Query No. 28

Subject: ***Accounting treatment of Compulsorily Convertible Debentures (CCDs) by the issuer under Ind AS 32, Financial Instruments: Presentation.***[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is jointly promoted by an oil and gas extraction company and an oil marketing company (OMC) with current shareholding in the ratio of 49% and 51% by these companies respectively (with 0.0002% held by individuals). The oil and gas extraction company is a Maharatna PSU company. The OMC is a Miniratna PSU company. The Company operates an Aromatics Complex at Mangalore Special Economic Zone with feed streams predominantly supplied by the OMC. The Complex was commissioned in October 2014. Due to initial year challenges and market conditions, the Company had incurred losses up to the financial year (F.Y.) 17-18 and during the F.Y. 2019-20 (During F.Y. 2018-19, the Company earned profit).

2. One of the JV partners' group entities had issued Compulsorily Convertible Debentures (CCDs) which enabled that Company's net-worth shoring-up. In order to shore-up net-worth of the Company, reduce the debt levels and strengthen the Company's Balance Sheet, during the F.Y. 19-20, the Company embarked on Capital Realignment Plan with due approvals from the Board followed by the promoter companies' (oil and gas extraction company and OMC) Board approvals. This comprised of equity infusion by promoters, medium-term loan facilities from banks, working capital support by the OMC in the form of bill discounting and issuance of Compulsorily Convertible Debentures (CCDs) to investors with backstop support from Sponsors (Promoter Companies).

3. During March 2020, the Company issued CCDs to investors (NBFCs and bank) to the extent of Rs.1,000 crore with backstop support from the promoter companies. The Company has an obligation to service the interest pay-outs during the tenure of the CCDs. It is also Sponsors' obligation to ensure that the Company meets the interest obligations on time.

4. The CCDs are not convertible in the hands of investors under any circumstance and the put option can be exercised by investors only on the sponsors and not on the issuer (the Company). These CCDs are convertible only in the hands of sponsors at the end of the tenure/buy-out option or exercising of put option by the investors (mandatory and irrevocable put option available to investors on sponsors only) and the Company would be required to convert the same into equity shares of the Company ranking pari-passu with existing shares at the time of conversion in the same proportion of shareholding /backstop support by reckoning share price at that time as per conversion formula defined in the transaction documents. Objective of such CCD issuance was to de-leverage the highly leveraged balance sheet of the Company through deferred equity infusion considering eventual merger plans of the oil and natural gas extraction company with OMC in the near term. The Company's CCD issuance was carried out broadly in line with CCDs transaction structure of a group company.

5. The querist has given the accounting policy followed by the Company as follows:

> "**3.20.1.2 Compound financial instruments**
>
> The component parts of compound financial instruments issued by the Company are classified separately as financial liabilities and equity in accordance with the substance of the contractual arrangements. At the date of issue, the fair value of the liability

[1] Opinion finalised by the Committee on 18.1.2021 to 20.1.2021.

component is estimated using the prevailing market interest rate for similar instruments. This amount is recognised as a liability on an amortised cost basis using the effective interest method until extinguished upon conversion or at the instrument's maturity date. The conversion option classified as equity is determined by reducing the amount of the liability component from the fair value of the compound financial instrument as a whole. This is recognised and included in equity, net of income tax effects, and is not subsequently remeasured. In addition, the conversion option classified as equity will remain in equity until the conversion option is exercised, in which case, the balance recognised in equity will be transferred to other component of equity. When the conversion option remains unexercised at the maturity date of the convertible note, the balance recognised in equity will be transferred to retained earnings. No gain or loss is recognised in profit or loss upon conversion or expiration of the conversion option. Transaction costs that relate to the issue of the convertible notes are allocated to the liability and equity components in proportion to the allocation of the gross proceeds. Transaction costs relating to the equity component are recognised directly in equity. Transaction costs relating to the liability component are included in the carrying amount of the liability component and are amortised over the lives of the convertible notes using the effective interest method."

6. Accounting Methodology: In view of the nature of instrument being compound financial instrument, accounting for the same has been carried out in the books of the Company by bifurcating the total proceeds of CCDs into equity and liability/debt components in compliance with Indian Accounting Standard (Ind AS) 32, 'Financial Instruments: Presentation'. The liability component of the same has been determined by considering discounted value of future cash outflows of the Company on account of the interest service obligations. The liability/debt component derived has been reduced from total value of CCDs to arrive at equity component accounted under other equity in financial statements.

