

Query No. 1

Subject: *Accounting for funded interest term loan (FITL) subsequent to restructuring of a loan taken from a shareholder.¹*

A. Facts of the Case

1. XYZ Ltd. (hereinafter referred to as ‘the company’) is a pharmaceutical manufacturing unit, which is a subsidiary of A Ltd. (74% share) and B Ltd. (26% share). Annual turnover of XYZ Ltd. for the financial year (F.Y.) 2016-17 is INR 77.66 crore and it is not listed on any recognised stock exchange. However, XYZ Ltd. is required to adopt Indian Accounting Standards (Ind ASs) from F.Y. 2016-17 onwards, with the date of transition to Ind AS being 1st April 2015.

2. XYZ Ltd. had taken loans from B Ltd. (which is also a financial institution) from 2002-03 to 2007-08. During this period, the company was unable to pay interest on the loan amount. So after discussion with B Ltd., an agreement dated 14th September 2009 (the agreement) was signed with B Ltd., as per which, B Ltd. had converted the unpaid interest into a funded interest term loan (interest-free loan) of amount INR 2,77,40,554.

3. The total loan related to this interest was INR 3,75,32,873.44 detailed as below:

Principal Loan	Interest Rate
2,00,00,000.00	12.50%
1,25,00,000.00	12.50%
18,00,000.00	12.00%
13,36,586.00	10.00%
11,92,128.97	10.00%
7,04,158.47	12.00%
3,75,32,873.44	

4. Interest amounting to INR 2,77,40,554 on the above loans was converted into a Funded Interest Term Loan (FITL) which was interest-free and had to be repaid in instalments as per the schedule stipulated in the agreement (a copy of which has been supplied by the querist for the perusal of the Committee).

5. According to the querist, the effective interest rate was determined as per Ind AS and the requisite adjustments were made in the financial statements for the F.Y. 2016-17. (A copy of the working of the effective interest rate and summary of treatment given in the financial statements have also been supplied by the querist for the perusal of the Committee.)

6. The auditors of the Comptroller and Auditor General of India (CAG) observed in their review of the company’s financial statements, that the interest-free loan should be fair valued

¹ Opinion finalised by the Committee on 5.6.2018 and 6.6.2018.

by discounting all future cash flows at the market interest rate as per Ind AS 113 and the resultant gain should be recognised in the profit and loss account for the F.Y. 2015-16 along with the imputed interest cost on the discounted loan amount.

7. The company's contention was that though the FITL is separated from the main term loan, for calculation of effective interest rate, it should be taken as a part of the original term loan and effective interest rate should be determined accordingly.

8. The company has provided an undertaking to the CAG that it would seek an expert opinion from the Expert Advisory Committee for determination of the correct accounting treatment for the transaction as per the requirements of Ind ASs.

B. Query

9. Accordingly, the company has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment followed by the company is in consonance with Ind ASs and if not, the company has requested the Committee to suggest the correct accounting treatment for the aforesaid transaction.

C. Points considered by the Committee

10. At the outset, the Committee notes the following relevant information from the agreement dated 14th September 2009, between the company and B Ltd. and other documents supplied by the querist:

- (i) XYZ Ltd. had taken various loans from its shareholder, B Ltd., which is a financial institution and a Government of Goa undertaking, as follows:
 - a. Term loan of INR 2,00,00,000 vide agreement dated 02.02.1995
 - b. Term loan of INR 5,00,00,000 vide agreement dated 09.12.2005
 - c. Various unsecured loans to meet financial requirements from time to time; outstanding amount was INR 1,75,32,873.44 as on 31.03.2009
 - d. New term loan towards settlement of XYZ Ltd.'s bank loan and for implementation of a voluntary retirement scheme (VRS) for its employees. This new term loan of INR 2,00,00,000 at an interest rate of 12.5% per annum was sanctioned vide letter dated 23.03.2009 and was disbursed in two instalments of INR 1,22,66,000 on 14.09.2009 and INR 77,34,000 pursuant to a financial restructuring package for XYZ Ltd.'s existing liabilities to B Ltd.
- (ii) The company was unable to pay interest on its outstanding term loans and unsecured loans and was granted a financial restructuring package by B Ltd. vide agreement dated 14th September 2009 as follows:

