Query No. 6

Subject: Accounting for interest-free subordinate debts under Ind AS framework.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the Company') is a joint venture company, with equal equity participation from the Government of India (GoI) and Government of National Capital Territory of Delhi (GNCTD). The Company has been entrusted with the responsibility of construction and operation of the rail-based Mass Rapid Transit System (MRTS) for Delhi/NCR areas.

2. Project financing is done in the form of equity, grants, loan from bilateral/multilateral agency (JICA) etc. along with interest-free subordinate debts as part of funding pattern for execution of metro projects. The Company has completed Phase-I, II and III; and Phase-IV work is going on.

3. The interest-free subordinate debts are provided by the GoI, GNCTD and other Government authorities as a part of funding arrangement for construction of MRTS project for the specific purpose of financing of land, rehabilitation and resettlement, central taxes and state taxes. These are repayable in 5 equal instalments after the repayment of interest-bearing loan of relevant phases from GoI, i.e., after 30 years.

4. The details of interest-free subordinate debts received by the Company till 31.03.2023 are given below:

Loan provider	Purpose of loan	Amount (Rs. in lakhs)
GoI	Land	2,29,028.54
	Central Taxes	2,96,827.50
GNCTD	Land	2,28,022.24
	State Taxes	1,69,978.00
	Central Taxes	2,30,660.00
Haryana Urban Development Authority (HUDA)	Central Taxes	12,350.00
New Okhla Industrial Development Authority (NOIDA)	Central Taxes	5,060.00
	Total	**11,71,926.28**

(Refer Note No. 15 'Borrowings' of Financial Statements for the financial year (F.Y.) 2022-23)

Accounting treatment being followed by the Company

5. In compliance with the provisions of paragraphs 5.1.1, B5.1.1 and B5.1.2A of Indian Accounting Standard (Ind AS) 109, these interest-free subordinate debts are accounted for as financial liabilities which are subsequently measured at amortised cost. Such interest-free

[1] Opinion finalised by the Committee on 24.4.2024.

subordinate debts are also provided by the GoI and state governments/ authorities to other organisations involved in development of MRTS in their respective states on same terms and conditions.

6. Further, no active market is available for such loans in India, which can be substantiated from the letter dated 22.11.2019 received from the State Bank of India (SBI), wherein it is mentioned that "There are restrictions in sanctioning of such a term loan as per our extant loan guidelines. Firstly, the loan tenor and the moratorium period is too elongated. As per our extant guidelines, we can provide term loan up to 10 years only. Secondly, we don't undertake subordinated debt". Further, on issue of audit observations by Comptroller and Auditor General of India (C&AG), the Company again requested to SBI for such loan but SBI vide letter dated 06.09.2023 reconfirmed their stand. Hence, market rate of interest on these loans is not available.

7. Therefore, their transaction price is considered to be at fair value at initial recognition and following disclosure is made in Explanatory Note No. (A)(iv) of Note No. 15 'Borrowings' of the financial statements of the Company for the F.Y. 2022-23:

> "The Interest-Free Subordinate Loans are accounted for at the values at which they are received since they are received at the same terms and conditions at which such loan is provided to other metro projects, and hence they are considered to be at fair value."

Provisional Comment issued by C&AG during Supplementary Audit

8. During supplementary audit of financial statements of the Company for the F.Y. 2022-23, the office of Comptroller & Auditor General of India (C&AG) issued a provisional comment which is reproduced below:

> *"Financial Liabilities -Borrowings- (Note 15)-Term Loans- Interest-Free Subordinate Loans- Rs. 1171926.28 lakh*
>
> The disclosure in Note 15 (A)(iv) that interest-free subordinate loans are accounted for at the values at which they are received since they are received at the same terms and conditions at which such loans are provided to other metro projects and hence they are considered to be at fair value is contradictory to provisions of Ind AS 109. While paragraph 5.1.1 of Ind AS 109 required the entity to recognise the financial liability initially at fair value, paragraph 4.2.1 required classification of all financial liabilities subsequently at amortised cost. Non-valuation of the subordinate debt at amortised cost has resulted in non-compliance to Ind AS 109, the impact of which cannot be quantified."

9. In reference to above provisional comment, the Company has submitted its reply which is reproduced below:

> "In addition to paragraph 5.1.1 of Ind AS 109, Application guidance on Ind AS 109 is given in Appendix B, which forms integral part of the Standard. The relevant paragraphs of Appendix B, providing guidance on determination of fair value, are reproduced below:
>
> "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.…) … *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...”*

“B5.1.2A *The best evidence of 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..)…”

From the combined reading of paragraphs 5.1.1, B5.1.1 and B5.1.2A of Ind AS 109, it is clear that financial liabilities should normally be recognised at transaction price i.e. fair value of consideration given or received, *unless fair value can be determined by using prevailing market rate of interest for a similar instrument in terms of currency, term, type of interest rate and other factors with a similar credit rating*.”