7. The querist has given the rationale and justification for accounting methodology followed by the Company as follows:

I. Company's views on accounting methodology:

The Company has completed issuance of CCDs during March, 2020 to three investors after execution of all relevant documents and receipt of subscription. Post allotment of debentures to investors, the CCDs are held by investors in the capacity of debenture holders duly represented by debenture trustees. The said CCDs are backstop supported by the Sponsor/Promoter Companies, viz., oil marketing company and oil and gas extraction company in the ratio of 51% and 49% through option agreement. From the transaction documents, it may be noted that the following features are unique to this arrangement:

- Investors have un-conditional irrevocable put option on sponsors only and not on the issuers (the Company). The CCDs are compulsorily convertible into equity capital of the Company in the hands of the Sponsors in accordance with the terms of transaction documents. Issuer would be issuing shares to sponsors and not to the investors. Conversion price of shares would be determined based on valuation at the time of such conversion. Post issuance, shares would be ranking pari-passu with existing shares.
- Company's liability is limited to payment of interest to the investors as the value of CCDs is paid back to the investors by the Sponsor Companies upon exercising of Put Option. Pursuant to the option agreement, Sponsor/Promoter companies have

undertaken that they will ensure that the service account is operated, maintained and funded at all times, in accordance with the terms of the transaction documents.

- Sponsors have extended the backstop support as above in the ratio of their existing shareholding.

Considering the above unique features of the CCDs read with the terms of transaction documents, the legal point of view on nature of the instrument is that, the consequence of infusion of funds by Parents/Sponsors through CCDs will ultimately be an equity investment into the Company pursuant to conversion of CCDs to equity shares of the Company; and such conversion is not optional but compulsory and does not contemplate repayment of the principal by the issuing Company. Hence, the CCDs issued by the Company can be characterised as equity related instruments or quasi-equity instruments from the date of issuance of such CCDs by the Company.

Further, the Central Government while bringing about the changes in Foreign Policy structure under Foreign Exchange Management Act (FEMA) notified FEMA (Non-debt Instruments) Rules, 2019 on 17.10.2019. The said rules while prescribing the conditions on foreign Investment and related matter defines and considers the equity instruments as under:

> "Rule 2(k) "**equity instruments**" means equity shares, **convertible debentures**, preference shares and share warrants issued by an Indian company;
>
> Explanation:-
>
> (i) Equity shares issued in accordance with the provisions of the Companies Act, 2013 shall include equity shares that have been partly paid. "*Convertible debentures" means fully, compulsorily and mandatorily convertible debentures…*
>
> Rule 2 (ai) "*non-debt instruments*" means the following instruments; namely:-
>
> (i) *all investments in equity instruments*in incorporated entities: public, private, listed and unlisted; …"

The sum and substance of above discussions clearly classify the CCDs *as equity related instrument or quasi-equity instrument or non-debt instrument.*

II. Accounting Treatment: With the above background, the accounting treatment of such instrument in the Company's financial statements is considered as under:

The financial statements are prepared in accordance with the Companies Act and Ind ASs; and the Company has to comply with the requirements of Division II - Ind AS Schedule III to the Companies Act, 2013. The Institute of Chartered Accountants of India (ICAI), to comply with these provisions, issued Guidance Note (GN) on Division II- Ind AS Schedule III to the Companies Act, 2013 (GN revised edition issued during July-2019)[2].

A. Analysis of relevant paragraphs of Guidance Note and Indian Accounting Standards (Ind AS):

Guidance Note

Paragraph 8.2.1.6.states that, Ind AS 32 defines an equity instrument as "*any contract that evidences a residual interest in the assets of an entity after deducting*

[2] The Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013 (July 2019 Edition) has been subsequently revised in January 2022.

all of its liabilities". The accounting definition of 'Equity' is principle based as compared to the legal definition of 'Equity' or 'Share', such that any contract that evidences residual interest in an entity's net asset is termed as 'Equity' irrespective of whether it is legally recognized as a 'Share' or not. Accordingly, all instruments (including convertible preference shares and **convertible debentures**) that meet the definition of 'Equity' as per Ind AS 32 in its entirety and when they **do not have any component of liability**, should be considered as having the nature of 'Equity' for the purpose of Ind AS Schedule III. Such instruments shall be termed as 'Instruments entirely equity in nature'.

