CHAPTER 1

Accounting for Compulsorily Convertible Debentures

This article aims to:

Provide guidance on accounting for Compulsorily Convertible Debentures under Ind AS 32, *Financial Instruments: Presentation* and covers a recent EAC opinion issued on the same topic.

Overview

Compulsorily Convertible Debentures (CCDs) are an important source of finance and are used by the companies for raising funds. Simply put, CCDs, as the name suggests, are debentures with an underlying characteristic of compulsory conversion into equity after a certain period of time, or on happening of a specified event. CCDs are different from simple debt instruments, as they include a convertibility feature which acts as an incentive for the investors over and above the interest income. Thus, unlike equity, CCDs ensure a fixed return to the investors along with a potential upside on conversion.

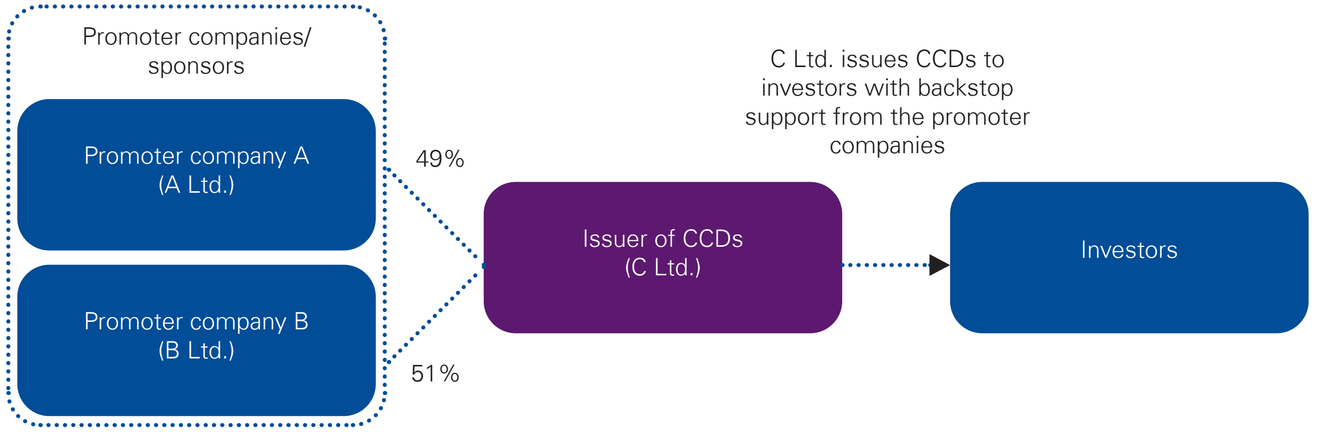
Under the Indian Accounting Standards (Ind AS), Ind AS 32, *Financial Instruments: Presentation* establishes the principles for classifying CCDs, from the perspective of the issuer, into financial liabilities and equity instruments. As per Ind AS 32, while determining such classification, an entity would first need 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, classifies as a financial liability under Ind AS. Accordingly, the Institute of Chartered Accountants of India (ICAI) has from time to time provided clarifications on accounting for CCDs.

Recently, the Expert Advisory Committee (EAC)[1] of ICAI issued guidance on accounting for CCDs through its opinion on 'Accounting treatment of Compulsorily Convertible Debentures (CCDs) by the issuer under Ind AS 32, *Financial Instruments: Presentation*'. In this article, we aim to discuss the main principles enunciated in this opinion.

1. EAC opinion on 'Accounting treatment of Compulsorily Convertible Debentures (CCDs) by the issuer under Ind AS 32, Financial Instruments: Presentation' issued in ICAI journal in January 2022.

Facts of the case

Figure 1: Facts of the case



(Source: EAC opinion on 'Accounting treatment of Compulsorily Convertible Debentures (CCDs) by the issuer under Ind AS 32, *Financial Instruments: Presentation*' issued in ICAI journal in January 2022.)

C Ltd. (the Company), being jointly promoted by A Ltd. and B Ltd. (promoter companies/sponsors) issued CCDs to its investors with backstop support from the promoter companies. The Company has an obligation to make periodic interest payments to the investors during the tenure of the CCDs. The terms of the arrangement provide that the CCDs would not be convertible in the hands of investors, instead the CCDs would be bought back by the promoters of C Ltd.. The Company would be required to convert the CCDs into equity shares ranking *pari-passu* with existing shares at the time of conversion, in the same proportion of shareholding/backstop support of the promoters. The conversion would be made considering the share price prevailing at that time. The Company accounted for the CCDs as compound financial instruments by bifurcating the total proceeds of the CCDs into equity and liability/debt components.