- a. The outstanding unsecured loan of INR 1,75,32, 873.44 merged with the outstanding (old) term loan of INR 2,00,00,000, making a total of INR 3,75,32,873.44 (known as the 'first outstanding amount') would be payable in 12 quarterly instalments from 01.04.2010 to 01.01.2013. This outstanding amount would carry an interest of 10% per annum with effect from 01.04.2009 to be paid quarterly along with the instalments.
 - b. The outstanding interest on the unsecured loan amounting to INR 92,82,749.23 as on 31.03.2004 and interest of INR 1,84,57,804.77 on the old term loan referred to in 10(i) above, calculated at 10% per annum from 01.04.2004 until 31.03.2009; totalling to INR 2,77,40,554 (known as the 'second outstanding amount') was converted into a Funded Interest Term Loan (FITL). B Ltd. agreed not to charge any further interest on this FITL with effect from 01.04.2009. The FITL would be repaid in 9 quarterly instalments with effect from 01.04.2013 until 01.04.2015.
 - c. The outstanding (old) term loan of INR 5,00,00,000 (known as the 'third outstanding amount') would be repaid in 11 quarterly instalments from 01.07.2015 to 01.01.2018. Interest on this outstanding amount would not be remitted by the company until the same is being reimbursed by the Government of Goa to B Ltd. However, in the event, the reimbursement of the interest is not received from the Government, the company would be required to pay interest at 12.5% per annum in 11 quarterly instalments on the third outstanding amount from the last date of reimbursement of interest received from the Government.
- (iii) The repayment schedule agreed in the financial restructuring package mentioned in point (ii) above, was further revised on 19.03.2011 to extend the repayment timelines for the first, second and third outstanding amounts, as well as reduce the interest rate applicable to the third outstanding amount from 12.5% per annum to 10% per annum. The revised schedule also reduced the interest rate applicable to the new term loan to 10% per annum, however, it provided for earlier repayment of this new term loan.
- (iv) On transition to Ind ASs, the company has computed the effective interest rate (EIR) under Ind AS 113, 'Fair Value Measurement' for the first outstanding amount of INR 3,75,32,873 and the FITL of INR 2,77,40,554, considering the cash inflows and outflows under the revised repayment schedule. Further, the company has adjusted the loan balance outstanding in its financial statements on transition to Ind ASs to reflect the amortised cost based on the EIR computed as per this method. This adjustment resulted in an increase in the loan balance of INR 15,81,314 as on 1st April 2015, with similar consequential adjustments being made to the loan amount as on 31st March 2016.
- (v) The CAG auditors observed that the interest-free loan (being the FITL) should be fair valued by discounting all future cash flows at the market interest rate as

per Ind AS 113 and the resultant gain should be recognised in the profit and loss account for the F.Y. 2015-16. Accordingly, the CAG observed that the company's borrowings and other income and profit for the F.Y. 2015-16 were overstated by an amount of INR 64,69,313, being the difference between the FITL amount and its present value at a discount rate of 10%.

- (vi) The querist's contention was that the FITL is not a loan sanctioned by B Ltd. Rather, it is the unpaid interest on a term loan, which the company has defaulted on. On restructuring, the interest accrued until the date of restructuring was converted into the FITL in a manner similar to that of banks or financial institutions assisting borrowers with stressed cash flows. Therefore, this was a modification of the terms of repayment with a change in the timing of cash flows. Ind AS 109, 'Financial Instruments', specifically deals with such cases. The company has, therefore, viewed the FITL as a part of the term loan and computed the EIR based on the combined revised cash flows of the term loan as well as the FITL.

11. The Committee notes that the main issue raised in this query relates to the measurement of the FITL (being the second outstanding amount) from B Ltd. at amortised cost on the date of transition to Ind AS. Specifically, whether the company's approach to determining the EIR and the resulting amortised cost based on the combined, revised repayment schedule relating to the first and second outstanding amounts, is appropriate. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, including the measurement of the third outstanding amount and the new term loan from B Ltd. Accordingly, the querist should separately determine the appropriate accounting treatment for the other outstanding loan amounts based on relevant considerations under Ind AS. The Committee has also not considered whether 10% discount rate used by the company for calculating fair value is appropriate. The same should be estimated by the company in accordance with Ind AS 113 principles.