Paragraph 8.2.1.7.states that, **Instruments entirely equity in nature**, may be presented as a separate line item on the face of the Balance Sheet under 'Equity' after 'Equity Share Capital' but before 'Other Equity', as shown below:

Name of the Company…….

Balance Sheet as at…….

(Rupees in ….)

Particulars	**Note No.**	**Figures as at the end of current reporting period**	**Figures as at the end of previous reporting period**
EQUITY AND LIABILITIES			
Equity			
(a) Equity Share Capital			
(b) Instruments entirely equity in nature			
(c) Other Equity			

In the Statement of Changes in Equity, the reconciliation for instruments entirely equity in nature should be presented as below:

STATEMENT OF CHANGES IN EQUITY

…

B. Instruments entirely equity in nature *

(a) Compulsorily Convertible Preference Shares

Balance at the beginning of the reporting period	Changes in compulsorily convertible preference shares during the period	Balance at the end of the reporting period

(b) Compulsorily Convertible Debentures

Balance at the beginning of the reporting period	Changes in compulsorily convertible debentures during the period	Balance at the end of the reporting period

(c) [Instrument] (Any other instrument entirely equity in nature)

Balance at the beginning of the reporting period	Changes in [instrument] during the period	Balance at the end of the reporting period

Other Equity

[Table providing reconciliation of Other Equity]

** …It is assumed that Instruments entirely equity in nature have such terms and conditions that qualify them for being entirely equity in nature based on the criteria given in para 16 of Ind AS 32.* ***Companies should assess terms and conditions specific to their instruments for deciding whether they are entirely equity in nature.***[3]

Paragraph 8.2.1.9 states that, All those compound financial instruments which have both 'Equity' and 'Liability' components, shall be split in accordance with Ind AS 32 and their 'Equity component' shall be presented under 'Other Equity' portion of Statement of Changes in Equity while their 'Liability component' shall be presented as a separate line item under 'Borrowings'.

On going through the above paragraphs of Guidance Note alongwith related Ind AS provisions and considering the terms and conditions associated with CCDs issued by the Company, it is viewed that:

(i) In substance, the CCDs are more of equity in nature as these instruments are compulsorily convertible into equity shares of the Company which evidences residual interest in the assets of the Company.

(ii) One more special feature of the contract is, upon conversion, the shares are issued to Sponsors being existing shareholders at their shareholding ratio without altering their control and thereby preserving their stake in residual interest. Even though CCDs are issued by the Company to investors, the redemption happens only through sponsors.

(iii) The only liability to the issuer is serving of coupon rate till the conversion of CCDs into equity shares of the company.

Considering above, the Company's CCDs are in substance equity in nature with co-existence of a component of liability to the Company being serving of coupon rate till buyback by sponsors. Hence, it needs to be evaluated whether the CCDs in entirety qualify as equity in terms of paragraph 16 of Ind AS 32.

It may be noted that, as per paragraph 16 of Ind AS 32 which provides for classifying the instrument *as an equity instrument rather than a financial liability*in entirety, subject CCDs of the Company are instruments which are more of equity in nature with co-existence of liability component of serving coupon rate. In view of this, requirement of treating the subject CCDs *in entirety*either as equity or liability as prescribed in paragraph 16 of Ind AS 32 would not arise. Hence, the accounting treatment suggested in paragraph 8.2.1.9 of GN to split the CCDs in accordance with Ind AS 32 into 'equity

[3] This paragraph has been quoted by the querist from July 2017 Edition of the Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013, which has been subsequently revised in July 2019 Revised Edition of Guidance Note on Division II - Ind AS Schedule III to the Companies Act 2013.

component' and 'liability component' applicable to a compound financial instrument has been followed.

Ind AS 32 provides for the accounting treatment of compound financial instruments having equity as well as debt component. The standard has specifically dealt with the accounting treatment for such instrument in paragraphs 28 to 32 along with accounting guidance in paragraphs AG30 to AG35 which is an integral part of the standard.

As per paragraph 28, the issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.

