Opinion

Treatment of Financial Liability under Ind AS 32 and Ind AS 109

The following is the opinion given by the Expert Advisory Committee of the ICAI 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 company (hereinafter referred to as 'the company') is a special purpose vehicle incorporated by consortium of (i) ABC Ltd., an ABC Group listed company (ii) XYZ Authority, a Government of Maharashtra undertaking and (iii) GEF Ltd. (technology partner).

2. Equity share capital of the company is ₹ 512 crore, held by the members of consortium as under:

   ABC Ltd. – 69%

   XYZ Authority – 26%

   GEF Ltd. – 5%

3. The company was awarded the responsibility to undertake the design, construction, operation and maintenance of the Mass Rapid Transit System (MRTS) for the Versova – Andheri - Ghatkopar corridor in Mumbai. XYZ Authority, on 7th March, 2007 granted the company a concession for a period of 35 years, for the exclusive rights to construct, operate and charge fares to users of the Mumbai Metro in accordance with the provisions of the concession agreement, at the end of which the company must transfer the rights, title and interest in the Mumbai Metro Project assets, in a serviceable condition, free of encumbrances to XYZ Authority.

4. The construction of the Metro Rail Project was completed and its commercial operations had commenced on 8th June, 2014. The project is fully operational since then.

5. Original project cost was estimated at ₹ 2,356 crore. However, due to delays, the project completion cost was escalated to ₹ 4,026 crore. The increase of ₹ 1,670 crore was financed by ABC Ltd. and a consortium of banks jointly.

6. As per agreed terms with the consortium of banks, ABC Ltd. was required to bring in funds towards promoter's share in increase in the project cost by way of interest free subordinated-debt (sub-debt). Further, repayment of this sub-debt can be made only after repayment of entire Rupee term loans to consortium of banks. The instalment repayments to consortium of banks are scheduled for next 22 years, till 2037.

7. The company has received ₹ 759 crore as interest free 'subordinated-debt' from ABC Ltd. till 31st March, 2016 to fund the project requirements. (Copy of audited financial statements for financial year (F.Y.) 2015-16 has been provided by the querist for the perusal of the Committee).The sub-debt is shown under 'Note 5 – Long Term Borrowings'.

8. The querist has stated that Indian Accounting Standards (Ind ASs) have come into effect from 1st April, 2016. The company being a subsidiary of ABC Ltd. is required to adopt the Ind ASs with effect from 1st April, 2016. Sub-debt, being a financial liability, is required to be accounted and disclosed as per the requirements of Indian Accounting Standard (Ind AS) 32, 'Financial Instruments: Presentation'. As mentioned earlier, sub-debt is interest free and repayable after repayment of entire Rupee term loans to consortium of banks, i.e., after 22 years. The querist has also separately clarified that subordinated debt is also non-convertible.

9. The following accounting treatment has been considered by the company in respect of accounting treatment of financial liability of ₹ 759 crore received as interest free sub-debt from ABC Ltd. (parent/holding company) in the books of the company:

   A. As at 31st March, 2015 (1st April, 2015), the amount of sub-debt received from ABC Ltd. aggregated ₹ 715 crore. The querist has fair valued the same on 31st March discounting the sub-debt based on the discounting rate applicable and accounted for the said sub-debt at fair value of ₹ 42.69 crore (as against the book value of ₹ 715 crore) since the amounts are estimated to

be repayable only after 22 years. The company has passed the following entry to give effect to the fair valuation:

Date	Particulars	Debit	Credit
01-04-2015	Subordinate debt from ABC Ltd.	672.31 cr	
	To Contribution received (Other equity)		672.31 cr
	(Being fair value recognized as on 31st March, 2015)		

B. Thus, sub-debt is shown at a fair value of ₹ 42.69 crore at the beginning of the financial year (F.Y.) 2015-16. During the F.Y. 2015-16, a further sub-debt of ₹ 44 crore was received from ABC Ltd. in 2 instalments, which was also fair valued as mentioned above and the following entries are passed to give effect of the fair valuation:

30-06-2015	Subordinate debt from ABC Ltd.	24.01 cr	
	To Contribution received (Other equity)		24.01 cr
	(Being fair value of ₹ 1.98 crores recognized as on 30th June, 2015 for additional 26 crores received from parent company)		

31-03-2016	Subordinate debt from ABC Ltd.	16.56 cr	
	To Contribution received (Other equity)		16.56 cr
	(Being fair value of ₹ 1.44 crores recognized as on 31st March, 2016 for additional 18 crores received from parent company)		

10. The querist has also accounted for the finance costs for the unwinding of fair value as on 31st March, 2015 (1st April, 2015); 31st March, 2016 and 30th June, 2016.

11. Presently, the difference in fair value of the subordinated debt and the book value is disclosed as 'Other equity' under the heading 'Equity'.

12. Further on the basis of additional information supplied by the querist it is observed that all financial liabilities classified as subsequently measured at amortised cost.

B. Query

13. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the above accounting treatment and presentation is in line with Ind AS 32 / Ind AS 109. Also whether there is any other way of presentation for the interest free sub-debt received from the parent company.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised by the querist relates to accounting treatment and presentation of interest free sub-debt from the holding company ABC Ltd. in the books of the company. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, e.g., accounting for term loan taken from the consortium of banks, discounting rate applicable for discounting the sub-debt for arriving at its fair value or amortised cost, taxation implications including deferred tax etc. At the outset, the Committee wishes to point out that the opinion expressed, hereinafter is in the context of financial statements for the financial year 2016-17 and it is presumed from the Facts of the Case that the company has not voluntarily opted for preparation of financial statements from the financial year 2015-16. Thus, the date of transition to Ind ASs for the company as per the requirements of Ind AS 101, First-time Adoption of Indian Accounting Standards is 01-04-2015.

