

## *Query No. 1*

**Subject:** *Recognition of non-convertible cumulative redeemable preference shares as borrowing and its measurement and disclosure requirements.*<sup>1</sup>

### **A. Facts of the Case**

1. A public sector undertaking (hereinafter referred to as ‘the Company’) is a subsidiary of M/s ABC. The Company is engaged in the business of petroleum refining and its products are sold predominantly to Oil Marketing Companies (OMCs).

2. During the financial year 2015-16, the Company has issued 100,00,00,000 non-convertible cumulative redeemable preference shares of Rs.10/- each for cash at par on private placement preferential allotment basis to M/s ABC, the holding Company for funding of an upgradation project through equity and also for improving the net worth of the Company as per Companies Act.

3. Features of the instrument:

- (a) **Coupon rate:** 6.65% net of dividend distribution tax- Post tax yield of AAA rated corporate bond i.e., prevailing 10 year G-Sec yield plus a spread of AAA rated corporate bond.
- (b) **Tenure:** 10 years with put and call option
- (c) **Put/call option:** The put/call option can be exercised at any point of time at face value based on mutually agreed terms or at the end of 5 years at face value.
- (d) **Mode of redemption:** Redemption out of profits which would otherwise be available for dividends or out of proceeds of fresh issue of preference shares made for the purpose of redemption in line with the requirements of the Companies Act, 2013.
- (e) **Voting rights:** Preference shareholder has a right to vote only on resolutions placed before the shareholders which directly affect their rights attached to preference shares, like winding up of Company or repayment of preference shares etc.

4. *Views of the Company on recognition of non-convertible cumulative redeemable preference shares:*

As per paragraph 11 of Indian Accounting Standard (Ind AS) 32, ‘Financial Instruments: Presentation’:

**“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**

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<sup>1</sup> Opinion finalised by the Committee on 16.3.2020.

- (b) a contract that will or may be settled in the entity's own equity instruments and is:**
- (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or**
  - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments....”**

*Classification of non-convertible cumulative redeemable preference shares as financial liability*

5. The querist has stated that non-convertible cumulative redeemable preference shares are mandatorily redeemable at the end of 10 years at face value and hence, when an instrument requires mandatory redemption by the issuer for a fixed or determinable amount, a contractual obligation to deliver cash at redemption exists. Therefore, the instrument qualifies as liability. Accordingly, the Company has classified the non-convertible cumulative redeemable preference shares as financial liability and recognised it under the head 'Long term borrowings'. Further, in the present case, the instrument carries a coupon rate of 6.65% net of dividend distribution tax (post tax yield of AAA rated corporate bond at the time of issue i.e., prevailing 10 year G-Sec yield plus a spread of AAA rated corporate bond). The dividends are cumulative and shall be paid out of available distributable profits.

*Initial measurement of financial liability*

6. All financial liabilities are recognised initially at fair value and, in the case of liabilities measured at amortised cost net of directly attributable transaction costs. Since the effective interest rate for the given instrument is equal to market interest rate, *as the same was benchmarked to G-Sec + Spread of AAA rated Corporate Bonds at the time of issue*, the initial recognition of the financial liability at fair value is equal to face value of the share. Since the face value of the preference shares and the fair value at inception are the same, the amortised cost of the preference shares at the end of each reporting period will also be the same. Since the preference shares were issued and are redeemable at par, the question of amortisation of premium /discount does not arise. (Emphasis supplied by the querist.)

*Subsequent measurement of financial liability*

7. The accounting policy of the Company in line with the requirements of Ind AS is as follows:

“Financial liabilities that are not held-for-trading and are not designated as at FVTPL are measured at amortised cost at the end of subsequent accounting periods. The carrying amounts of financial liabilities that are subsequently measured at amortised cost are determined based on the effective interest method. Gains and losses are recognised in profit or loss when the liabilities are derecognised as well as through the EIR amortisation process.

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 EIR. The EIR amortisation is included as finance costs in the statement of profit and loss.”

### *Disclosure requirements of financial liability*

8. As per paragraph 25 of Ind AS 107, 'Financial Instruments: Disclosures',  
"Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount."

