Computation of Effective Interest Rate on Borrowings

A. Facts of the Case

1. A company is a leading public sector undertaking in India operating in the power sector. To finance the capital expenditure, the company borrows term loan from multilateral/bilateral agencies such as World Bank, Asian Development Bank and KfW etc.

2. The company entered into a loan agreement (a copy of which has been supplied by the querist for the perusal of the Committee) for Euro 500 million with a foreign lender for financing its projects. The loan agreement with the lenders sets out the rate of interest and fees payable by the company to the lenders. This loan is guaranteed by the Government of India (GOI) for due and punctual payment of the principal, interest and other charges through separate guarantee agreement.

3. The company is required to pay an initial guarantee fee to the GOI on the sanctioned amount and thereafter subsequent guarantee fee is payable on first April of every year on the amount outstanding at the beginning of the year as per the office memorandum of Ministry of Finance, Government of India (a copy of which has been supplied by the querist for the perusal of the Committee).

4. As per the company's accounting policy, financial liabilities are recognised at fair value minus transaction costs that are directly attributable to the issue of financial liabilities. After initial recognition, financial liabilities are subsequently measured at amortised cost using the effective interest rate method. Amortised cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the effective interest rate (EIR).

5. During the audit of accounts for the financial year (F.Y.) 2017-18, Government auditor made an observation that the company did not consider subsequent guarantee fee for the purpose of calculation of effective rate of interest on borrowing while the same should be considered for calculation of effective rate of interest on borrowing in line with Indian Accounting Standard (Ind AS) 109, 'Financial Instruments.' Auditor referred, *inter alia*, to paragraphs 5.4.1, B5.4.1, and B5.4.2 of Ind AS 109 in his audit query.

6. The querist has stated that Appendix A to Ind AS 109, *inter alia*, states that 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. (Emphasis supplied by the querist.)

7. According to the querist, a perusal of the above clearly shows that for calculating the effective interest rate, only cash flows arising under the loan agreement towards interest and fees payable to the lenders are to be considered. Since *guarantee fee is not payable to the lenders, but it is payable to the Government of India,* the same should not be considered for the purpose of computing the effective interest rate. (Emphasis supplied by the querist.)

8. Paragraph B5.4.2 of Appendix B to Ind AS 109 states as follows:

   "B5.4.2 Fees that are an integral part of the effective interest rate of a financial instrument include:

   (a) origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.

   (b) …

   (c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part

of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services."

As per the querist, the definition of origination fee as per the above-reproduced paragraph B5.4.2 of Ind AS 109 is the upfront/front-end/arrangement fee levied by lenders for providing the loan facility and is also a means to improve their overall returns on the loan. The reference to guarantee in paragraph B5.4.2 is in the context of the nature of activities performed by lender such as *"evaluating and recording guarantees, collateral and other security arrangements" and does not refer to guarantees provided by third parties.* As such, guarantee fees payable to the GOI is not the origination fee as per paragraph B5.4.2 and should not be considered for computation of the effective interest rate. (Emphasis supplied by the querist.)

9. The querist has further stated that as per paragraph B5.4.8 of Appendix B of Ind AS 109, "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." The initial guarantee fee is considered as a transaction cost in terms of paragraph B5.4.8 above and has been considered for computation of effective interest rate. The company pays subsequent guarantee fee on first April of every year on the loan amount outstanding at the beginning of the year. The company considers the subsequent guarantee fee, as in the nature of *holding cost* of the loans in line with above paragraph. Subsequent guarantee fee is a periodical cost and is expensed / capitalised in the period in which it accrues. Accordingly, it is not included in the calculations of effective interest rate. (Emphasis supplied by the querist.)

B. Query

10. On the basis of above, the querist has sought an opinion from the Expert Advisory Committee of the Institute of Chartered Accountants of India as to whether subsequent guarantee fee paid to the Government of India as stated above should be considered for computation of effective interest rate in compliance with the provisions of Ind AS 109.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised in the query relates to accounting for guarantee fee paid to the Government of India in relation to the loan taken from the foreign lender. 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 loan obtained by the bank, measurement of amortised cost of the loan, EIR computation etc. At the outset, the Committee notes that the financial liability in the extant case is being subsequently measured at amortised cost using the effective interest rate method.

