Query No. 7

Subject: Accounting Treatment of Shareholder's Loan provided to Joint Venture Company under Ind AS framework.[1]

A. Facts of the Case

1. A Government of India Undertaking (hereinafter referred to as 'the Company'), is engaged in refining of crude oil having a refining capacity of 3.0 MMTPA. The Company is jointly owned by O Limited, Government of Assam (GoA) and E Limited. O Ltd. holds 69.63% whereas GoA and E Ltd. own 26% and 4.37% respectively. The refinery is located in the state of Assam. The capacity of the refinery is being enhanced from 3.0 MMTPA to 9.0 MMTPA.

2. The Board of Directors of the Company earlier approved shareholder's loan amounting to Rs. 654 crore to be given to its joint venture company, A Limited for the implementation of bio refinery project. A Ltd. has also obtained term loan from Punjab National Bank (PNB) amounting to Rs. 2,170 crore for financing its project cost. It may be noted that A Ltd. will produce fuel grade ethanol and other platform chemicals viz. acetic acid and furfural alcohol using bamboo as feedstock, together with bio-coal (residue of feedstock after processing) for producing power and stillages (dry basis) to be used as fertilizers. The above shareholder loan is provided under two different agreements for an amount of Rs. 261 crore and Rs. 393 crore respectively. The Company has disbursed an amount of Rs. 443.50 crore to A Ltd. in various tranches till 31st March, 2023. The salient features of both the shareholder's loan agreement are as under:

Terms	1st Loan Agreement (Rs. 261 crore)	2nd Loan Agreement (Rs. 353 crore)
Nature	Unsecured	Unsecured
Commencement Date	06th August, 2020	15th August, 2022
Repayment	At once, at the end of fifteen years from the date of agreement i.e. 05th August 2035.	At once, at the end of eleven years from Commercial operation Date (COD).
Rate of Interest	Annualised Term Loan Interest Rate of PNB + 0.85%. Shareholder's Loan interest rate shall be subject to changes in the Term Loan Interest Rate	Annualised Term Loan Interest Rate of PNB + 0.73%. Shareholder's Loan interest rate shall be subject to changes in the Term Loan Interest Rate.
Interest Accrual and Payment	Interest upto Commercial Operation Date (COD) **shall not be accrued and paid.** After COD interest will be paid out of project cash flows on yearly basis at the end of every financial year till repayment of the loan.	Interest upto Commercial Operation Date (COD) **shall not be accrued and paid**. After COD interest will be paid out of project cash flows on yearly basis at the end of every financial year till repayment of the loan.

Note: Premium over Annualised Term Loan interest rate is subject to revision till actual COD of the project which has not yet started.

[1] Opinion finalised by the Committee on 24.4.2024.

3. *Accounting treatment applied by the Company:*

Since shareholder’s loan is a financial asset for the Company as there is a contractual right to receive cash from another entity, provisions of Ind AS 109, ‘Financial Instruments’ were applied to accounting for the shareholder’s loan in financial books of the Company.

As per paragraph B5.1.1 of Ind AS 109, fair value of a financial instrument at the time of initial recognition is normally the transaction price (i.e. 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.

As per paragraph B5.1.2, If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, i.e. net of the fee it receives.

Further, as per paragraph B4 of Ind AS 113, ‘Fair Value Measurement’, the transaction price might not represent the fair value of an asset or a liability at initial recognition if the transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

Considering the above provisions of Ind AS, shareholder’s loan should initially be recognised at fair value. In the instant case, transaction price is not the fair value as the shareholder’s loan agreement includes interest holiday during construction period which is generally not offered by financial institutions to its borrowers and hence, the instrument needs to be fair valued based on market observable data, i.e., interest rate for a 15 year loan (since loan is repayable after 15 years) (Refer paragraph B5.1.2A of Ind AS 109). Subsequently, financial asset would be measured at amortised cost using interest rate used for fair valuation for the total receipt in the form of interest during the tenure of loan and discount it to derive the effective rate of interest and interest accrual is made accordingly.

Based on the above, the Company calculated the fair value (Rs. 400.54 crore) of loan disbursed (Rs. 443.50 crore) till 31st March 2023 as mentioned above resulting into difference between fair value and transaction value (Rs. 42.96 crore). The fair value of the loan (Rs. 400.54 crore) has been presented as financial asset and difference between the transaction value and the fair value has been presented as ‘Investment in Joint Venture’. Fair value of the loan has been worked out by considering discount rate based on annualised term loan interest rate plus premium (considered to be the market rate).