Paragraph 15 of Ind AS 32 states that the issuer of a financial instrument shall classify the instrument, or *its component parts*, on initial recognition as a financial liability, a financial asset or an equity instrument *in accordance with the substance of the contractual arrangement*and the definitions of a financial liability, a financial asset and an equity instrument.

As per paragraph 31 of Ind AS 32, the issuer of a compound financial instrument will have to split the financial instrument into liability and equity portions by first calculating the liability portion and the residual will be the equity portion.

As per the terms of issue, the obligations on the part of the Company are:

(i) To service the coupon (interest) to the investors during the period till conversion of CCDs into equity shares.

(ii) Issuance of equity shares ranking at par with existing shares of the Company to the Sponsor companies upon conversion of CCDs.

(iii) Under no circumstances, the CCDs are convertible in the hands of investors as they are convertible only in the hands of Sponsor.

The interest liability will have to be computed by calculating the present value of the interest scheduled over the tenure of the CCD's.

Paragraph 31 of Ind AS 32 also states that the sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.

Paragraph AG31 of Ind AS 32 states as follows:

"AG31 A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivative features. Paragraph 28 requires the issuer of such a financial instrument to present the liability component and the equity component separately in the balance sheet, as follows:

(a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. On initial recognition, *the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted*at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

…"

In the case of the CCD issued by the Company, the obligation is only to pay the contractual cash flows for the interest portion. There are no cash flows contracted for the principal portion due to the put option given to the investors as well as the back stop facility provided by the sponsors.

Considering this arrangement, the Company has calculated the present value of their cash flows for interest as a liability and the residual amount as the equity component.

B. Further, Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' prescribes that, developing and applying an accounting policy should result in information that is:

(a) relevant to the economic decision-making needs of users; and

(b) reliable, in that the financial statements:

(i) represent faithfully the financial position, financial performance and cash flows of the entity;

(ii) reflect the *economic substance of transactions*, other events and conditions, and not merely the legal form;

(iii) are neutral, ie free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

C. Keeping the above aspects and considering the special nature of CCDs issued by the Company, accounting policy of the Company, accounting treatment and disclosures are in line with Ind AS requirements including Ind AS 32.

In view of the above, the Company is of the firm belief that the accounting treatment followed in its financial statements is in compliance with the provisions of Indian Accounting Standards (Ind AS).

(Emphasis supplied by the querist.)

8. The Company also placed reliance on the following which substantiate this CCD transaction instruments to be in the nature of equity:

(i) Financial advisor's to the transaction view is as follows:

- CCD is an alternative to direct equity investment.
- CCD is accepted as quasi-equity by both rating agencies and the lenders
- There is no obligation of repayment of the principal amount by the issuer.

(ii) Legal cases upholding the nature of compulsorily convertible debentures as "Equity in nature" referred by the Company are as under:

(a) Supreme Court of India in Narendra Kumar Maheshwari vs. Union of India

(b) Ahmedabad Special Bench of ITAT in AshimaSyntex Limited vs. ITAT

(c) Ahmedabad Special Bench of ITAT in Banco Products (India) Ltd. vs. DCIT

In essence, in the above cases, it has been viewed that a compulsorily convertible debenture, which will automatically convert into equity shares of the issuing company, which does not contemplate repayment of principal by issuing company is regarded as equity instrument from the date of issuance by the issuing company.

(iii) The Company also searched public domain and accessed few relevant examples pertaining to accounting treatment of CCDs followed by other companies. The CCD transaction structures are unique in every case. The Company's CCD transaction structure also being unique cannot be straight away compared with general examples available in publications on accounting and academic discussions. This needs to be seen from the perspective of its unique nature and substance of transaction. Moreover, treatment of financial instruments (especially compound financial instruments) under Ind AS is continuously evolving through discussions in academic forums. As CCD issuances do not happen regularly in the market unlike issuance of NCDs /bonds, the Company has endeavoured to access few near comparable examples from published data sources.

9. The accounts for the year ended 31st March 2020 were audited by the statutory auditors wherein aforesaid accounting treatment has been reviewed by the Company's statutory auditors during annual statutory audit for the F.Y. 19-20. The financial statements have been adopted by the Board of the Company on 05.06.2020 and statutory auditors report was also placed and considered by the Audit Committee and the Board.

