Query No. 25

Subject: ***Treatment of 'prepayment penalty' incurred for foreclosure of existing loan and availing new loan/borrowings***[1].

A. Facts of the Case

1. A company is into the business of development of retail mall and residential real estate project. The company has constructed a retail mall in Coimbatore by taking project finance term loan of Rs. 180 crore from consortium of banks led by the Central Bank of India. Project finance carries interest rate of 13.5%. The tenor of the loan was 10 years and at this point of time balance period of loan is 6.5 years. Shops in mall are given on rent to various national and international brands. As per business model, the company avails project finance for construction of mall and once mall is completed, leasing is done. Project finance loan is refinanced by taking lease rent discounting (LRD) term loan from banks. Project finance carries high rate of interest (13.5% p.a.), whereas, lease rental discounting loan is available at lower rate of interest (9% p.a.).

2. The querist has stated that the company has got sanction of LRD (lease receivable discounting) loan from bank (new bank) for Rs. 200 crore at the rate of interest 9% p.a. The objective of fresh loan is to refinance high cost current project finance debt (existing loan) taken from other banks (existing bank). The current outstanding amount of loan is around Rs. 165 crore with rate of interest 13.5% p.a. As per sanction terms with new bank, they have directly discharged outstanding amount of present loan from the existing bank. As per sanction terms with existing bank, prepayment penalty of 1%-2% is applicable on foreclosure of loan. According to the querist, b*y settlement of existing loan and paying prepayment penalty, the company gets many business benefits, such as, lower rate of interest, additional funds, enhancement of loan tenor and reduction in monthly installment.* It is the business model of the company to take project finance loan during construction of property to be leased and once property is ready to use for leasing, project finance loan (costly loan) is repaid by availing LRD loan (cheaper rate of interest loan). The company has carried out the cost-benefit analysis of the transaction and concluded that benefits received by the company by availing new loan facility outweigh the costs incurred in closing/repayment of the existing loan (i.e. the benefits of new loan are multiple times of prepayment penalty as per business model of company). *If these benefits (reduced rate) are not available, the company will not prepay the loan and pay prepayment penalty to existing banks. Commercial rationale of swapping the loan was to avail net benefit of reduced rate post prepayment penalty.* (Emphasis supplied by the querist.)

3. The querist has further stated that Indian Accounting Standard (Ind AS) 109, 'Financial Instruments' defines transaction costs as "*Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.* The company has availed the loan from its existing bank at a very high rate of interest (i.e. 13.5% p.a.), which requires the company to incur substantial amount of interest expense, while higher amount of loan based on credit

[1] Opinion finalised by the Committee on 5.6.2018 & 6.6.2018.

rating of the company is available in the market at a lower rate of interest which has been offered by the another bank (i.e. 9% p.a.). *It is clear from the business perspective that the company has incurred the 'prepayment charges' only to avail new loan which is available at significantly reduced rate. The company would not have incurred the prepayment penalty/charges, if it would not have availed the newly available reduced rate of loan.* (Emphasis supplied by the querist.)

4. *Objective of availing loan at reduced rate was after considering the charges, if any in the form of pre-payment penalty along with reduced rate, hence by calculating net effective rate for the company post such loss and gain on transaction.* Every prudent business entity would like to utilize its resources to the optimum level and would like to avoid all the avoidable/unnecessary expenses. Since the market lenders are willing to provide better credit facility, in the form of higher amount of loan at a substantially lower interest rate than the current borrowing terms and regulations which were provided by the existing lender / bank; as per the cost-benefit analysis carried out by the company, the benefits available after availing the borrowing from the new lender surely outweigh the cost to be incurred in foreclosure of the exiting loan (i.e., 1%-2% of outstanding loan amount). (Emphasis supplied by the querist.)

5**.** According to the querist, it is a known fact that accounting shall represent the language of the business, which in substance, will be post considering the business prudence including management intention and estimates under the framework of relevant laws and accounting standards applicable. Careful analysis of the definition of the transaction cost suggests that transaction cost shall only be an incremental cost (*i.e., the cost which would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument).* As discussed above, management intends to incur the 'prepayment penalty' *only* to avail the new loan facility and would not have incurred the same if the company would not have received the substantial benefits from the new loan facility. *This means that such prepayment penalty/charges may be considered as in the nature of an incremental cost which may be said to be directly attributable to the acquisition of a financial liability in the form of new loan/borrowing. This can also be demonstrated since* new bank has paid off the old loan paid directly, in substance all such cost incurred was part of the same transaction. (Emphasis supplied by the querist.)

6. Paragraph 5.1.1 of Ind AS 109 states that *except for trade receivables within the scope of paragraph 5.1.3, "***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"**. As per the querist, since the new loan is a financial liability; on its initial recognition it shall be measured at fair value minus the *transaction costs that are directly attributable to the acquisition of a financial liability* and subsequently measured at amortized cost as per effective interest rate (EIR) method. Paragraph B 5.4.4 of Appendix B to Ind As 109 states that "When applying the effective interest method, an entity generally amortises any fees, points paid or received, *transaction costs* and other premiums or discounts that are included in the calculation of the effective interest rate over the expected life of the financial instrument. (Emphasis supplied by the querist.)

