Ind AS
Worked Example

Accounting Treatment of a
Repurchase Agreement

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SCENARIO

ABC Ltd's reporting period ends on 31 March every year. On 1 April 20x1, ABC Ltd sold a property it owned to a bank for CU 6,000 (market value CU 8,000). The net carrying amount of the property on 1 April 20x1 was CU 2,400. The remaining useful economic life of the property was 15 years from 1 April 20x1. ABC Ltd continued to occupy the property and was also responsible for its maintenance. ABC Ltd has the option to repurchase the property on 31 March 20x3. ABC Ltd's incremental borrowing rate is 10%. The applicable income tax rate is 40%.

Reliability and faithful representation

For financial statements to be of value to their users they must possess certain qualitative characteristics; reliability is one such important characteristic. Accounting information should be reliable. Reliability gives the user confidence and trust that the financial statements are a reasonable explanation of the actual items or events that have occurred. In order for financial statements to be reliable, they must faithfully represent an entity's underlying transactions and other events. Faithful representation is the correspondence between accounting figures and descriptions and the resources or events that these figures and descriptions represent. It is necessary that they are accounted for and presented in accordance with their *substance* and *economic reality* and not merely their *legal form.*

Substance over form

Substance is the reality of a transaction or situation as opposed to its form. *Substance over form* is an accounting concept whereby transactions and other events are accounted for and presented in accordance with their economic reality rather than their legal form. In accounting, substance should normally take precedence over form in deciding how a particular transaction should be recorded. For example, if an entity sells an asset without transferring the physical possession of that asset, and continues to enjoy the future economic benefits embodied in that asset, then the transaction is not represented faithfully by recording it as a sale. In fact, in all probability, the transaction is a financing arrangement.

WHAT THE STANDARD SAYS

Refer **paragraphs 66(b), B64, B67 – B69 of Ind AS 115**

Definition of a repurchase agreement

According to Ind AS 115, one of the forms of a repurchase agreement is that it is a contract in which an entity sells an asset and also has the option (either in the same contract or in another contract) to repurchase the asset. If an entity has an option to repurchase the asset, a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset.

Financing arrangement

Consequently, the entity should account for the contract as a financing arrangement if the entity can repurchase the asset for an amount that is equal to or more than the original selling price of the asset. It should be noted that when comparing the repurchase price with the selling price, an entity shall consider the *time value of money*.

According to Ind AS 115, if the repurchase agreement is a financing arrangement, the entity shall continue to recognise the asset and also recognise a financial liability for any consideration received from the customer. The entity shall recognise the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest. If the option lapses unexercised, an entity shall derecognise the asset; and also shall derecognise the liability and recognise revenue.

Accounting treatment

From the above, it can be comprehended that the repurchase transaction is to be treated as a financing arrangement that does not give rise to revenue. Therefore, no revenue would be recognised and the 'sale proceeds' would be treated as borrowing. The borrowing is to be treated as a financial liability measured at amortised cost with an effective interest rate of 10%. The property would remain an asset of ABC Ltd and depreciation under straight line method is to be charged. Since there will be a deductible temporary difference, a deferred tax asset is to be created through Profit and Loss.

For the reporting period ended on 31 March 20x2

1. *Recognition of sale proceeds as a financial liability –*

Cash		CU 6,000	
	Financial liability		CU 6,000

2. *Recognition of interest expense –*

Interest expense		CU 600 (CU 6,000 x 10%)	
	Financial liability		CU 600

3. *Depreciation of the property –*

Depreciation		CU 160 (CU 2,400 ÷ 15)	
	Property		CU 160

4. *Creation of deferred tax asset –*

Deferred tax asset		CU 240 (CU 600 x 40%)	
	Deferred tax income		CU 240

For the reporting period ended on 31 March 20x3

If the option is exercised

1. *Recognition of interest expense –*

Interest expense		CU 660 (CU 6,600 x 10%)	
	Financial liability		CU 660

2. *Depreciation of the property –*

Depreciation		CU 160 (CU 2,400 ÷ 15)	
	Property		CU 160

3. *Derecognition of financial liability –*

Financial liability		CU 7,260 (CU 6,000 + CU 600 + CU 660)	
	Cash		CU 7,260

4. *Derecognition of deferred tax asset –*

Tax expense		CU 240	
	Deferred tax asset		CU 240

If the option lapses unexercised

1. Same as before
2. Same as before
3. *Derecognition of property –*

Cost of sales		CU 2,080 (CU 2,400 – CU 160 – CU 160)	
	Property		CU 2,080

4. *Derecognition of financial liability and recognition of revenue –*

Financial liability		CU 7,260	
	Revenue		CU 7,260

5. *Creation of deferred tax asset –*

Deferred tax asset		CU 264	
	Deferred tax income		CU 264 (CU 660 x 40%)

6. *Derecognition of deferred tax asset –*

Tax expense		CU 504 (CU 240 + CU 264)	
	Deferred tax asset		CU 504