10. Subsequently, the financial statements have been reviewed by resident audit team from the Comptroller and Auditor General (C&AG). C&AG had issued an audit enquiry with regard to accounting methodology followed by the Company w.r.t. CCDs. The audit enquiry was dropped. However, the matter of treatment of CCDs was also taken up by the regional office of C&AG at Chennai by the Audit Team. It was informed that there could be different interpretations under Ind AS with regard to CCDs. Considering complexity of the matter and time constraints, the Company extended an assurance of referring the matter to the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI). Based on such assurance, C&AG has issued Nil comments for the year and issued a management letter separately advising the Company's management to place the same before Audit Committee & the Board and also take up with the Expert Advisory Committee of the ICAI.

11. Extract from Management letter issued by the C&AG states as follows:

"Certain Deficiencies noticed as detailed below, were not issued as Audit Comment. However, the same is bought to your notice for Corrective and remedial Action.

Balance Sheet: Equity and Liabilities:

(1) Equity: (b) Other Equity-₹(-)19,596.89 million:

The above head 'other equity' includes ₹7,740.67 million arrived at on initial recognition (05.03.2020) after deducting the amortized amount of interest liability of ₹2,250.89 million and the pro-rata transaction cost of issue of CCD ₹8.44 million from the fair value of CCD ₹10,000 million.

The recognition of equity is not in line with Ind AS 32 [paragraph 16 (a) and 16 (b) (i) read with paragraph 15] and we differ on the accounting treatment followed by the company.

The financial liability on conversion of CCD into equity shares amounting to ₹10,000 million at the end of tenure is not recognised in the financial statements.

The draft provisional comment is dropped on the basis of assurance given by the company to refer the issue to the Expert Advisory Committee (EAC) of the ICAI for its opinion on the treatment of financial liability in the financial statements. Further action taken/proposed to be taken to rectify the lapses/errors may be communicated to audit."

In view of the management letter of C&AG, the Company seeks EAC opinion on the correctness of the accounting methodology adopted.

12. The querist has supplied the key terms of CCDs as follows:

Sponsor	The two promoter shareholders of the Company
Company/Issuer	The Company
Sponsor	Oil and gas extraction company and OMC
Type of Instrument	Compulsorily Convertible Debentures (CCD)
Nature of the Instrument	The Debenture shall mean an instrument which is compulsorily convertible into equity capital of the Company by the Sponsor/nominees of the Sponsors in accordance with the terms mentioned herein.
Mode of Issue	Private Placement on a fully paid up basis
Listing	Unlisted
Issuance Mode	Demat only. Demat credit to be received within 15 days of the Debentures Pay-in-Date.
Depository	NSDL or CDSL
Debenture Trustee	S Trustee Company Limited
Use of Funds	The Company shall use the proceeds for repayment of existing credit facility(ies), availed by the Company and general working capital purposes.
Face Value	Rs 1 crore per Debenture.
No. of Units	1,000
Tenure	36 (thirty-six) months from the Deemed Date of Allotment; with mandatory Put / Call Option at the end of the 35th month.
Coupon Payment Date	shall mean with respect to the first coupon period 31 March, 2020 thereafter on 30th June, 30th September, 31st December and 31st March of each year.
Rating of Instrument	The Debentures are expected to be assigned a rating of AAA (CE).
Accelerated Buy Out Option with the Sponsor	▪ Upon signing of a binding term sheet for equity infusion in the Issuer at any time prior to the expiry of 35 months from the Deemed Date of Allotment, the Sponsor may, with a prior written notice of 15 days to the Debenture Trustee, buy–out Debentures at Face Value ("Accelerated Buy Out of Securities") from the Investor (s); ▪ Coupon amount accrued and due but unpaid till the date of the Accelerated Buy Out shall be paid to the Investor (s) as on the date of the Accelerated Buy Out. ▪ The Sponsors will have a right to buy-out the CCDs (partly or fully at Face Value) at any point of time. On exercising such accelerated buy-out option prior to the 12th month of the instrument, the Investors will be compensated through Yield Protection Premium