Based on the above requirement, the comparison of fair value along with its carrying amount has been disclosed in Note 35 (fair values) for financial liabilities, viz., non-convertible cumulative redeemable preference share classified as borrowings in line with the requirements of Ind AS 32.

Moreover, paragraph 97 of Ind AS 113 states that,

"For each class of assets and liabilities not measured at fair value in the balance sheet but for which the fair value is disclosed, an entity shall disclose the information required by paragraph 93(b), (d) and (i)..."

Paragraphs 93(b) and (d) read as follows:

- (b) for recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3)
- (d) for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. ...

Thus, as mandated by paragraphs 93(b) and (d) of Ind AS 113, the Company has disclosed the fair value hierarchy as Level 2 for non-convertible cumulative redeemable preference shares and the description of valuation technique for fair value measurement as estimated by discounting future cash flows.

Further, brief descriptions about the terms and conditions of the issue of preference shares have also been disclosed by the Company. The relevant extracts from the financial statements of the Company have been provided by the querist for the perusal of the Committee.

### *Accounting treatment of Dividend*

9. As per paragraph 25 of Ind AS 32, "A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, *or the issuer's future revenues, net income* or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) ..." (Emphasis supplies by the querist.)

The terms of issue of the preference shares are such that the dividends are cumulative in nature. Therefore, the Company would not have an unconditional right to avoid declaring dividend and would have to classify the financial instrument as a financial liability. The timing of payment of dividend is contingent to the extent of availability of profits in a

particular year. However, *there is reasonable expectation that the preference dividends will be paid in time.* In the light of the above, dividend payments are not discretionary and hence, the Company has classified the dividend payable as a financial liability. (Emphasis supplied by the querist.)

10. The accounting entries are as follows:

1) *Recognition of non-convertible cumulative redeemable preference shares at the inception:*

Face Value of Non-convertible Cumulative Redeemable Preference shares: Rs. 1000 Crore

Market value of the Non-convertible Cumulative Redeemable Preference shares at the time of issue: Rs. 1000 Crore

Bank A/c Dr. 1000 Crore Dr.

To Financial Liability 1000 Crore Cr.

(Since the effective interest rate for the given instrument is equal to market interest rate, as the same was benchmarked to G-Sec + Spread of AAA rated corporate bonds at the time of issue, the initial recognition of the financial liability at fair value is equal to face value of the share)

2) *Treatment of interest expense for preference shares (including dividend distribution tax) treated as financial liabilities:*

Finance cost entry for the F.Y. 2015-16 (from the period 24.09.2015 to 31.03.2016)

Finance Cost 41.55 Crore Dr.

To interest accrued but not due on financial liabilities 41.55 Cr.

Finance cost entry for the F.Y. 2016-17

Finance Cost 80.04 Crore Dr.

To interest accrued but not due on financial liabilities 80.04 Cr.

Finance cost entry for the F.Y. 2017-18

Finance Cost 80.04 Crore Dr.

To Interest accrued but not due on financial liabilities 80.04 Cr.

(The finance cost has been arrived at considering the effective interest rate method including the dividend and dividend distribution tax)

There is no other cost involved for raising the preference shares and hence, the same has not been considered for calculating effective interest rate (EIR). Further, there are no premium or discount to the market rate at the time of issue of preference share and hence, no amortisation of premium / discount cost considered as part of EIR.

11. *Government auditors' view on the measurement principles of non-convertible cumulative redeemable preference shares classified as financial liability:*

The Company's contention of recognising non-convertible cumulative redeemable preference shares as financial liability in line with paragraph 11 of Ind AS 32 is accepted by the Comptroller and Auditor General of India (C&AG). However, the C&AG is of the opinion that the non-convertible cumulative redeemable preference shares recognised as

borrowings should be valued at amortised cost and accordingly the carrying value of the financial liability at the end of each reporting period will not be the same.

**B. Query**

12. In the light of the above, the opinion of the Expert Advisory Committee is sought on the following:

- (i) Whether the measurement principles followed by the Company on initial recognition and subsequent measurement of the non-convertible cumulative redeemable preference shares as detailed above is correct. If not, what would be the correct measurement of the financial liability?
- (ii) Whether the disclosures made by the Company are full and adequate. If not, what additional disclosures are required to be made by the Company in this regard?