7. The querist has also stated that Ind AS Transition Facilitation Group (ITFG) has issued a guidance in response to similar query raised, but one needs to appreciate the facts and business rationale. This case is quite different in terms of how the company operates, and as mentioned, the company always structures its finance in such a way that the company moves from higher loan (initial stage of our business) to a lower rate by accepting pre-payment penalty, since the company, in its business, accepts the new loan rate after adjusting the penalty charges. The company's comparison of loan rate among different banks at initial stage always considers (a) coupon rate and (b) prepayment penalty, since the company is aware at the beginning itself that the company will transfer the loan at lower rate once business is developed for that project. Based on above, management believes that as per above discussion and guidance, it may be directionally guided that the prepayment penalty incurred by the company to foreclose the exiting loan facility may be treated as the transaction cost for availing the new loan facility which shall be amortized over the expected life of the financial instruments. According to the querist, if prepayment charges are recognised in the statement of profit and loss, then this accounting treatment as per matching concept of accounting may not be appropriate as the benefits of incurring prepayment charges (interest savings on new loan) will accrue over period of new loan.

B. Query

8. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to what shall be the accounting treatment of the 'prepayment penalty' incurred for foreclosure of existing loan and availing new loan/borrowing?

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting treatment of the 'prepayment penalty' incurred for foreclosure of existing loan (from existing bank) and availing new loan/borrowing (from new bank). The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for the existing or new loan, calculation of effective interest rate, etc. Moreover, the opinion expressed hereinafter is from the perspective of Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended till date.

10. At the outset, the Committee wishes to highlight the following requirements of Ind AS 109 with regard to accounting for the existing/ original financial liability:

(a) Paragraph B.4.3.5(e) of Ind AS 109 states that a prepayment option embedded in a host debt contract is not closely related to the host the contract unless it meets the one of criterion (two criteria) prescribed in the paragraph. Depending on the management's assessment as to whether prepayment option is closely related to the host contract, other accounting consequences should follow. In other words, an embedded derivative which is not closely related to the host debt contract will need to be separated and accounted for as standalone derivate contract.

(b) Ind AS 109 defines the term 'effective interest rate' as "The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments)." This requires that effective interest rate on a loan should be calculated considering prepayment and other related terms.

Since the company has not raised any specific issue with regard to separation of prepayment option and in the absence of detailed information on accounting for the existing loan, the Committee refrains itself from commenting further on the existing loan accounting. Rather, it is presumed that while accounting for the existing loan, the company has duly considered and ensured due compliance with the above requirements.

11. In the context of the issue raised, the Committee notes the definition of transaction costs as per Appendix A to Ind AS 109, as follows:

> "Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument."
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> "B5.4.8 Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs."
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> **5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, 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."**

From the above, the Committee notes that transaction costs are the incremental costs which are directly attributable to the acquisition or disposal of a financial liability. Further, the Committee notes that at the time of initial recognition, financial liability shall include only the transaction costs that are directly attributable to the acquisition or issue of the new financial liability and not the transaction cost of disposal of the existing financial liability. The Committee is of the view that prepayment penalty in the extant case is the transaction cost of disposal of the existing financial liability (loan) which is payable to the existing loan provider rather than the incremental cost of acquisition or issue of the new financial liability (new loan) from a different new bank. The Committee is further of the view that such a penalty is incurred to extinguish the existing liability and to get the benefits due to lower cost liability (loan) and not for acquiring the new financial liability (loan). Therefore, such penalty cannot be treated as directly attributable to the acquisition of the new financial liability. Accordingly, the Committee is of the view that prepayment penalty in the extant case cannot be considered as transaction cost of the new loan; rather should be treated as transaction cost of extinguishment of existing loan, which in accordance with paragraph 5.7.2 of Ind AS 109 should be recognized as part of the gain or loss on extinguishment/derecognition of the old loan in the statement of profit and loss. In this context, the Committee notes the requirements of paragraph 5.7.2 as follows:

> **"5.7.2 A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 6.5.8–6.5.14) shall be recognised in profit or loss when the financial asset is derecognised, reclassified in accordance with paragraph 5.6.2, through the amortisation process or in order to recognise impairment gains or losses. An entity shall apply paragraphs 5.6.2 and 5.6.4 if it reclassifies financial assets out of the amortised cost measurement category. A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 6.5.8–6.5.14) shall be recognised in profit or loss when the financial liability is derecognised and through the amortisation process. (See paragraph B5.7.2 for guidance on foreign exchange gains or losses.)"**

D. Opinion

12. On the basis of the above and subject to any adjustment arising from paragraph 10, the Committee is of the view that prepayment penalty of an existing loan in the extant case cannot be considered as transaction cost of the new loan; rather should be treated as transaction cost of extinguishment of existing loan, which in accordance with paragraph 5.7.2 of Ind AS 109 should be recognized as part of the gain or loss on extinguishment/derecognition of the old loan in the statement of profit and loss, as discussed in paragraph 11 above.