	for the balance period until the end of 12 months from the Pay-in date. ▪ The Yield Protection Premium will be calculated as follows for each Debenture – [(Face Value of a Debenture) X (Coupon rate – 1 yr. G-sec rate) X (No. of days till end of 12 months /365)] / [(1+ 1 yr. G-sec rate) ^ (No. of days till end of 12 months /365)]
"Put Option" or "Mandatory Buy-out by the Sponsor"	a) In the event that the Sponsor has not procured a Nominee who has, or the Sponsor by itself has not, acquired all the Debentures from the Investor (s) prior to the expiry of 35 months from the Deemed Date of Allotment of Debentures, the Sponsor will mandatorily, and without requiring any notice or intimation in this regard, buy the outstanding Debentures for the aggregate Face Value of the Debentures and the accrued/ outstanding but unpaid amounts (including but not limited to unpaid coupon amount), if any, at the end of 35th month from the Deemed Date of Allotment ("Mandatory Buy-out"). Purchase of Debentures shall be undertaken mandatorily by the Sponsor for the entire outstanding Debentures amount; b) The Mandatory Buy-out set out above, shall be binding on the Sponsor and not optional in nature and shall not be dependent on any notice being delivered to the Sponsor; and c) The Debenture Trustee shall give a prior notice of 60 days to the Sponsor in regards to the Mandatory Buy-out. However, the obligation of the Sponsor under the Mandatory Buy-out shall remain, independent of any such notice being given to the Sponsor. d) Sponsors' liability: The liability of each Sponsor shall be limited to its proportionate shareholding in the Company, i.e. the Sponsors will not be joint and severally liable
Accelerated Put Option available to the Investor (s)	a) Accelerated Put Option may be exercised by the Investor(s) on the Sponsor in case of non-payment of coupon amount due and payable on the applicable Coupon Payment Dates wherein such default continues for a period of 1 (one) Business Days (including the Coupon Payment Date) from such Coupon Payment Date; and b) Accelerated Put Option shall be applicable on the entire outstanding principal amount of Debentures and any other dues due to the Investor(s).
Transfer	a) In case of exercise of Accelerated Buy-out Option, the Sponsor, by itself, or through any other affiliate or Nominees (s) nominated by the Sponsor, may acquire the outstanding Debentures. b) In case of Mandatory Buy-out and/or the Accelerated Put Option, the Sponsor or its Nominees shall be mandatorily required to buy the outstanding Debentures held by the Investor(s). c) The Debentures, if required by the Principal Investor (s), maybe transferred only to the Permitted Investor at any time during the Tenure. Provided that such Permitted Investor (s) shall be permitted to transfer the Debentures to any of the Principal Investor (s)/ other Permitted Investor(s).
Conversion	The Debentures will not have any conversion option for the period it

Option	is held by the Investor(s). On exercise of any of the following, the conversion option shall be effective: a) Accelerated Buy-out Option; b) Mandatory Buy-out; c) Accelerated Put Option; Sponsor/ Nominee shall have the unilateral right to convert the Debentures held by them to equity of the Company.
Conversion Terms for Debentures	Debentures shall be automatically and compulsorily converted into ordinary equity shares of the Company at the end of the Tenure; provided however in the event that the Investors continue to hold the Debentures at the end of the Tenure, for any reason whatsoever, the conversion of the Debentures shall not happen until such time as the Sponsor has acquired the Debentures from the Investor. Further, in the event, the Sponsor exercises the Accelerated Buy-out Option or when the Debentures are transferred to Nominee(s), the Sponsor may require the Company to convert the Debentures including the coupon amount and any other fee paid to the Investor (s) by the Sponsor into ordinary equity shares of the Company, before the end of the Tenure of the Debentures. Such conversion shall occur at the Conversion Price.
Conversion Price	To be decided 35 months from date of issuance or within 30 days of the exercise of the following, whichever is earlier: a) Accelerated Buy-out Option; b) Mandatory Buy-out; c) Accelerated Put Option;
Ranking of shares	The equity shares issued upon conversion of the Debentures shall rank pari-passu in all respect with the equity shares existing at the time of such conversion, including with respect to voting rights, bonus and rights shares.
Transaction Documents	Customary documents for such Debenture issuance, including: ▪ Debenture Trust Deed (DTD) setting out the terms of issuance of Debentures set out in this term sheet; ▪ Option agreement setting out the terms of the Mandatory Buy-out, Accelerated Put Option, and the Accelerated Buy-Out Option; ▪ Debenture Trustee Agreement setting out the terms of appointment of Debenture Trustee and the rights and duties of the Debenture Trustee; and ▪ Service Account Agreement setting out the terms of operation of the Service Account. ▪ Private Placement Offer Letter (PAS-4) Pricing Supplement setting out the applicable coupon rate in respect of each series of debentures.