Considering these facts, the EAC opined on (a) the accounting treatment of the CCDs issued by the Company (b) disclosures of CCDs issued in the Company's financial statements, and (c) where EAC opinion is contrary to the accounting treatment of the company, the corrective actions required to be taken by the Company.

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Overview of the EAC opinion

Whether the CCDs issued by C Ltd. are 'compound financial instruments'

As per Ind AS 32, a financial instrument or its components, is classified on initial recognition as a financial asset, financial liability, or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial asset, financial liability, or an equity instrument. In this regard, Ind AS 32 provides the definitions of financial asset, financial liability, and equity, which can be evaluated for the components of the CCD.

The CCD in the current case has two components:

a. Component 1: Obligation of C Ltd. to make periodic interest payments to the investors during the tenure of the CCDs

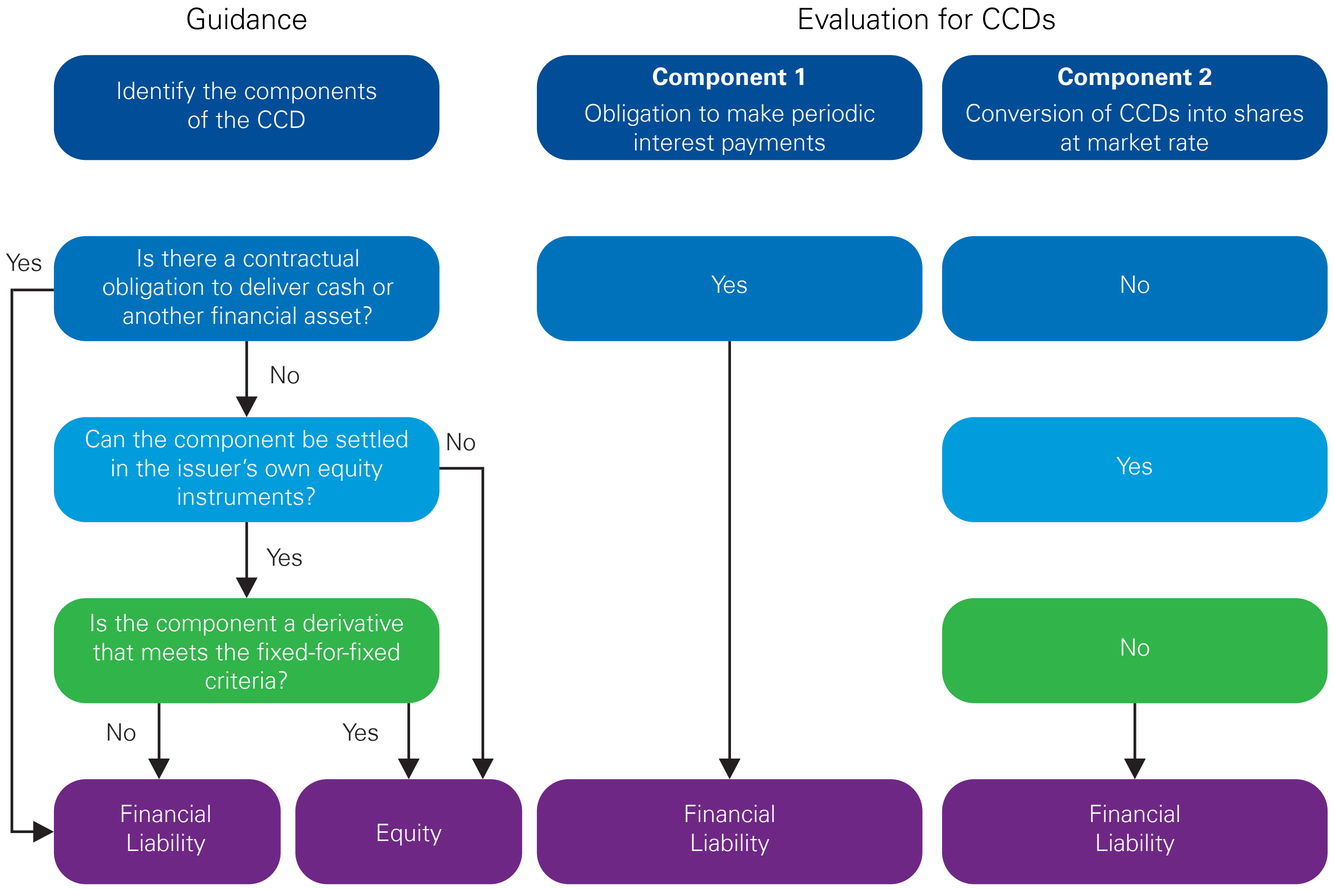
b. Component 2: Converting the CCDs into equity shares at the share price prevailing at the time of conversion

Figure 2 depicts the evaluation of the guidance provided by Ind AS 32 and its applicability to the components of the CCD.

