

ACCOUNTING FOR DEEP-DISCOUNT BONDS

under Ind AS



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INTRODUCTION

A deep-discount bond is a bond that sells at a significantly lesser value than its par value. For example, a deep-discount bond is issued at CU 750 – par value of which is CU 1,000. This means an investor will pay CU 750 to acquire a deep-discount bond but will get CU 1,000 at the end of a specified period (ie, the life of the bond, eg, 3 years). The difference between the redemption value and the issue price is the interest for the bond, ie, CU 250 (CU 1,000 – CU 750), in this case. Therefore, CU 750 is the present value of the cash flows needed (ie, CU 1,000) to fulfil the liability, applying a specified *effective interest rate* (ie, a rate that exactly discounts estimated future cash payments through the expected life of the financial liability).

ESSENCE OF DEEP-DISCOUNT BONDS

Deep-discount means a larger or greater than usual reduction in price. In particular, these bonds generally sell at a substantial discount to par and have a yield that is significantly higher than the prevailing rates of fixed-income bearing securities with a similar profile. A zero-coupon bond is an example, where total interest is paid at the end of the life of the bond. A company may issue such bonds when its credit rating is suddenly downgraded.

APPLICATION

The *Conceptual Framework for Financial Reporting under Ind AS* requires entities to prepare financial statements applying accrual accounting (ie, expenses that **should have been paid** and income that **should have been received** are to be recognised). Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Ind AS 12 *Income Taxes* requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves.

STANDARD REFERENCE

12 Income Taxes

32 Financial Instruments: Presentation

33 Earnings per Share

109 Financial Instruments

EXAMPLE

On 1st April 20x1, A Ltd. has 100 ordinary shares of CU 10 each and issues 10 deep-discount bonds of CU 75 each (face value CU 100 each). The bonds are redeemable on 1st April 20x4.

Additional information:

Profit before finance cost	CU 300 per year
Effective interest rate	10%
Income tax rate	40%

SOLUTION

The amount of interest of CU 250 (CU 1,000 – CU 750) is allocated among different reporting periods by applying effective interest rate, ie, 10%.

Unwinding of Deep-discount Bonds

Year	Opening Balance	Finance cost @ 10%	Closing Balance
20x2	750	75	825
20x3	825	83	908
20x4	908	92 (Bal. fig.)	1,000

The liability (CU 750) is the present value of the redemption amount (CU 1,000). The unwinding of the discount is recognised in profit and loss and classified as '**Finance cost**'.

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20x1–x2

Apr 1 20x1

- Cash CU 750
- Deep-discount bonds CU 750

Mar 31 20x2

- Finance cost CU 75 (10% of CU 750)
 - Deep-discount bonds CU 75
- Profit and loss CU 75
 - Finance cost CU 75
- Current tax expense CU 120 (**Note 1**)
 - Cash CU 120
- Tax expense CU 120
 - Current tax expense CU 120
- Deferred tax asset CU 30
 - Deferred tax income CU 30 (**Note 2**)
- Deferred tax income CU 30
 - Tax expense CU 30
- Profit and loss CU 90
 - Tax expense CU 90 (CU 120 – CU 30)

20x2–x3

Mar 31 20x3

- Finance cost CU 83 (10% of CU 825)
 - Deep-discount bonds CU 83
- Profit and loss CU 83
 - Finance cost CU 83
- Current tax expense CU 120 (Note 1)
 - Cash CU 120
- Tax expense CU 120
 - Current tax expense CU 120
- Deferred tax asset CU 33
 - Deferred tax income CU 33 (Note 2)
- Deferred tax income CU 33
 - Tax expense CU 33
- Profit and loss CU 87
 - Tax expense CU 87 (CU 120 – CU 33)

20x3–x4

Mar 31 20x4

- Finance cost CU 92 (10% of CU 908 – balancing figure)
 - Deep-discount bonds CU 92
- Profit and loss CU 92
 - Finance cost CU 92
- Current tax expense CU 120 (Note 1)
 - Cash CU 120
- Tax expense CU 120
 - Current tax expense CU 120
- Deferred tax asset CU 37
 - Deferred tax income CU 37 (Note 2)
- Deferred tax income CU 37
 - Tax expense CU 37
- Profit and loss CU 83
 - Tax expense CU 83 (CU 120 – CU 37)