B. Query

13. On the basis of above, the opinion of the Expert Advisory Committee is sought on the following issues:

(i) Whether the accounting treatment of CCDs issued by the Company and the disclosures made by the Company for the year ending 31st March 2020 is in line with the requirement of Ind AS 32 and the applicable provisions of other Indian Accounting Standards.

(ii) In case, EAC opinion is contrary to accounting treatment adopted by the Company:

(a) What is the correct accounting treatment that should have been followed in the matter?

(b) What are the corrective or remedial actions to be taken by the Company in this respect?

C. Points considered by the Committee

14. The Committee notes that the basic issue raised by the querist relates to the accounting treatment of the Compulsory Convertible Debentures (CCDs) issued by the Company and the related disclosures made in its financial statements for year ended 31st March 2020 under Ind AS. 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 CCDs in the financial statements of the Sponsors and the Investors, valuation and measurement (initial and subsequent) of CCDs (including embedded derivative, if any), deferred tax implications, accounting for the interest payments on the CCDs, control assessment, etc. The Committee further notes that in determining whether to classify a financial instrument (or its components) on initial recognition as a financial liability or as equity, Ind AS 32, requires an entity to assess the substance of a contractual arrangement rather than its legal form. Therefore, it is possible for an instrument that qualifies as equity for legal or regulatory purposes, to be classified as a financial liability under Ind AS. The Committee has only looked into the issue from an Ind AS perspective and has not looked into the regulatory or legal classification and implications, including those arising under Income-tax Act and FEMA. Further, the Committee presumes from the Facts of the Case that the interest/coupon rate in respect of the extant CCDs is at the prevalent market rate of interest for similar kind of instruments (having same terms, comparable credit status and cash flows, etc.).

15. The Committee notes that Ind AS 32, 'Financial Instruments: Presentation' states the following:

"15 The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

16 When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no 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 issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset *for a fixed number of its own equity instruments*. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. 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."

"21 A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to Rs. 100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

22 Except as stated in paragraph 22A, a contract that will be settled by the entity (receiving or) *delivering a fixed number of its own equity instruments* in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own

shares) is added directly to equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from equity. Changes in the fair value of an equity instrument are not recognised in the financial statements."

"**28 The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.**

29 An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a bond or similar instrument convertible by the holder into a *fixed number* of ordinary shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately in its balance sheet."

Appendix A, Application Guidance, Ind AS 32 Financial Instruments:

Presentation

"AG27 The following examples illustrate how to classify different types of contracts on an entity's own equity instruments:

(a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument (except as stated in paragraph 22A). Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognises a financial liability for the present value of the redemption amount (with the exception of instruments that have all the features and meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D). One example is an entity's obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.

(b) …

(c) …

(d) *A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or afinancial liability.* An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than gold. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability."

(Emphasis supplied by the Committee.)

16. Further, the Committee notes that Ind AS 109, 'Financial Instruments' provides as follows:

"4.3.1 An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to 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. A derivative that is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument."

"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)."

"Embedded derivatives (Section 4.3)

B4.3.1 When an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard, paragraph 4.3.3 requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss."

"B4.3.3 An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative."

17. The Committee notes from the above that the appropriate classification as a financial liability, equity or a combination of both, is determined by the entity when the financial instrument is initially recognised. The Committee notes that the exceptions in Ind AS 32, paragraphs 16A-D do not apply in the extant case. The Committee further notes that Ind AS 32 defines an equity instrument as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. While classifying a financial instrument as a liability or equity, equity classification is appropriate only if the instrument fails the definition of a financial liability. In order for an instrument to be classified as an equity instrument under Ind AS 32, it is not sufficient that it involves the reporting entity delivering or receiving its own equity instruments. The number of equity instruments delivered, and the consideration for them, must be fixed ('fixed for fixed' requirement). Contracts that will be settled other than by delivery of a fixed number of shares for a fixed amount of cash do not meet the definition of equity. An entity may have a contractual obligation to deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be delivered equals the amount of the contractual obligation. Such a contract is a financial liability. Even though the contract must, or may, be settled through delivery of the entity's own equity instruments, the number of own equity instruments required to settle the contract will vary. The contract will therefore not fulfil the requirements of an equity instrument and is, therefore, a financial liability.