15. The Committee is of the opinion that based on the facts available in the extant case, that the interest free sub-debt received by the subsidiary company from the holding company is repayable after 22 years it should be treated as a financial liability. Further, the Committee assumes that there are no other factors which will render the interest free sub debt into equity or compound financial instrument.

16. The Committee notes the following requirements of Ind AS 109 and Ind AS 113 as follows:

Ind AS 109:

"4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:

(a) *financial liabilities at fair value through profit or loss.* Such liabilities, including *derivatives* that are liabilities, shall be subsequently measured at fair value.

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 3.2.15 and 3.2.17 apply to the measurement of such financial liabilities…"

5.1.1 At initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.

5.1.1A However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph B5.1.2A."

"B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and Ind AS 113). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset."

"B5.1.2A The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also Ind AS 113). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:

(a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability."

Ind AS 113:

60. If another Ind AS requires or permits an entity to measure an asset or a liability initially at fair value and the transaction price differs from fair value, the entity shall recognise the resulting gain or

loss in profit or loss unless that Ind AS specifies otherwise."

"B4 When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

(a) The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

(b) …"

From the above, the Committee notes that at initial recognition, financial liability is recognized at fair value (plus transaction costs, if any in case of financial liability not at fair value through profit or loss), which is normally the transaction price. However, where the transaction price of a financial liability is different from its fair value, such as, in case of interest free loan, the same has to be valued at fair value, which, as per above-reproduced paragraph B5.1.1, can be measured at the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Further, the subsequent measurement of such financial liability shall be at amortised cost and interest shall also be accrued in each reporting period, on such amortised cost calculated on the basis of effective interest rate.

17. With regard to the difference in the fair value at the initial recognition and transaction price, the Committee notes that paragraph 60 of Ind AS 113 states that if "the transaction price differs from fair value, the entity shall recognise the resulting gain or loss in profit or loss unless that Ind AS specifies otherwise." Further, paragraph B5.1.1 of Ind AS 109, reproduced above states that "if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset." From the above, the Committee is of the view that the difference in the fair value and transaction price should be recognized as gain or loss in the statement of profit and loss unless it qualifies for recognition as some other element. In this context, the Committee notes the definitions of 'Income' and 'Expense' as per the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards as follows:

"70. The elements of income and expenses are defined as follows:

(a) Income increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants."

The Committee notes from the above that income or expense is any increase or decrease in economic benefits during the accounting period, other than those relating to contributions from or distributions to equity participants, respectively. Thus, the transactions with equity participants cannot be recognized as income or expense; rather these should be recognized as equity. In the extant case, the interest-free debt is provided by the parent company in its capacity as equity participant and accordingly, the Committee is of the view that at the time of initial recognition and measurement of interest free subordinated loan provided by the holding company to the subsidiary, the difference between the transaction price and fair value should be recognized as equity contribution from the holding company rather than as an income or expense (profit or loss) and should be appropriately disclosed under 'other equity' in the financial statements considering the requirements of Schedule III to the Companies Act, 2013.

18. The Committee further notes the following paragraphs of Ind AS 101, First-time Adoption of Indian Accounting Standards, which states as follows:

"6 An entity shall prepare and present an *opening Ind AS Balance Sheet* at the *date of transition to Ind ASs*. This is the starting point for its accounting in accordance with Ind ASs subject to the requirements of paragraphs D13AA and D22."

"Date of transition to Ind ASs	The beginning of the earliest period for which an entity presents full comparative information under Ind ASs in **first Ind AS financial statements."** (Appendix A to Ind AS 101)

"7 An entity shall use the same accounting policies in its opening Ind AS Balance Sheet and throughout all periods presented in its first Ind AS financial statements. Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, except as specified in paragraphs 13–19 and Appendices B–D."

"9 The transitional provisions in other Ind ASs apply to changes in accounting policies made by an entity that already uses Ind ASs; they do not apply to a *first-time adopter's* transition to Ind ASs, except as specified in Appendices B–D."

"12 This Ind AS establishes two categories of exceptions to the principle that an entity's opening Ind AS Balance Sheet shall comply with each Ind AS:

(a) paragraphs 14–17 and Appendix B prohibit retrospective application of some aspects of other Ind ASs.

(b) Appendices C–D grant exemptions from some requirements of other Ind ASs."

"18 An entity may elect to use one or more of the exemptions contained in Appendices C-D. An entity shall not apply these exemptions by analogy to other items."

From the above, the Committee notes that on the date of transition, viz., 01. 04. 2015, the company shall prepare an opening Ind AS balance sheet and use the accounting policies which shall comply with each Ind AS effective at the end of its first Ind AS reporting period, except as specified in paragraphs 13–19 and Appendices B–D. Accordingly, the Standard requires retrospective application of accounting policies unless there is specific exemption/exceptions in the Standard from such retrospective application. In this regard the Committee notes that the prescriptions in paragraph B8C and D20 of Ind AS 101 would also be relevant in case it is impracticable for the company to apply effective interest rate with retrospective effect. Considering the fact that company has chosen to classify the financial liability as subsequently measured at amortised cost and the loan transactions of recent period the Committee assumes that the company has decided not to avail any exemption/ relaxation under Ind AS 101.

D. Opinion:

19. On the basis of above, the Committee is of the opinion that the company should follow the following accounting treatment:

(a) As stated in paragraph 19 above the difference between the fair value and transaction price of interest free subordinated debt at the date of initial recognition shall be taken to other equity.

(b) Interest expense from the date of initial recognition of liability till Ind AS transition date that would have been recognised using effective interest rate method shall be debited to retained earnings as of 01-04-2015,

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 23rd August, 2017. 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 five volumes. A CD of Compendium of Opinions containing thirty five 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'.
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