(Emphasis supplied by the querist.)

10. In case of the Company, as per Sanction Order of Phase-IV project issued by GoI (Ministry of Housing and Urban Affairs), in addition to equity contribution by the promoters/shareholders (GoI and GNCTD), subordinate debts for central taxes, state taxes, land and R&R are also provided by the promoters/shareholders. The interest-free subordinate debts are provided to the Company at the same terms and conditions at which they are provided to other metro/similar projects.

11. Besides, such loans are repayable after senior debt has been fully repaid. Further, loans of such high quantum, at terms and conditions of subordinate debt, are not provided by any bank/other financial institutions. In this regard, the Company had requested SBI for such loan with similar quantum, long term period and other similar terms & conditions. SBI, vide its letter replied that as per their extant guidelines, it can provide term loan with tenor up to 10 years only and secondly, it does not undertake subordinate debt.

Therefore, it is evident that there are no comparable prevailing market rates for such loans with similar type and term in the Indian banking system, which can be used for discounting of cash outflows to arrive at the present value, as envisaged in paragraph B5.1.1 of Ind AS 109.

Hence, they are considered already to be at fair value as permitted by provisions of Ind AS 109. This fact has been disclosed by the Company vide Explanatory Note No. (A)(iv) of Note No. 15 to the financial statements, which is reproduced below:

“The Interest-Free Subordinate Loans are accounted for at the values at which they are received since they are received at the same terms and conditions at which such loan is provided to other metro projects, and hence they are considered to be at fair value.”

12. Further, as regards observation of audit regarding non-valuation of the subordinate debt at amortised cost in compliance of paragraph 4.2.1 of Ind AS 109, it is submitted that, the term ‘amortised cost’ has been defined in Appendix A of Ind AS 109, which forms integral part of the Standard. The same is reproduced below:

"**amortised cost of a financial asset or financial liability**

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 **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**."

In compliance with the above provisions of paragraph 4.2.1 of Ind AS 109, the subsequent measurement of interest-free subordinate debt is being done by the Company at amortised cost by reducing principal repayments, from the initial recognition amount which is equal to the transaction price. As regards the amortisation of interest component, since initial recognition is done at transaction price and maturity amount is also equal to transaction price, there is no implicit interest component and effective interest method is not applicable in the present case. Hence, as per the querist, the Company has fully complied with the provisions of paragraph 4.2.1 of Ind AS 109.

13. Thus, the reasons for not recognising interest-free subordinate debt at fair value are summarised as follows:

i. The Interest-Free Subordinate Loans are received at the same terms and conditions at which such loans are provided to other metro projects, and hence, they are considered already to be at fair value.

ii. There is no comparative market in the Indian Banking system where loans of similar quantum, tenure and subordinate repayment terms are available; therefore, there is no reliable and comparable market rate of interest available for the interest-free subordinate debts, which can be used to arrive at the fair value.

iii. Use of any interest rate will lead to incorrect fair valuation and mislead the users of the financial statements.

iv. Consequently, principal repayments are reduced from the initial recognition amount to arrive at the amortised cost in accordance with paragraph 4.2.1 of Ind AS 109, in the absence of any interest component**.**

The Company has been consistently following same practice since adoption of Ind AS till date. The Company has also disclosed the fact vide Explanatory Note No. (A)(iv) of Note No. 15 'Borrowings' that interest-free subordinate debts are considered already to be at fair values, thereby ensuring transparency in the financial statements.

Assurance:
Keeping in view the observation of Audit, it is assured that the matter will be referred to the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) for its opinion**.**

In view of above explanation, it is requested by the Company to C&AG to drop the Provisional Comment.

14. The Company has also submitted the following points for consideration of the Committee:

(i) Interest-Free Subordinate Debts are received by the Company at the same terms and conditions at which these are provided by the Government to all metro organisations for similar projects.

(ii) There is no rate available in the Indian Banking system, for such loans of similar quantum, tenure and terms & conditions. The Company has received confirmation from the State Bank of India regarding same firstly on 22.11.2019 and secondly on 06.09.2023 on issue of Audit observation by CAG.

(iii) Use of any arbitrary interest rate will lead to incorrect valuation and mislead the users of the financial statements.

(iv) The Company has been constantly following same practice since adoption of Ind AS till date and also disclosed the fact vide Explanatory Note no. (A)(iv) of Note No. 15 'Borrowings'.

B. Query

15. In view of the above, opinion of the Expert Advisory Committee is required on the following issues:

(i) Whether accounting treatment followed by the Company as explained in paragraphs 5 to 7 above, i.e., considering transaction price to be the fair value on initial recognition, is correct.