18. The Committee notes that in the extant case, interest is payable to the investors by the Company as per the terms of the CCDs, which in the view of the Committee, would meet the criteria for financial liability classification, since there is an obligation to pay cash that the issuer (the Company) cannot avoid (interest payment obligation). For this component, on a stand-alone basis, there is no feature that is similar to equity.

19. The Committee also notes from the Facts of the Case that the CCDs are convertible only in the hands of sponsors at the end of the tenure/buy-out option or exercising of put option by the investors and the Company would be required to convert the same into equity shares of the Company ranking pari-passu with existing shares at the time of conversion in the same proportion of shareholding /backstop support by reckoning share price at that time as per conversion formula defined in the transaction documents. The conversion option shall be effective on the exercise of the Accelerated Buy-out Option, the Mandatory Buy-out or the Accelerated Put Option giving the sponsor/ nominee an unilateral right to convert the debentures into equity of the Company.

Thus, with regard to conversion feature of the CCD, the Committee notes that in the extant case, there is no contractual obligation to pay cash that the issuer (the Company) cannot avoid, since the conversion into own equity shares is compulsory. However, the conversion ratio for the purpose of the conversion shall be dependent on the share price of the Company at the time of conversion. The equity conversion feature can only be settled through the issue of equity shares – however, there is an obligation to issue a variable number of shares – the number of shares to be issued is based on the share price on conversion. In other words, the conversion price and, hence, the conversion ratio of CCDs into ordinary equity shares of the Company is not fixed at the point of initial recognition of the CCDs. Therefore, the conversion component within the instrument would not meet the criteria laid down in Ind AS 32 for the purpose of classifying as equity. Accordingly, overall, the CCDs do not meet the criteria for being classified as compound instrument as there is no equity component. The CCDs should be classified as financial liabilities in entirety.

20. The Committee further notes that terms of the CCDs contain Accelerated Buy-out Option, or the Accelerated Put Option during the 35-month tenure of the CCDs. Upon exercise of these options by the Sponsors/ Investor, the Company would be required to convert the

CCDs into equity shares. The Committee is of the view that these options may represent embedded derivatives under Ind AS 109, which should be evaluated by the Company in the extant case. Further, the Company shall also evaluate whether these embedded derivatives are 'closely related' to the host contract as per the requirements of Ind AS 109. The Committee notes that as per the requirements of Ind AS 109, for convertible notes with embedded derivative liabilities, the embedded derivative liability is determined first and the residual value is assigned to the debt host liability.

21. The Committee notes that the Company has provided the disclosures relating to CCDs in its financial statements for financial year ended 31st March 2020 based on compound instruments classification. The Company shall present and make the disclosures for the CCDs, as per the applicable requirements of Ind AS 32, Ind AS 107, Ind AS 113 and Division II – Ind AS Schedule III to the Companies Act, 2013 that are relevant for financial liabilities.

22. The Committee further notes that Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' states as follows:

> "41 Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind ASs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (see paragraphs 42–47).
>
> **42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by:**
>
> **(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or**
>
> **(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."**

The Committee notes from the above that as per Ind AS 8, material prior period errors are corrected retrospectively by restating the comparative amounts for prior period(s) presented in which the error occurred. If the error occurred before the earliest period presented, the opening balance of assets, liabilities and equity/ retained earnings for the earliest period presented are adjusted. Therefore, the Company shall correct the accounting treatment of the CCDs as a prior period error retrospectively in the first set of financial statements approved for issue after the discovery of the error.

D. Opinion

23. On the basis of above, the Committee is of the following opinion on the issues raised in paragraph 13 above:

(i) The accounting treatment of CCDs issued by the Company as compound instrument is not in line with the requirements of Ind AS 32, as discussed in paragraphs 15 to 19 above. The disclosures in the financial statements shall be provided based on the classification as financial liabilities, as discussed in paragraph 21 above.

(ii) (a) The CCDs shall be classified as financial liabilities in entirety under Ind AS 32, as discussed in paragraph 19 above.

(b) The Company shall correct the accounting treatment of the CCDs as a prior period error retrospectively in the first set of financial statements approved for issueafterthe discovery of the error, as discussed in paragraph 22 above.