use or sale. We give below our comments in this regard:

  1. Paragraphs 8 and 10 of IAS 23, *Borrowing Costs*, states as under:
     "8 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.
     10 The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When

an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified."

Just because borrowings that directly relate to a qualifying asset are outstanding after that qualifying asset is ready for its intended sale or use, the borrowing costs incurred on those borrowings do not become directly attributable to the acquisition, construction or production of another qualifying asset. The borrowing costs on a specific borrowing that is outstanding after the qualifying asset for which it was borrowed is ready for its intended sale or use would not have been avoided if the expenditure on another qualifying asset had not been made. Therefore, capitalising the borrowing costs incurred on specific borrowings after the qualifying asset to which they specifically related has been ready for its intended use or sale on another qualifying asset defeats the very principle of avoidable costs. If such is the intention of IASB, the principle of avoidable costs should be removed from the standard and IASB needs to devise a new principle for what could be regarded as directly attributable.

2. It is well established principle that the way a business is financed and the way a business is operated are independent of each other. Borrowing costs are period costs representing time value of money, credit risk and margins of the lender. It has nothing to do with item that is bought by using the borrowed funds. Therefore, borrowing costs should not affect the depreciation charge which is based on the pattern of consumption of asset and nothing to do with the interest risk. The capitalisation of borrowing costs distorts depreciation and inventory costs.
3. The concept of capitalisation permits hedge accounting without hedge accounting principles being followed as it changes the exposure to profit or loss from over the period of the borrowing to over the useful life of the qualifying asset. A borrowing creates interest rate exposure. However, capitalisation of interest on borrowing converts the interest exposure into depreciation exposure which misleads the reader of financial statements and impairs true and fair view. Therefore, all borrowing costs should be recognised in profit or loss for the period. IASB may consider to include appropriate hedge accounting principles in IAS 23 if it intends to continue with the principle of capitalisation of borrowing costs.
4. Paragraph 16(b) of IAS 16, *Property, Plant and Equipment* on Elements of Cost states as under:

   "16 The cost of an item of property, plant and equipment comprises:

   (a) …..

   (b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management

   (c) …."

Thus, for any costs to be considered as cost of an item of property, plant and equipment, it needs to satisfy the test of directly attributable and necessary. The incurrence of borrowing cost does not satisfy the second test of necessity. The principle of capitalisation of borrowing costs is based only on the first test of 'directly attributable' and hence is inconsistent with the principles enunciated in IAS 16. The IASB should either amend IAS 16 to remove the second test of necessity or amend IAS 23 to make it consistent with IAS 16 by including the principle of necessity. The impact of amending IAS 23 by including the principle of necessity will be that none of the borrowing costs shall be eligible for capitalisation as incurrence of borrowing costs is not necessary for the asset to be capable of operating in the manner intended by management.

- Amendments proposed to clarify the accounting for long-term interests in an associate or joint venture:
  We agree with the amendments proposed to clarify the accounting for long-term interests in an associate or joint venture and its effective date.

5B, ADHIKAR SOCIETY-1, NEAR 'D' CABIN, SABARMATI, AHMEDABAD, GUJARAT - 380019