**C. Points considered by the Committee**

13. The Committee notes that the basic issues raised in the query relate to the initial recognition and measurement, subsequent measurement and disclosure requirements in respect of the non-convertible cumulative redeemable preference shares issued by the Company. The Committee, has therefore, considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, determination of fair value of the preference shares and the level of inputs used for determining such fair value, related party disclosures, etc. The Committee presumes from the Facts of the Case that there is no prepayment penalty/negative compensation in the extant case.

*Recognition:*

14. With regard to recognition of the non-convertible cumulative redeemable preference shares, the Committee notes the definition of ‘financial liability’ as per Ind AS 32, ‘Financial Instruments : Presentation’ as follows:

**“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) a contract that will or may be settled in the entity’s own equity instruments and is:**

...”

“25 A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer’s future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle

it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

- (a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;
- (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or
- (c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B.”

The Committee notes from the Facts of the Case that the non-convertible redeemable preference shares are to be mandatorily redeemed at the end of 10 years. The redemption represents a contractual obligation of the entity to deliver cash. Hence, the recognition of the financial instrument, viz., non-convertible cumulative redeemable preference shares, as a financial liability is in accordance with the requirements of Ind AS 32, ‘Financial Instruments: Presentation’.

*Classification:*

15. At the outset, the Committee notes that in the extant case, the non-convertible cumulative redeemable preference shares have the put/call option, which can be exercised at any point of time at face value based on mutually agreed terms or at the end of 5 years at face value. In this context, the Committee notes the definition of ‘derivative’ as provided in Appendix A to Ind AS 109, ‘Financial Instruments’, as follows:

“**Derivative** A financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’).
- (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- (c) it is settled at a future date.”

From the above, the Committee notes that the call or put option in the extant case meets the definition of derivative. Now, the question arises as to whether it is required to be separated from the host contract, viz., financial liability on account of non-convertible cumulative redeemable preference shares in terms of the requirements of Ind AS 109. In this regard, the Committee notes the following requirements of Ind AS 109:

**“4.3.3 If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:**

- (a) **the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);**
- (b) **a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and**
- (c) **the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).”**

“B4.3.5 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 4.3.3(a)) in the following examples. In these examples, assuming the conditions in paragraph 4.3.3(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.
- (b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

...

- (e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:
  - (i) the option’s exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or
  - (ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with Ind AS 32.

...”

In the extant case, the exercise price of the call/put option after 5 years or earlier is the face value of shares, which in the view of the Committee, will be approximately equal to the amortised cost. Therefore, the Committee is of the view that the economic characteristics and risks of embedded derivative (call/put option) in the extant case are closely related to the host contract and accordingly, there is no need for separation of such derivative from the host contract.

16. With regard to classification of non-convertible cumulative redeemable preference shares, the Committee notes the following paragraphs of Ind AS 109, “Financial Instruments”, as follows:

**“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. ...”**

**“4.2.2 An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:**

- (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or**
- (b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in Ind AS 24 Related Party Disclosures), for example, the entity’s board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).”**

**“4.3.5 Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:**

- (a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or**
- (b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that**

permits the holder to prepay the loan for approximately its amortised cost.

**4.3.6 If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.”**

*Appendix A to Ind AS 10, ‘Financial Instruments’:*

<b>“financial liability at fair value through profit or loss</b>	A financial liability that meets one of the following conditions: <ul style="list-style-type: none"><li>(a) it meets the definition of <b>held for trading</b>.</li><li>(b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5.</li><li>(c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1.”</li></ul>
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From the above, the Committee notes that these instruments do not have the following characteristics:

- are held for trading (assuming that the Company is not trading in its own preference shares),
- are derivative instruments and
- are liabilities that have arisen on transfer of a financial asset which does not qualify for derecognition.