Interest on loan (Rs. 39.34 crore) upto 31st March, 2023 has been calculated considering fair value of the loan from the date of disbursement. The interest income is reflected as 'Other non-operating income' under the head 'Other Income' in the Statement of Profit and Loss of the Company with corresponding addition to financial asset and added to the loan value. (Sample calculation for one tranche has been supplied by the querist for the perusal of the Committee).

4. During supplementary audit of the financial statements for financial year (F.Y.) 2022-23, the Comptroller and Auditor General of India (CAG) has raised observation in regard to recognition of interest income on shareholder's loan by the Company as under:

Balance Sheet

Non-current assets

(g) Financial Assets (ii) Loans (Note No. 8) Rs. 491.90 crore

Statement of Profit and Loss for the year ended 31st March 2023

Other Expenses (Note No. 42) - Provision for Doubtful debts,

Advances and claims Nil

Profit before Tax for the year: Rs. 4,953.23 crore

'Non-current financial assets - Loan' includes Rs. 39.34 crore (Rs. 34.15 crore for the financial year 2022-23 and Rs. 5.19 crore for the financial year 2021-22) as interest receivable on Shareholders' loan given to M/s A Ltd., a joint venture of the Company.

According to the clause 4 (c) of the Shareholder's Loan Agreement (August 2020), up to Commercial Operation Date (COD) of the bio-refinery, interest shall not be accrued and paid for the Shareholder's Loan. After COD, interest would accrue and be paid on yearly basis, till the repayment of the outstanding Shareholder's Loan. It was further observed that M/s A Ltd. has not yet (June 2023) declared COD as the overall physical progress of the Project was only 85% (as on 15th May, 2023).

Thus, in view of the clause 4 (c) of the Shareholder's Loan Agreement, the Company would not be able to recover Rs. 39.34 crore from M/s A Ltd., as interest is not accruable upto the date of COD. Accordingly, a suitable provision should be made in the books of the Company to cover the same.

Thus, non-provision of this non realisable interest income from the joint venture company (M/s A Ltd.) has resulted in understatement of 'Other Expenses – Provision for Doubtful debts, Advance and Claims' by Rs. 39.34 crore and overstatement of 'Profit before Tax for the year' and 'Non-current financial assets -Loan' by Rs. 39.34 crore each.

5. To the above observation, management of the Company submitted the reply as under:

The Company has provided shareholder's loan to its joint venture company A Limited for implementation of bio refinery project. As per the provision of shareholder's loan agreement, the loan is repayable after 15 years from the date of the agreement. The agreement also states that interest on loan will be accrued and paid from the date of commencement of commercial operation (COD). The Company has disbursed an amount of Rs. 443.50 crore to A Ltd. in various tranches till 31st March, 2023. It may be noted that irrespective of whether interest is accrued or not as per the provisions of agreement, interest accrual has to be made as per the provision of Ind AS 109, 'Financial Instruments'.

Shareholder's loan and interest accrued thereon is a financial asset as there is a contractual right to receive cash from another entity as per provisions of Ind AS 109 and should initially be recognised at fair value (paragraph 5.1.1 of Ind AS 109).

In the instant case, transaction price is not the fair value as the shareholder's loan agreement includes interest holiday during construction period which is not offered by financial institutions to its borrowers and hence the instrument needs to be fair valued based on market observable data i.e. interest rate for a 15 year loan (since loan is repayable after 15 years) (Ref: paragraph B5.1.2A of Ind AS 109). Subsequently, financial asset would be measured at amortised cost using interest rate used for fair valuation for the total receipt in the form of interest during the tenure of loan and discount it to derive the effective rate of interest and interest accrual is made accordingly.

Based on the above, the Company has calculated fair value (Rs. 400.54 crore) of loan disbursed (Rs. 443.50 crore) resulting into difference between fair value and transaction value (Rs. 42.96 crore).

The fair value of loan disbursed has been presented as financial asset in the Company's balance sheet (Reference Note No. 8) and difference between the present value and transaction value is presented under Investment in joint venture (Reference Note No. 7).

Interest on loan (Rs. 39.34 crore) upto 31st March, 2023 has been calculated considering the fair value of loan from the date of disbursement. The amount is reflected as financial asset in the Company's balance sheet as loan to joint venture (Reference Note No. 8). The interest income for the year is accounted as other non-operating income under the head 'Other Income' (Reference Note No. 36).

As regards audit observation on creation of provision towards accrual of interest upto the period of COD, the Company is of the view that same is not required since the entire loan amount and interest would be recovered and nothing would remain unrecovered by the end of the tenure of the loan.

B. Query

6. On the basis of the above, the querist seeks the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) on the following issues:

(a) Whether the accounting treatment of the shareholder's loan made by the Company is in line with provisions of applicable Ind AS.

(b) If not, EAC is requested to provide necessary guidance backed by sample calculation along with the relevant journal entries.