20x4–x5

Apr 1 20x4

- Deep-discount bonds CU 1,000
 - Cash CU 1,000

Mar 31, 20x5

- Current tax expense CU 20 (Note 1)
 - Cash CU 20
- Profit and loss CU 120
 - Current tax expense CU 20
 - Deferred tax asset CU 100 (Note 3)

Deep-discount bonds

Date	Heads of Account	Carrying amount		
		Dr.	Cr.	Balance
20x1				
Apr 1	Cash		750	750
20x2				
Mar 31	Finance cost		75	825
20x3				
Mar 31	Finance cost		83	908
20x4				
Mar 31	Finance cost		92	1,000
20x5				
Apr 1	Cash	1,000	–	–

Balance Sheet as at 31 March (Extract)

	20x2	20x3	20x4	20x5
CU				
Equity and Liabilities				
<i>Equity</i>				
Share capital	1,000	1,000	1,000	1,000
<i>Non-current liabilities</i>				
Deep-discount bonds	825	908	–	–
<i>Current liabilities</i>				
Deep-discount bonds	–	–	1,000	–

Statement of Profit and Loss for the year ended 31 March (Extract)

	Note	20x2	20x3	20x4	20x5
CU					
Profit before finance cost		300	300	300	300
Finance cost		(75)	(83)	(92)	(–)
Accounting profit		225	217	208	300
Tax expense –					
Current tax expense	1	120	120	120	20
(Deferred tax income)	2	(30)	(33)	(37)	–
Deferred tax asset	3	–	(87)	(83)	100
Profit for the year (A)		135	130	125	180
Basic earnings per share (A ÷ number of shares)		1.35	1.30	1.25	1.80

FACTORS TO CONSIDER

- ✓ Cash proceeds from issuing bonds is a financing activity.
- ✓ Cash repayments to redeem bonds is also a financing activity.
- ✓ Interest paid may be classified as operating activity, because it enters into the determination of profit or loss. Alternatively, it may be classified as financing activity, because it is a cost of obtaining financial resources.

Statement of Cash Flows (Extract)

CU	
20x2	
Cash flows from financing activities	
Proceeds from issue of deep-discount bonds	750

CU	
20x5	
Cash flows from operating activities	
Interest on deep-discount bonds	(250)
Cash flows from financing activities	
Repayment of deep-discount bonds	(750)

Note 1: Current tax expense

	CU			
	20x2	20x3	20x4	20x5
Profit before finance cost	300	300	300	300
Finance cost allowed	(–)	(–)	(–)	(250)
Taxable profit	300	300	300	50
Current tax expense (@ 40%)	120	120	120	20

Note 2: Deferred tax income

For a liability, deferred tax income arises when the carrying amount of the liability is more than its tax base, which is its carrying amount, *less* any amount that will be deductible for tax purposes in respect of that liability in future periods (nil, ie, CU 750 – CU 0 = CU 750).

CU		
Year	(Carrying Amount – Tax Base) x Tax Rate	Amount to be recognised
20x2	(CU 825 – CU 750) = CU 75 x 40% = CU 30	30
20x3	(CU 908 – CU 750) = CU 158 x 40% = CU 63	33 (63 – 30)
20x4	(CU 1,000 – CU 750) = CU 250 x 40% = CU 100	37 (100 – 63)

Note 3: Deferred tax asset

		CU
Year	Calculation	Amount
20x5	CU (30 + 33 + 37)	100

CONCLUSION

A deep-discount bond has a *fulfilment value*, which provides information about the present value of the estimated cash flows needed to fulfil the liability ie, the redemption of the deep-discount bond. The change in the fulfilment value is reflected in 'expenses' in Profit and Loss. Hence, fulfilment value may have *predictive value* (ie, information about predicting future accounting numbers, particularly if the liability will be fulfilled).

Ind AS 12 *Income Taxes* requires a disclosure to show an explanation of the relationship between accounting profit and tax expense. For example, if the accounting profit is CU 100 and the income tax rate is 40%, then the tax expense should be CU 40 (CU 100 x 40%). Without the creation of deferred tax income, in this case, that relationship cannot be established.

There is no effect on the diluted earnings per share, since there is no change in equity share capital. For basic earnings per share, there is a decrease as the years pass, because interest is allocated among different years during the life of the bond in an ascending order.

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