

Query No. 5

Subject: Treatment of investments in units of equity mutual funds under Ind AS 109.¹

A. Facts of the Case

1. X Ltd. is a company incorporated in India and its shares are listed on Bombay Stock Exchange and National Stock Exchange. It is engaged in software services and has made investments in financial assets which are essentially in the form of investments in Fixed Maturity Plans, Liquid Mutual Funds, Equity Mutual Funds, Tax Free Bonds, and Preference Shares.

2. The classification and accounting treatment of the financial assets is dealt with in Indian Accounting Standard (Ind AS) 109, 'Financial Instruments'. A financial asset can fall into one of the following three categories (see Section 4.1 of Ind AS 109) based on the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset:

- Measured at amortised cost
- Measured at fair value through other comprehensive income
- Measured at fair value through profit or loss

An entity's business model for managing financial assets could be holding the financial assets in order to collect the contractual cash flows or selling the financial assets or both (see paragraph B4.1.2A of Ind AS 109).

Measured at amortised Cost:

Paragraph 4.1.2 of Ind AS 109 is reproduced below:

“4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:

- (a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and**
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions.”

Although the objective may be to hold financial assets to collect contractual cash flows, the entity need not hold all of those instruments until maturity. The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the asset's credit risk (see paragraphs B4.1.3 and B4.1.3A of Ind AS 109).

Measured at fair value through other comprehensive income:

Paragraph 4.1.2A of Ind AS 109 is reproduced below:

“4.1.2A A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:

¹ Opinion finalised by the Committee on 4.1.2018.

- (a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions.”

Measured at fair value through profit or loss:

Paragraph 4.1.4 of Ind AS 109 is reproduced below:

“4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5-5.7.6).”

As per paragraph 5.7.5 of Ind AS 109, the equity instrument should not be held for trading, if election is made to present fair value changes in other comprehensive income.

3. The scope of Ind AS 32, ‘Financial Instruments: Presentation’ includes financial instruments issued by an entity that meet the definition of an equity instrument. The following extracts from paragraph 11 of Ind AS 32 are relevant in this regard:

“A *financial asset* is any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right
 - (i) to receive cash or another financial asset from another entity; or
 - (ii) ...
- (d) ...”

“An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.”

Examples of equity instruments include instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. (See paragraph AG13 and paragraphs 16C and 16D of Ind AS 109).

4. Equity mutual funds are open-ended equity schemes which aim to generate capital appreciation, generally long-term, to unitholders through investment in equity and equity related securities. The Scheme Information Document discloses the investment objective, risk factors and other information about the scheme. (Sample Consolidated Scheme Information Document for various open-ended equity funds has been furnished by the querist for the perusal of the Committee). The Asset Management Company (hereinafter referred to as ‘the AMC’) invests in equity and equity related securities on behalf of mutual fund. A unitholder of the mutual fund participates in the investment through subscription of units, whose underlying value is derived from such investments in

equities. In a broader economic sense, investment in equity mutual fund is similar to direct investment in equity. The investor indirectly carries similar risks as they would carry when investing directly in equity. However, if one were to limit by the accounting definition used in Ind AS 32, residual interest in the assets of the entities invested by the mutual fund would be with the mutual fund and not with the unitholder. This is, however, a pass through and the residual benefits or otherwise indirectly flow to the investor in the units (X Ltd. in this case) eventually. It is important to note that X Ltd. generally holds the investments in equity mutual funds for capital appreciation rather than benefit out of trading.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee as to whether the investments in equity mutual funds can be treated as investments in equity instruments for the purpose of application of Ind AS 109 and whether in such case the fair value changes of such investments can be routed through other comprehensive income.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised by the querist relates to treatment of investments in *units* of certain equity mutual funds (hereinafter referred to as ‘investments in equity funds’) as investments in equity instruments with possible recognition of fair value changes in other comprehensive income in accordance with Indian Accounting Standard (Ind AS) 109, ‘Financial Instruments’, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended till date (hereinafter referred to as ‘the Rules’). 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. The Committee notes that investments in units of mutual funds meet the definition of financial assets given in paragraph 11 of Ind AS 32, ‘Financial Instruments: Presentation’, notified under the Rules, (reproduced by the querist in paragraph 3 above). At the outset, the Committee wishes to point out that Asset Management Company (hereinafter referred to as ‘the AMC’) and the mutual funds managed by the AMC are distinct entities. Hereinafter, any reference to AMC should be understood in the context of relevant funds managed by the AMC. The Committee presumes that X Ltd. has not designated any investment in the equity funds in a hedging relationship. Further, the Committee presumes that X Ltd. has not designated any investment as measured at fair value through profit or loss to eliminate or significantly reduce a measurement or recognition inconsistency, as permitted in paragraph 4.1.5 of Ind AS 109. From the sample Consolidated Scheme Information Document for various open-ended equity funds furnished by the querist, the Committee notes that a portion of investments of a particular Scheme can be in debt instruments also. (The Committee presumes that X Ltd. invests in open-ended equity funds only and, hence, hereinafter, unless otherwise stated, any reference to equity funds is made in the context of open-ended equity funds only). The options under the Schemes could be growth option and dividend option with dividend payout and dividend reinvestment sub-options. Distribution of dividend and the frequency of distribution will depend, inter-alia, on the availability of distributable surplus and will be entirely at the discretion of the Trustee. Redemption and switch-out are possible. ‘Lock-in’ period is applicable only for Tax Plan under ‘Equity Linked Saving Scheme Guidelines’. Generally, redemption is at ‘Net Asset Value’ of the units, subject to ‘exit load’, if applicable.

