Treatment of foreign exchange fluctuations and interest cost on issuance of FCCB

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A listed company (hereinafter referred to as the 'company' or the 'issuer') has issued Foreign Currency Convertible Bonds (FCCB) amounting to USD 25 million on 26 April, 2013 to a Singapore based entity (bondholders). The tenure of the FCCB is five years and one day.
2. The querist has stated that utilisation of FCCB has been done after receipt on 26.04.2013 and expected to complete by 31.03.2014. As per the relevant FCCB subscription agreement ('the agreement'), a copy of which has been provided by the querist for the perusal of the Committee, some of the relevant features of the FCCB are as below:
   - FCCB is convertible after five years and one day at a pre-determined rate of ₹218/- per share at a pre-determined rate of USD @ ₹54.16.
   - The rate of USD is open in case of repayment of FCCB but fixed in case of conversion into equity.
   - The purpose of FCCB is to make capital expenditure.
   - The present market price of the shares is ₹230 per share and are being traded at NSE and BSE.
3. The querist has stated that FCCB is convertible into equity at a pre-determined equity price and also on a pre-determined dollar rate meaning thereby that the number of shares to be issued are fixed at inception itself. As per the querist, though FCCB is convertible at the option of investors, as per Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', the impact of mark-to-market (M2M) on FCCB has to be incorporated in the accounts, it being monetary item but in view of convertibility into equity it falls under non-monetary item and as per accounting standard, the restatement of liability is not required. The querist has also stated that in view of pre-determined dollar rate, the number of shares have been fixed at inception and the entire transaction has become contingent; therefore, this transaction has to be dealt with as per Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets'. The querist is of the view that considering the principles of AS 29, there is a possible obligation but probably will not require outflow of resources due to pre-determined dollar price in case of issuance of equity, and, hence, no provision is to be recognised and only disclosure is required for contingent liability.
4. The querist has further stated that the amount of FCCB is meant for capital expenditure and is a pre-condition for raising FCCB as per RBI guidelines. Therefore, the total amount of interest on FCCB, whether used or yet to be used for capital expenditure, has to be capitalised.

B. Query

5. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
   (a) What should be the treatment of foreign exchange fluctuation on the reporting date in view of option to convert FCCB into equity after five years and one day at a pre-determined equity rate and a pre-determined USD rate?
   (b) What should be the treatment of interest on FCCB used for capital expenditure progressively from April 2013 to March 2014 on the reporting date?

C. Points considered by the Committee

6. The Committee notes that the basic issues raised by the querist relate to whether the FCCB should be considered as a monetary item or a non-monetary item considering that it is convertible into fixed number of equity shares at a pre-determined USD rate and the treatment of interest on FCCB. The Committee has, therefore, considered only these issues and has not considered any other issue that may arise

from the Facts of the Case, such as, treatment of foreign exchange fluctuations in case the company opts to exercise the option under paragraphs 46/46A of AS 11, premium on conversion of FCCBs, etc.

7. The Committee notes some of the relevant features of the FCCB as per the relevant FCCB subscription agreement ('the agreement'), a copy of which has been provided by the querist for the perusal of the Committee, as below:
   - The bonds constitute direct, unsubordinated and unconditional obligations of the issuer and shall at all times rank *pari passu* and without any preference or priority among themselves. The payment obligations of the issuer under the bonds shall, save for such exceptions as may be provided by mandatory provisions of applicable law and subject to certain covenants specified in the agreement, at all times rank at least equally with all of its other present and future direct, unsubordinated and unconditional obligations.
   - The bonds bear interest at the rate of 5.44 percent per annum which is payable semi-annually in arrears.
   - Unless previously redeemed, converted or purchased and cancelled as provided in the agreement, the issuer will redeem the bonds on the maturity date in year 2018. The issuer may not redeem the bonds at its option prior to that date except in case of occurrence of specific events, *i.e.*, change in control or delisting/ suspension of trading of company's shares, or events of default, as detailed in the agreement.
   - The repayment of principal and payment of interest to the bondholders would be in US$ only.
   - Bondholders have the right to convert their bonds into shares at any time during the 'conversion period' as per the agreement before the maturity date subject of the provisions of the agreement.
   - The number of shares to be issued on conversion of a bond will be determined by dividing the principal amount of the bond to be converted (translated into Rupees at the fixed rate of ₹54.16 = US$ 1.00) by the conversion price in effect at the conversion date.
   - The conversion price will initially be ₹218 per share but will be subject to adjustment in the manner specified in the agreement on occurrence of specific events, such as free distribution, bonus issue, division, consolidation, reclassification of shares, declaration of dividend etc. as described in the agreement.
   - No adjustment involving any increase in the conversion price will be made, except in the case of consolidation of shares.
   - The issuer shall use the proceeds of the offering of the bonds for capital expenditure, repayment of rupee loan and other eligible purposes in compliance with applicable law, and subject to receipt of all applicable approvals and consents (if required).