Further, as appears from the Facts of the Case, these instruments have neither been designated upon initial recognition nor subsequently as at fair value through profit or loss in accordance with the requirements of paragraphs 4.2.2 or 4.3.5 and 6.7.1 of Ind AS 109 respectively. Moreover, as discussed above, since there is no requirement to separate the embedded derivative, the requirement to designate the entire contract as at fair value through profit or loss as per paragraph 4.3.6 of Ind AS 109 shall not be applicable in the extant case. Hence, the financial liability does not meet the requirements for classification as financial liability valued at fair value through profit or loss as specified in Ind AS 109: Financial Instruments. Accordingly, as per the requirements of Ind AS 109, the non-convertible cumulative redeemable preference shares shall be classified as subsequently measured at amortised cost.

*Initial Measurement:*

17. With regard to initial measurement, 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.”**

“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. ...”

From the above, the Committee notes that the financial liability (other than in the case of a financial liability measured at fair value through profit or loss) should be initially measured at fair value (which is normally the transaction price) minus transaction costs. The Committee also notes that in the extant case, there are no transaction costs/discount/premium on issue or redemption of preference shares. Further, as per the querist, since, the effective interest rate for the given instrument is equal to market interest rate, as the same was benchmarked to G- Sec + Spread of AAA rated corporate bonds at the time of issue, the initial recognition of the financial liability at fair value is equal to face value of the share. Thus, it appears that the face value of the preference shares is the transaction price in the extant case. Presuming that the Company has determined the fair value of the preference shares as their face value appropriately as per the principles of Ind AS 113, the Committee is of the view that the initial measurement at face value is correct.

*Subsequent Measurement:*

18. With regard to subsequent measurement of the preference shares, considering the requirements of paragraph 4.2.1 of Ind AS 109, as reproduced above and as discussed in paragraph 16 above, the Committee is of the view that the financial liability should be subsequently measured at amortised cost using the effective interest method. In this context, the Committee notes the following requirements of Ind AS 109, Ind AS 32 and the Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013 (Revised July, 2019 Edition), issued by the Institute of Chartered Accountants of India (ICAI):

*Ind AS 109*

<b>“Amortised cost of a financial asset or financial liability</b>	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 <b>effective interest method</b> of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any <b>loss allowance</b> .”
<b>“effective interest method</b>	The method that is used in the calculation of the <b>amortised cost of a financial asset or financial liability</b> and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.
<b>effective interest rate</b>	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the <b>gross carrying amount of a financial asset</b> 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**

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.”

*Ind AS 32*

**“35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.**

35A Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12, *Income Taxes*.

36 The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in profit or loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.”

*Guidance Note on Division II-Ind AS Schedule III to the Companies Act, 2013*

**“9.5.5. Finance Costs**

...

Dividend on preference shares, whether redeemable or convertible, is of the nature of 'Interest expense', only where there is no discretion of the issuer over the payment of such dividends. In such case, the portion of dividend as determined by applying the effective interest method should be presented as 'Interest expense' under 'Finance cost'. Accordingly, the corresponding Dividend Distribution Tax on such portion of non-discretionary dividends should also be presented in the Statement of Profit and Loss under 'Interest expense'.  
...”

From the above, the Committee is of the view that since in the extant case, redeemable preference shares have been classified as financial liability in its entirety, the 'dividend' thereon is in the nature of interest expense. The related dividend distribution tax should also be regarded as part of interest cost. Therefore, the future cash payments of 'dividend' and 'dividend distribution tax' shall form part of EIR calculation. The Committee is also of the view that there being no transaction costs or discount or premium, etc. involved, the effective interest in the extant case would be equal to the dividend and dividend distribution tax paid/payable. Hence, in a scenario where the effective interest rate approximates the annual payouts (estimated future cash payments), subsequent measurement of the financial liability in respect of preference shares is unlikely to result in a material difference in the carrying amount of financial liability at the end of each reporting period. Thus, the contention of the C&AG that the carrying value of the financial liability at the end of each reporting period will not be the same is incorrect.

*Disclosures:*

19. With regard to disclosures, the Committee notes the following requirements of Ind AS 107:

“8 The carrying amounts of each of the following categories, as defined in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:

(a) ...

(b) ...

(g) financial liabilities measured at amortised cost.