7. The Committee notes paragraphs 4.1.4, 5.7.5 and 5.7.6 of Ind AS 109, reproduced below:

“4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5-5.7.6).”

“5.7.5 At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is neither *held for trading* nor contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 applies. (See paragraph B5.7.3 for guidance on foreign exchange gains or losses.)

5.7.6 If an entity makes the election in paragraph 5.7.5, it shall recognise in profit or loss dividends from that investment in accordance with paragraph 5.7.1A.”

Further, the Committee notes the definition of equity instrument given in Ind AS 32, and reproduced by the querist in paragraph 3 above. In addition, the Committee notes that as an *exception*, paragraph 11 of Ind AS 32 requires certain financial instruments meeting the *definition* of a financial liability to be *classified* as equity instrument by the *issuer* in accordance with paragraphs 16A-16D of that Standard. (Paragraphs 16A-16B of Ind AS 32 deal with certain ‘puttable instruments’ while paragraphs 16C-16D of Ind AS 32 deal with certain instruments imposing a contractual obligation on the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation). Subject to meeting the prescribed conditions, it is possible that units of equity mutual funds may meet the conditions prescribed by paragraphs 16A-16D of Ind AS 32 and the mutual fund issuing such financial instruments should, subject to applicable regulatory requirements, classify such units as its equity instruments. The term ‘equity instruments’ in paragraph 4.1.4 of Ind AS 109, reproduced above, is italicised, which means that it is a defined term. Appendix A of Ind AS 109 makes cross-reference to paragraph 11 of Ind AS 32 for the definition of that term.

8. The Committee notes that the exceptions given in paragraphs 16A-16D of Ind AS 32 do not change the fundamental definition of equity instrument given in that Standard. Paragraph 18(b) of Ind AS 32, which specifically cites the example of open-ended mutual funds, and paragraph 19 of Ind AS 32 might give an impression as if financial instruments classified as equity instruments in accordance with paragraphs 16A-16D of Ind AS 32 also meet the definition of equity instrument. However, this is not conveyed by paragraph 11 of Ind AS 32, which, inter alia, reads, **“As an exception, an instrument *that meets the definition of a financial liability* is classified as an equity instrument, if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D”**. [Emphasis, supplied by the Committee]. Appendix A to Ind AS 109 (‘Defined terms’) makes cross-reference to Ind AS 32 for the *definition* of equity instrument and states, inter alia, that the term ‘equity instrument’ is used in Ind AS 109 with the meaning specified in Ind AS 32. Accordingly, only investments that meet the definition of equity instrument of the issuer, as given in Ind AS 32 can be considered as investment in equity instruments for the purposes of paragraphs 4.1.4 and 5.7.5 of Ind AS 109. As per paragraph 16 of Ind AS 32, the basic feature of an equity instrument is absence of

contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer. This is in line with the definition of financial liability given in paragraph 11 of Ind AS 32, which reads as below:

“A *financial liability* is any liability that is:

(a) a contractual obligation:

- (i) to deliver cash or another financial asset to another entity; or**
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or**

(b) ...

As an exception...”