8. The Committee notes the following definition of 'monetary items' given in AS 11, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

   "7.11 <u>Monetary items</u> are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money."

   Further, paragraph 12 of AS 11 provides that cash, receivables, and payables are examples of monetary items.

9. The Committee notes from the above that the essence of the definition of monetary items is that, inter alia, the asset to be received or liability to be paid should be in fixed or determinable amounts of money. The Committee notes that in the extant case, the nature of FCCB is that of a loan taken by the company which is repayable in fixed amount of money after a fixed tenure. The bondholder has an option to settle the loan by receiving the equity shares of the company. Accordingly, the company is under an obligation to deliver a fixed amount of cash till the time conversion option is exercised by the bondholder. The bondholder has a right to receive the principal amount of FCCB along with the interest thereon till the time conversion option is exercised and the company has a corresponding obligation. Therefore, the nature of FCCB is of a loan till the time the option is exercised. In view of this, the Committee is of the view that the FCCB is in the nature of a monetary item within the meaning of AS 11 and accordingly, should be reported using the closing rate at the balance sheet date

considering the requirements of AS 11. In this regard, the Committee also notes that revised Schedule VI to the Companies Act, 1956 as well as Schedule III to the Companies Act, 2013 also require the presentation of bonds/debentures with conversion options, as a part of borrowings. Borrowings are considered as monetary items as per the provisions of AS 11.

10. The Committee also notes the contention of the querist that the entire transaction is contingent and should be dealt with under AS 29. The Committee is of the view that there is no uncertainty regarding the payment of convertible bonds. The principal amount as well as interest thereon to be paid is fixed-only the mode of settlement can be in cash or through issuance of shares in case conversion option is exercised by the bondholder. Considering this, the Committee is of the view that AS 29 is not relevant in the current context.
11. Another issue raised by the querist relates to the accounting treatment of borrowing costs on FCCB in the financial statements of the company. The Committee notes that AS 16 defines a 'qualifying asset' as ***"an asset that necessarily takes a substantial period of time to get ready for its intended use or sale".*** AS 16 further explains that ***"what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered".*** Considering the above, the Committee is of the view that the company first needs to determine whether capital expenditure being funded from FCCB meets the definition of a qualifying asset.
12. The Committee also notes paragraphs 6, 8 and 10 of AS 16, notified under the Rules, as below:

    "6. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred."

    "8. 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 enterprise 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."

    "10. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings."

    Accordingly, in the extant case, the company needs to evaluate the purpose of obtaining the FCCB, including the purpose/usage of rupee loan (which is proposed to be repaid by the proceeds from FCCB).
13. The Committee also notes paragraph 14 of AS 16 which deals with commencement of capitalisation as follows:

    "14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

    (a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;

    (b) borrowing costs are being incurred; and

    (c) activities that are necessary to prepare the asset for its intended use or sale are in progress."

    The Committee notes from the above that all the above conditions need to be satisfied for commencement of capitalisation. Therefore, merely the fact that the FCCB is meant for capital expenditure as per RBI guidelines and therefore, the total amount of interest on FCCB, *whether used or yet to be used for capital expenditure*, has

to be capitalised, as stated by the querist, would not be sufficient.

14. The Committee also notes that as per paragraph 4(e) of AS 16, borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Therefore, the company also needs to determine the portion of foreign exchange fluctuation, arising on the restatement of FCCB as at the reporting date, which can be considered as borrowing costs and treated accordingly.

D. Opinion

15. Based on the above, the Committee is of the following view on the issues raised in paragraph 5 above:
    (i) The FCCB should be considered as a monetary item and, accordingly, should be reported using the closing foreign exchange rate at each balance sheet date, as per the requirements of AS 11.
    (ii) The accounting treatment of interest cost on FCCB should be in accordance with paragraphs 11 to 14 above.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on June 6, 2014. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty three volumes. A CD of Compendium of Opinions containing thirty two volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.