(h) ...”

“25 Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.”

“29 Disclosures of fair value are not required:

(a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

...”

“20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:

(a) ...

(b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in

accordance with paragraph 4.1.2A of Ind AS 109 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss.

...”

From the Facts of the Case, the Committee notes that the Company has disclosed the financial liability for preference shares in the balance sheet/Notes as a financial liability measured at amortised cost under the head ‘Long-term Borrowings’. The Committee is of the view that the same is in accordance with the requirements of paragraph 8 of Ind AS 107, ‘Financial Instruments: Disclosures’. The Committee also notes that in Note 13: Equity Share Capital, under ‘Authorised’ and ‘issued’ share capital, the Company has also disclosed the preference shares. In this context, the Committee notes the requirements of General Instructions for Preparation of Balance Sheet in Part I of Division II - Ind AS Schedule III to the Companies Act, 2013, as follows:

“9. Preference shares including premium received on issue, shall be classified and presented as ‘Equity’ or ‘Liability’ in accordance with the requirements of the relevant Indian Accounting Standards. Accordingly, the disclosure and presentation requirements in this regard applicable to the relevant class of equity or liability shall be applicable mutatis mutandis to the preference shares. For instance, redeemable preference shares shall be classified and presented under ‘non-current liabilities’ as ‘borrowings’ and the disclosure requirements in this regard applicable to such borrowings shall be applicable mutatis mutandis to redeemable preference shares.”

Further, the Committee also notes the following paragraphs of the Guidance Note on Division II-Ind AS Schedule III to the Companies Act, 2013 (Revised July 2019 Edition):

**“8.2.1.11. Clause (a) of Note 6(D)(I) - the number and amount of shares authorized:**

As per the Guidance Note on Terms Used in Financial Statements “Authorised Share Capital” means *“the number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as nominal share capital.”*

This disclosure is to be provided for instruments entirely equity in nature as well as for compound instruments that have an equity component, to the extent applicable.

**8.2.1.12. Clause (b) of Note 6(D)(I) - the number of shares issued, subscribed and fully paid, and subscribed but not fully paid:**

The disclosure is for shares:

- Issued;
- Subscribed and fully paid;
- Subscribed but not fully paid.

Though the disclosure is only for the number of shares under each of the above three categories, to make the disclosure relevant to understanding the company’s share capital, even the amount for each category above should be disclosed. Issued shares are those which are offered for subscription within the authorised limit. It is possible that all shares offered are not subscribed to and to the extent of unsubscribed portion, there will be difference between shares issued and subscribed. As per the Guidance Note on Terms Used in Financial Statements, the expression ‘Subscribed Share Capital’ is *“that portion of the issued share capital which has actually been*

*subscribed and allotted. This includes any bonus shares issued to the shareholders.”*

Though there is no requirement to disclose the amount per share called, if shares are not fully called, it should be appropriate to state the amount per share called.

As per the definition contained in the Guidance Note on Terms Used in Financial Statements, the expression ‘Paid-up Share Capital’ is *“that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise.”*

This disclosure is to be provided for instruments entirely equity in nature as well as for compound instruments that have an equity component, to the extent applicable.”

From the above, the Committee is of the view that the disclosure of redeemable preference shares, which are neither in the nature of ‘Equity’ in entirety nor are compound instruments having an equity component, under authorised and issued Equity share capital is not recommended. The Committee further notes from the Facts of the Case that the effective interest rate amortisation is included as ‘finance costs’ in the statement of profit and loss. In this regard, the Committee notes the following requirements of the Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013:

#### **“9.5.5. Finance Costs**

As per Note 4 of the General Instructions for the Preparation of the Statement of Profit and Loss, disclosure of Finance costs is to be bifurcated under the following:

- (A) Interest;
- (B) Dividend on redeemable preference shares
- (C) Exchange differences regarded as an adjustment to borrowing costs;
- (D) Other borrowing costs (specify nature).

...