As can be seen in figure 2, each component of the CCD is analysed separately to determine its classification. The analysis, based on guidance in Ind AS 32 indicates that:

- Component 1: Interest payable to investors by the Company meets the criteria for financial liability classification, since there is an obligation to pay cash that the Company cannot avoid.
- Component 2: With regard to the conversion feature of the CCD, there is no contractual obligation to pay cash, since the conversion into own equity shares is compulsory. Therefore, further evaluation of the conversion ratio is required[2]. As per the terms of the CCD, the conversion ratio of the CCDs will be dependent on the share price of the Company at the time of conversion- i.e. there is an obligation to issue a variable number of shares, and the fixed-for-fixed criteria is not met. Therefore, the conversion component within the CCD does not meet the criteria laid down in Ind AS 32 for the purpose of classifying as equity.

Figure 2: Evaluation of Ind AS 32 guidance for components of CCD



(Source: KPMG in India's analysis, 2022 read with Ind AS 32)

On the basis of the above evaluation, on an overall basis, the CCDs do not meet the criteria for being classified as a compound financial instrument as there is no equity component. Hence, the CCDs should be classified as financial liabilities in entirety.

2. The evaluation will be whether the component is a derivative that will be settled by the issuer with fixed amount of cash/other financial asset for a fixed number of own equity instruments (i.e. the fixed-for-fixed criteria).

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Disclosures and presentation for the CCD

Disclosures and presentation for the CCDs that are classified in their entirety as a financial liability should be made as per the applicable requirements of Ind AS 32, Ind AS 107, *Financial Instruments: Disclosures,* Ind AS 113, *Fair Value Measurement* and Schedule III (Division II – applicable to entities preparing their accounts in accordance with Ind AS) to the Companies Act, 2013, that are relevant for financial liabilities.

Accounting for accelerated buy-out option

In the current case, the terms of the CCDs contain an accelerated buy-out option, or the accelerated put option. Upon exercise of these options by the sponsors or investors, the Company would be required to convert the CCDs into equity shares, earlier than the expected tenure.

These options may represent embedded derivatives under Ind AS 109, *Financial Instruments.* It should be determined whether the embedded derivatives are closely related to the host contract as per the requirements of Ind AS 109. As per 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.

Correcting accounting errors

In the current case, the Company has accounted for the CCDs as compound financial instruments. However, based on the evaluation done by the EAC, the CCDs should be classified as a financial liability in their entirety. This tantamounts to an error in the classification of the CCDs.

As per Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* material prior period errors should be 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 should be adjusted. Therefore, the Company should 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.

Consider this

While CCDs which are convertible into a fixed number of shares at the end of their term are in the nature of compound financial instruments, yet such transaction structures are usually unique in every case. 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 regulatory purposes, to be classified as a financial liability under Ind AS.

Future developments

The International Accounting Standards Board (IASB) has undertaken a project on Financial Instruments with the Characteristics of Equity. Through this project, the IASB aims to address challenges identified in IAS 32, *Financial Instruments: Presentation,* by establishing clearer principles for classifying financial instruments as either financial liabilities or equity, improving the clarity and consistency of the classification requirements for the more complex financial instruments that create a challenge in practice and enhancing the presentation and disclosures about financial liabilities and equity. Clarifications vide an exposure draft is expected in the following six areas:

- Classification of financial instruments that will or may be settled in the issuer's own equity instruments - e.g. the application of the fixed-for-fixed condition to particular derivatives on own equity and the classification of mandatorily convertible financial instruments
- Accounting for obligations to redeem own equity instruments - e.g. accounting for written put options on non-controlling interests
- Accounting for financial instruments that contain contingent settlement provisions - e.g. financial instruments with a non-viability clause
- The effect of laws and regulations on the classification of financial instruments
- Reclassification between financial liability and equity instruments - e.g. when circumstances change or contractual terms are modified, and
- Classification of particular financial instruments that contain obligations that arise only on liquidation of the entity - e.g. perpetual financial instruments.

Since the Ind AS are largely aligned with the IFRS, it is expected that these updates would be adopted in Ind AS as well. Accordingly, companies that have issued compound financial instruments should watch this space for further information.

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