(ii) If not, what should be the correct accounting treatment.

C. Points considered by the Committee

16. The Committee notes that the basic issue raised in the query relates to appropriateness of accounting treatment followed by the Company of considering transaction price for interest free subordinate debts to be the fair value on initial recognition. Therefore, the Committee has examined this issue only and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for loan from bilateral/multilateral agency (JICA) etc. during various phases, accounting for various expenditures for which funds have been utilised, such as, acquisition of land, rehabilitation & resettlement, central taxes and state taxes, detailed accounting for interest-bearing loan including repayment thereof, application of requirements of Ind AS 23, 'Borrowing Costs', deferred tax impact (if any), etc. Further, the Committee has examined the query only from accounting perspective and not from any other perspective, such as, legal interpretation of various legal enactments, for example, various sanction letters of government, repayment terms of JICA Loan, SBI letter etc. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

17. At the outset, the Committee wishes to point out that in the extant case, since neither the querist nor the C&AG has raised the issue of the nature of funds received, viz., whether the subordinate debts have been provided by the Government or government authorities in the capacity of owner (and therefore are in the nature of participation by owners) or as Government (and therefore are in the nature of government grant) and accordingly, whether the difference (if any) between the fair value of loan and transaction price, viz., interest-free

portion on the loan (if any) should be considered as an equity contribution or as a government grant, this issue and accounting thereof has not been examined by the Committee.

18. In the context of issue raised, the Committee notes from the Facts of the Case that interest-free subordinate debts have been provided by GoI, GNCTD and other Government authorities as a part of funding arrangement for construction of MRTS project. These are repayable in 5 equal instalments after the repayment of interest-bearing loan of relevant phases from GoI i.e. after 30 years. The Committee further notes that the loan received from the government(s)/government authorities, is a financial liability as per Ind AS 32. Accordingly, it should be recognised and measured as per the requirements of Ind AS 109, 'Financial Instruments'. In this regard, the Committee notes the following paragraphs of Ind AS 109 and Ind AS 113, 'Fair Value Measurement':

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.

5.1.1A However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph B5.1.2A."

"B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and Ind AS113). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset."

"B5.1.2A The best evidence of 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 Ind AS 113). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:

(a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability."

Ind AS 113

"9 This Ind AS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

"11 A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:

(a) the condition and location of the asset; and

(b) restrictions, if any, on the sale or use of the asset.

12 The effect on the measurement arising from a particular characteristic will differ depending on how that characteristic would be taken into account by market participants."

"22 An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest."

"40 When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is not held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument using a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity."

From the above, the Committee notes that Ind AS 109 requires financial liabilities to be initially recognised at their fair value minus transaction costs (if not classified as subsequently measured at fair value through profit or loss, which is not the situation in the extant case). Therefore, the sub-ordinate loan bearing nil interest rate at its initial recognition should be measured at its fair value, minus directly attributable transaction costs (if any).

Further, based on reading of paragraph B 5.1.1 of Appendix B of Ind AS 109, 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), 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.

19. Further, the Committee notes that as per the requirements of Ind AS 113, the fair value should be determined using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest. Thus, the Committee is of the view that the fair value of a loan at market rates should normally consider the interest rates charged by market participants for loans with similar remaining maturities, cash flow patterns, currency, sector related or industry specific risks, currency risks, collateral, interest basis, etc. Since in the extant case, the subordinate loans/ debts have been provided at nil rate of interest, which is apparently not at market rates, the Company should measure the fair value of the loan using various valuation techniques and using inputs as per the requirements of Ind AS 113; and may also consider obtaining valuation by an expert valuer in this regard.

In this regard, the Committee also wishes to mention that the fact that the interest-free subordinate loans are received by the Company at the same terms and conditions at which such loans are provided to other metro projects does not make it at market terms and they cannot be considered already to be at fair value. The characteristics of a particular sector/industry, such as, priority sector should be taken into account while measuring fair value. Also, the fact that there is no rate available in the Indian Banking system, for such loans of similar quantum, tenure and terms & conditions do not justify non-determination of fair value of such loans. These can only lead to absence of observable inputs in case of fair value determination. However, absence of observable inputs does not make measurement of fair value impossible.

D. Opinion

20. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 15 above:

(i) The accounting treatment followed by the Company i.e. considering transaction price to be the fair value on initial recognition, may not be correct, as discussed in paragraph 19 above.

(ii) The Company in the extant case should measure the fair value of the liability (subordinate debts) using a valuation technique from the perspective of a market participant as per the various techniques and using inputs as per the requirements of Ind AS 113, as discussed in paragraph 19 above.

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