12. The Committee notes the following clauses of loan agreement between the company and KfW:

"2.1 After all conditions precedent to disbursement according to Article 11 have been fulfilled, KfW will disburse the Loan in accordance with the progress of the Project and upon request of the Borrower. …"

"Article 7

Guarantee

As security for this Loan, India, acting by its President (Guarantor) will enter into a separate guarantee agreement (Guarantee Agreement) with KfW prior to the first disbursement from the Loan."

"Article 10

Events of Default

10.1 KfW shall be entitled without having to resort to any legal procedure whatsoever to suspend disbursement or to terminate this Loan and to demand immediate payment of all amounts payable under this Loan Agreement, if any event constituting an important reason under German Law ("Event of default") shall occur, such as:

a) …

c) this Loan Agreement or the Guarantee or any parts thereof cease to have a binding effect upon the Borrower or the Guarantor or ceases to be enforceable against the Borrower or the Guarantor;

…"

"Article 11

Conditions Precedent

The obligation of KfW to make disbursements of any amount under this Loan Agreement shall be subject to satisfaction of the following conditions precedent:

11.1 The following documents have been submitted to KfW not later than 2 months after the date of signing of this Loan Agreement but in any case prior to the initial disbursement date without any cost for KfW and have been accepted by it as satisfactory in form and substance:

a) …

f) original of the Guarantee Agreement mentioned in Article 7 duly executed by the Guarantor has been submitted to KfW;"

From the above, the Committee notes that guarantee provided by the GOI in the extant case is a pre-condition for obtaining and continuing with the loan facility as per the loan agreement. Hence, as long as the loan continues, guarantee will also continue and therefore, during the term of loan, the guarantee is not cancellable.

13. Further, with regard to the issue raised regarding accounting for guarantee fee, the Committee notes the following paragraphs of Ind AS 109:

"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."

"5.3.1 After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 4.2.1–4.2.2."

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

"amortised cost of a financial asset or financial liability The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**."

"effective interest method 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)."

"transaction costs 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."

"Effective interest method

B5.4.1 In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

B5.4.2 Fees that are an integral part of the effective interest rate of a financial instrument include:

(a) origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.

(b) commitment fees received by the entity to originate a loan when the loan commitment is not measured in accordance with paragraph 4.2.1(a) and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.

(c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services."

"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."

The Committee notes from the above that *fees paid or received between parties to the contract* that are an integral part of the effective interest rate and transaction costs are to be considered while applying effective interest method. Further, the fees that are an integral part of the effective interest rate of a financial liability include the origination fee paid on issuing such liability. Accordingly, the Committee is of the view that the origination fee referred above is applicable in the extant case if the fees is paid/received between the parties to the contract (viz., lender and the borrower in case of a loan). Since the guarantee fee (initially as well as subsequently) in the extant case is not paid between the lenders and

the borrowers, the Committee is of the view that the same cannot be considered as 'fees paid or received between parties to the contract that are an integral part of the effective interest rate'. The Committee further notes that transaction costs are incremental costs that are directly attributable to the acquisition or issue of a financial liability and an incremental cost is one that would not have been incurred if the entity had not acquired or issued the financial instrument. In this context, the Committee is of the view that the guarantee fee paid (initially as well as subsequently) in the extant case is an incremental cost which is directly attributable to the acquisition of the loan facility as this cost would not have been incurred if the company had not incurred the loan liability. Accordingly, the Committee is of the view that the financial guarantee fee paid (initially as well as subsequently) by the company should be considered in the extant case for computation of effective interest rate while measuring the loan liability at amortised cost in compliance with the provisions of Ind AS 109.

D. Opinion

14. On the basis of the above, the Committee is of the opinion that the financial guarantee fee paid (initially as well as subsequently) by the company should be considered in the extant case for computation of effective interest rate while measuring the loan liability at amortised cost in compliance with the provisions of Ind AS 109.

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 January 08, 2019. 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 six volumes. A CD of Compendium of Opinions containing thirty six 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. ■