#### **B) Dividend on redeemable preference shares**

Dividend on preference shares, whether redeemable or convertible, is of the nature of ‘Interest expense’, only where there is no discretion of the issuer over the payment of such dividends. In such case, the portion of dividend as determined by applying the effective interest method should be presented as ‘Interest expense’ under ‘Finance cost’. Accordingly, the corresponding Dividend Distribution Tax on such portion of non-discretionary dividends should also be presented in the Statement of Profit and Loss under ‘Interest expense’.

On the other hand, where there is a discretion of issuer over the payments of dividend on preference shares, whether redeemable or convertible, the entire dividend is in the nature of distribution of profit and accordingly, shall be presented in Statement of Changes in Equity. Accordingly, the corresponding Dividend Distribution Tax should also be presented in Statement of Changes in Equity.”

From the above, the Committee is of the view that since the preference shares are cumulative in nature, the disclosure of EIR amortisation under ‘finance costs’ is appropriate. Further, the disclosures regarding the comparison of the carrying amount and the fair value of the liability in the Notes by the Company is also in accordance with paragraph 25 of Ind AS 107, Financial Instruments: Disclosures’. The Committee also notes that in the extant case, the Company has disclosed the fair value hierarchy as Level 2 for non-convertible cumulative redeemable preference shares and has also disclosed the

description of valuation technique for fair value measurement as estimated by discounting future cash flows, in accordance with the disclosure requirements as per paragraph 93 of Ind AS 113. In this context, the Committee notes the following requirements of Ind AS 113:

- “72 To increase consistency and comparability in fair value measurements and related disclosures, this Ind AS establishes a fair value hierarchy that categorises into three levels (see paragraphs 76-90), the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (*Level 3 inputs*).”
- “74 The availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques (see paragraph 61). However, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorised.
- 75 If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy. For example, if a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a *Level 2 input* and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorised within Level 3 of the fair value hierarchy.

### **Level 1 inputs**

- 76 Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- 77 A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 79.”
- “79 An entity shall not make an adjustment to a Level 1 input except in the following circumstances:
- ...
- (c) when measuring the fair value of a liability or an entity’s own equity instrument using the quoted price for the identical item traded as an asset in active market and that price needs to be adjusted for factors specific to the item or the asset (see paragraph 39). If no adjustment to the quoted price of the asset is required, the result is a fair value measurement categorized within Level 1 of the fair value hierarchy. However, any adjustment to the quoted price of the asset results in a fair value measurement categorized within a lower level of the fair value hierarchy.”

### **Level 2 inputs**

- “81 Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- 82 If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:
- (a) quoted prices for similar assets or liabilities in active markets.
  - (b) quoted prices for identical or similar assets or liabilities in markets that are not active.
  - (c) inputs other than quoted prices that are observable for the asset or liability, for example:
    - (i) interest rates and yield curves observable at commonly quoted intervals;
    - (ii) implied volatilities; and
    - (iii) credit spreads.
  - (d) market-corroborated inputs.”
- “84 An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs.”

### **Level 3 inputs**

- “86 Level 3 inputs are unobservable inputs for the asset or liability.”
- “93 To meet the objectives in paragraph 91, an entity shall disclose, at a minimum, the following information for each class of assets and liabilities (see paragraph 94 for information on determining appropriate classes of assets and liabilities) measured at fair value (including measurements based on fair value within the scope of this Ind AS) in the balance sheet after initial recognition:
- (a) ...
  - (b) for recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).  
...
  - (d) for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement...  
...
  - (i) for recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.”
- “97 For each class of assets and liabilities not measured at fair value in the balance sheet but for which the fair value is disclosed, an entity shall disclose the

information required by paragraph 93(b), (d) and (i). However, an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy required by paragraph 93(d). For such assets and liabilities, an entity does not need to provide the other disclosures required by this Ind AS.”

From the above, the Committee is of the view that the Company should keep in mind the above-reproduced requirements of Ind AS 113, while determining the fair value and giving disclosures as per Ind AS 107 and Ind AS 113.

#### **D. Opinion**

20. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 12 above:

- (i) For initial recognition and measurement, classification and subsequent measurement of the non-convertible cumulative redeemable preference shares, refer to paragraphs 14 to 18 above.
- (ii) For disclosures to be made by the Company, refer to paragraph 19 above.

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