12. The Committee further notes that the borrowing from B Ltd. is a financial liability of XYZ Ltd. It is assumed that the same is not held for trading nor it otherwise meets criteria for designation at fair value through profit or loss under Ind AS 109. Hence, it should be subsequently measured at amortised cost. Appendix A to Ind AS 109 defines the amortised cost of a financial instrument as the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortization 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. The effective interest rate is "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.**"

The amount at which a financial liability (classified at amortised cost) is to be initially recognized under Ind AS 109 is its fair value plus or minus any transaction costs that are

directly attributable to the issue of the financial liability. (Refer paragraph 5.1.1 of Ind AS 109)

13. XYZ Ltd. has obtained the loan from B Ltd. prior to its date of transition to Ind ASs. Hence, Ind AS was not applicable at the time of initial recognition of the borrowing. Therefore, the Committee considers that a key issue is to determine the appropriate recognition and measurement requirements for this liability on transition to Ind ASs. Ind AS 101, 'First-time adoption of Indian Accounting Standards' provides guidance on transition to Ind ASs. Paragraph 10 of Ind AS 101 states that "Except as described in paragraphs 13-19 and Appendices B-D, an entity shall, in its opening Ind AS Balance Sheet:

- (a) recognise all assets and liabilities whose recognition is required by Ind ASs;
- (b) not recognise items as assets or liabilities if Ind ASs do not permit such recognition;
- (c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind ASs; and
- (d) apply Ind ASs in measuring all recognised assets and liabilities."

14. XYZ Limited entered into a financial restructuring agreement with B Ltd. in 2009, in which it converted the interest accrued and due to B Ltd. into a funded interest term loan. Further, it has extended the repayment term of its first outstanding amount. As a result of this restructuring transaction, under previous GAAP, the company derecognised the interest accrued and recognised the FITL as an unsecured term loan, under 'long term borrowings' in its financial statements. Based on the terms given including different interest rates and repayment terms, they continue to be separate loans and cannot be treated as one loan. The Committee notes that under Ind AS 109, the company would have been required to assess whether the modification in the terms of the borrowings would result in their derecognition and the recognition of a new liability. However, paragraph 13 and Appendix B of Ind AS 101 prohibit retrospective application of some aspects of other Ind ASs. The Committee notes that paragraphs B2 and B3 of Ind AS 101 provide as follows:

"B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in Ind AS 109 prospectively for transactions occurring on or after the date of transition to Ind ASs. For example, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to Ind ASs, it shall not recognise those assets and liabilities in accordance with Ind ASs (unless they qualify for recognition as a result of a later transaction or event).

B3 Despite paragraph B2, an entity may apply the derecognition requirements in Ind AS 109 retrospectively from a date of the entity's choosing, provided that

the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.”

15. From the above and assuming that the company in the instant case has not exercised the option under B3, the Committee is of the view that since the company had already derecognised the interest liability and recognised the borrowing pursuant to the FITL under previous GAAP, on transition, the company should not reassess whether the derecognition of accrued interest on the old loans and recognition of the new loans (including the FITL) would have been appropriate under Ind AS. Further, the company’s approach to determining the EIR and the resulting amortised cost based on the combined, revised repayment schedule relating to the first and second outstanding amounts, is not appropriate. This is because various facilities continue to be separate loans with their own interest and repayment terms.

16. However, paragraph 10(d) of Ind AS 101 requires an entity to apply Ind ASs retrospectively in measuring all *recognised* financial assets and liabilities on transition. All financial liabilities as per Ind AS 109 are initially recognised at their fair value plus transaction costs, if any. Since the FITL is an interest-free loan, the Committee notes that the company would have to determine its fair value on initial recognition (i.e., at the time of the financial restructuring), being its discounted present value based on the prevailing market interest rate (for a similar instrument as to currency, term, type of interest rate and other factors with a similar credit rating) at the time of initial recognition. An issue which therefore arises is the nature of, and appropriate accounting treatment under Ind AS for the difference between the nominal amount of the FITL and its initial recognition amount (i.e. its fair value). In this regard, the Committee notes paragraph B 5.1.1 of Appendix B of Ind AS 109, which states as follows:

“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 AS113). 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.”