(c) Whether as opined by C&AG, the Company is required to make suitable provision towards recognition of non-realisable interest income upto COD from the shareholder's loan extended to the joint venture company.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to accounting treatment of shareholder's loan provided to joint venture company in the Company's separate financial statements. 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, determination of fair value, requirements of Ind AS 24, 'Related Party Disclosures', accounting treatment in the consolidated financial statements of the Company, presentation of interest income in the financial statements, accounting for expected credit loss on loan receivable as a whole (if any, apart from nil interest payment during certain period), impact of premium charged over interest rate of PNB, deferred tax impact (if any), sample calculation of effective interest rate on loan as shared by the querist, accounting in the books of A i.e. the joint venture company which is the recipient of the loan, etc. Further, the Committee has examined the query only from accounting perspective and not from any other perspective, such as, legal interpretation of shareholder's loan agreement 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 and as applicable on 31st March, 2024.

8. The Committee notes from the Facts of the Case that the Company is providing shareholder's loan to its joint venture company (A Limited) for implementation of bio refinery project. The loan provided to joint venture company (A Limited), being a financial asset, should be recognised and measured as per 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

"4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

(a) the entity's business model for managing the financial assets and

(b) the contractual cash flow characteristics of the financial asset.

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

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

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

“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**.”

“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 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. 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

"B4 When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

(a) The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

(b) …"

From the above, the Committee notes that Ind AS 109 requires financial assets to be initially recognised at their fair value plus transaction costs (if not classified as subsequently measured at fair value through profit or loss).

Further, based on reading of paragraph B5.1.1 of Appendix B of Ind AS 109, the fair value of a financial instrument at initial recognition is normally the transaction price. 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; and the difference between the amount lent and the fair value of an interest-free loan is generally recognised as a gain or loss unless it qualifies for recognition as some other type of asset. The fair value of a loan at market rates would normally consider the interest rates charged by market participants for loans with similar remaining maturities, cash flow patterns, currency, credit risk, collateral, interest basis, etc. The Committee further notes that as per paragraph B4 of Ind AS 113, the transaction price might not represent the fair value of an asset or a liability at initial recognition if the transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

9. On the basis of the above, the Committee is of the view that in the extant case, the overall contractual interest on the loan to the joint venture during the loan tenure, which bears no interest for a certain period, cannot be considered to be at market terms. The financial asset should be initially recognised and measured at its fair value, which should 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 as per the requirements of paragraph B5.1.1 of Ind AS

109. With regard to the difference between the amount lent and the fair value of the loan (hereinafter also referred to as the ‘below market element’), the Committee is of the view that where a loan to related party is not on normal market terms, the substance of the below-market element should be ascertained, to determine the accounting for this part of the loan receivable. The Committee is of the view that if a loan is made by an equity holder, for example, by parent to a subsidiary/joint venture on favorable terms, the substance of the transaction is that the subsidiary/joint venture has received a contribution from the parent to the extent that the cash advanced exceeds the fair value of the subsidiary’s/joint venture’s financial liability or lender’s fair value of the financial asset.

Accordingly, in the extant case, in substance, the below market interest element may be construed as a non-reciprocal capital contribution by the Company to JV (A limited) and should be recognised by the Company as an investment in joint venture (as a component of the overall investment in the joint venture) in its separate financial statements.

Further, subsequently, as per the requirements of paragraphs 4.1.1 and 4.1.2 of Ind AS 109, the financial asset shall be measured at amortised cost since the financial asset (loan receivable) in the extant case appears to be held to collect contractual cash flows and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. The interest income on financial asset should be accrued and calculated by the Company by using effective interest method considering the imputed 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, which was used to determine the fair value on initial recognition and the same should be recognised in the profit or loss.

The Committee also wishes to clarify that the difference in the interest as per the contractual terms and interest accrued in the financial statements as per effective interest rate, is due to accounting as per applicable Ind AS. Further, the Committee also notes that the interest is realisable when the actual payout starts from the joint venture; therefore, at this stage, there is no non-realisable interest income which is required to be accounted for.

D. Opinion

10. On the basis of the available facts and figures and the discussions mentioned herein above, read alongwith the observations given in paragraph 7 above, the Committee is of the following opinion on the issues raised (as mentioned in paragraph 6 above):

(a) The accounting treatment of the shareholder’s loan made by the Company is in line with provisions of applicable Ind AS, as discussed in paragraphs 8 and 9 above;

(b) In view of the opinion at (a) above, this issue becomes infructuous. And hence not answered;

(c) The interest accrued will be received when actual payout starts from the joint venture, as discussed in paragraph 9 above. Since there is no non-realisable interest income reported at this stage, the question of making any provision does not arise.

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