The Committee is of the view that the exception requiring *classification* of certain financial instruments meeting the definition of a financial liability as equity by the *issuer* in accordance with paragraphs 16A-16D of Ind AS 32 cannot be applied by the *holder* of such instruments while applying Ind AS 109. This is because Ind AS 109 does not provide for an exception similar to the exception contained in Ind AS 32. In reaching this conclusion, the Committee relies on the views of the IFRS Interpretations Committee published in ‘IFRIC Update’, September 2017, duly supported by paragraph BC5.21 of International Financial Reporting Standard 9, ‘Financial Instruments’. Hence, it is not necessary to examine whether in the extant case, the investments in equity funds answer the description of the financial instruments mentioned in paragraphs 16A-16B of Ind AS 32 (or paragraphs 16C-16D in case of close-ended equity funds, if any). In the extant case, X Ltd. invests in the units of the equity funds and not in the equity (shares) issued by the AMC. The equity funds issue only units and not equity shares. There is contractual obligation on the part of the equity fund to deliver cash on redemption of the units or to deliver units of another scheme (which are financial assets) on ‘switch-out’. Even if the units of the equity fund may represent a right to the residual interest in the assets of the fund available to the holders of the units (the querist’s discussion in paragraph 4 above on residual interest in the assets of the entities in which the equity fund has invested is not relevant) because of the link between redemption and ‘Net Asset Value’ of the units, the ability of the unitholders to put back the units to the Fund (subject to ‘lock-in’ period, if applicable in some cases (see paragraph 6 above)) for cash or units of another scheme (which are financial assets) in case of switch-out means that the units of the open-ended equity fund meet the *definition* of a financial liability from the perspective of the issuer, given in paragraph 11 of Ind AS 32 (reproduced above), irrespective of their *classification* by the issuer. In the case of open-ended funds, mere fact that contractual obligation on the part of the issuer to deliver cash (or issue units of another scheme in the case of switch-out) depends on the exercise of the redemption/ switch-out option by the unitholders does not mean that the issuer has an unconditional right to avoid such an obligation. This is equally applicable for units of close-ended equity funds, since, redemption or switch-out is certain to occur on the maturity date of such funds. The classification of such units in the financial statements of the funds is irrelevant. In the case of dividend option, the existence of discretion on the part of Trustee to declare dividend does not alter the position. This is because if dividend is not declared, it will be inbuilt in ‘Net Asset Value’ of the units, which is payable on redemption (either directly or in substance in the case of ‘switch-out’). Hence, the Committee is of the view that irrespective of classification of units in the financial statements of the funds, investments in equity funds cannot be treated as investments in equity instruments by the holder of

mutual fund units for the purposes of Ind AS 109 and, consequently, the election to recognise fair value changes of particular investments in equity instruments permitted in paragraph 4.1.4 of Ind AS 109 read with paragraph 5.7.5 of Ind AS 109 is not available for investments in equity funds, even if the fund itself invests entirely in equity and equity-related securities. Incidentally, the Committee wishes to point out that in the case of equity fund schemes, a portion of the investments made by the fund can be in debt instruments also (see paragraph 6 above). The treatment of such investments is discussed in paragraph 9 below.

9. The Committee notes that in the extant case investments in equity funds are held generally for capital appreciation rather than for trading purposes. However, it is obvious that irrespective of the way such investments are managed, the contractual cash flows from such investments do not consist of solely payments of principal and interest on the principal amount outstanding. The contractual cash flows from such investments depend on the cash flows to the fund from its investments which are mainly in equity and equity related securities. Hence, such investments cannot be measured at amortised cost in accordance with paragraph 4.1.2 of Ind AS 109 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A of Ind AS 109. Further, any embedded derivative in such investments, even if not closely related to the host contract, cannot be separated because paragraph 4.3.2 of Ind AS 109, in effect, prohibits separation of embedded derivatives from assets within the scope of that Standard and requires application of paragraphs 4.1.4-4.1.5 of that Standard to the entire host contract. Consequently, entire investments in equity mutual funds should be measured at fair value through profit or loss (without separation of any embedded derivatives) in accordance with paragraph 4.1.4 of Ind AS 109, despite the fact X Ltd. generally holds such investments for capital appreciation rather than for trading purposes.

D. Opinion

10. On the basis of the above, the Committee is of the opinion that investments in (units of) equity mutual funds cannot be treated as investments in equity instruments for the purposes of application of exception permitted in paragraph 5.7.5 read with paragraph 4.1.4 of Ind AS 109 for particular equity investments. Consequently, the question of routing the fair value changes of such investments through other comprehensive income does not arise at all.