17. From the above, the Committee is of the view that based on reading of paragraph B 5.1.1 of Appendix B of Ind AS 109, the difference between the amount lent and the fair value of an interest-free loan is generally recognised as a gain or loss unless it qualifies for recognition as an asset or liability or some other element. The Committee further notes that in the present instance, the loan is from a shareholder, B Ltd. (which is also a financial

institution), to its associate, XYZ Ltd. If the querist determines that, in substance, B Ltd. is acting in its capacity of a shareholder by providing financial support in the form of interest-free funding (due to financial difficulty of its associate), the difference between the FITL amount and its fair value may be recognized in equity by the company. This is because, in substance, the interest-free element may be construed as a contribution by a shareholder to the company. The interest-free element of the loan may, in such a case, be considered as a non-reciprocal capital contribution by B Ltd., acting in its capacity as a shareholder. However, if the querist determines based on the specific facts and circumstances that B Ltd. is acting as a lender (i.e., similar to an unrelated lender) providing financial restructuring package to its borrower due to financial difficulty, then under Ind AS 109, the difference between the FITL amount and its fair value would generally be recognised in profit or loss, unless it qualifies for recognition as an asset or liability.

18. The amortised cost on the date of transition would then be determined by unwinding the discount for the period from the date of initial recognition to the transition date. The resultant adjustment, related to the unwinding of the discount, should be recognised in retained earnings on transition.

19. The Committee notes that another issue to consider in the extant case is whether the loan provided by B Ltd. may be considered a government loan as B Ltd. is a government entity, i.e., whether B Ltd. is acting in its capacity as Government. In this regard, the Committee notes that paragraph B10 of Ind AS 101, *inter alia*, states that “Except as permitted by paragraph B11, a first-time adopter shall apply the requirements in Ind AS 109, *Financial Instruments*, and Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, prospectively to government loans existing at the date of transition to Ind ASs and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant. Consequently, if a first time adopter did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with Ind AS requirements, it shall use its previous GAAP carrying amount of the loan at the date of transition to Ind ASs as the carrying amount of the loan in the opening Ind AS Balance Sheet. An entity shall apply Ind AS 109 to the measurement of such loans after the date of transition to Ind ASs”.

20. The Committee further notes that paragraph 3 of Ind AS 20, ‘Accounting for Government Grants and Disclosure of Government Assistance’, *inter alia* states that **“Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity”**. The Committee notes that the FITL is an interest-free loan extended by B Ltd. to the company as a consequence of a financial restructuring package due to financial difficulty. The interest-free benefit is therefore not in the nature of government assistance or benefits provided to similar entities in general. There are no further terms or conditions attached to the receipt of this benefit that need to be complied with by the company. These factors indicate that B Ltd. is not acting in its capacity as Government in providing the interest-free FITL to the company. Hence, the FITL does not meet the definition

of a government grant. Therefore, the Committee is of the view that the interest-free element of the loan extended by B Ltd. to the company is not in the nature of government assistance or a government grant and the exemption from fair valuation of government loans under Ind AS 101 would not apply in the extant case.

D. Opinion

21. On the basis of the above, the Committee is of the following opinion on the issue raised by the querist, relating to the measurement of the FITL (being the second outstanding amount) in paragraph 9 above:

- a. The company is not required to reassess whether its derecognition of the old term loan and the interest accrued and due thereon and the recognition of a new term loan (including the interest-free FITL) on modification of the contractual terms is appropriate under Ind AS, due to the first-time adoption exemption, as discussed in paragraph 15 above. Further, the company's approach to determining the EIR and the resulting amortised cost based on the combined, revised repayment schedule relating to the first and second outstanding amounts, is not appropriate.
- b. Considering the requirements of Ind AS 109, the company is required to determine the fair value of the FITL on the date of the financial restructuring, as its initial recognition amount, as discussed in paragraph 16 above.
- c. If the querist determines that B Ltd. was acting in its capacity as a shareholder when providing interest-free financial support to the company, the difference between the nominal amount and the initial recognition amount of the FITL should be recognised in an appropriate component of equity on transition to Ind AS. However, if the querist determines that B Ltd. is acting as a lender, then the difference between the nominal amount and the initial recognition amount of the FITL would generally be recognised in the statement of profit or loss, as discussed in paragraph 17 above.
- d. The amortised cost of the FITL on the date of transition to Ind AS should be determined by unwinding the discount from the date of initial recognition to the transition date. The unwinding of the discount should be recognised as an adjustment in retained earnings on transition.
- e. The benefit of an interest-free loan provided by B Ltd., a government undertaking, is not in the nature of a government grant or government assistance, since B Ltd. is not acting in its capacity as Government in this case. Therefore, the exemption from fair valuation of a below-market rate government loan on first-time adoption of Ind ASs would not apply to the FITL, as discussed in paragraph 20 above.