Chapter 2

Accounting of financial instruments under Ind AS

This article aims to:

Discuss key matters for accounting of compulsorily convertible preference shares as liability or equity with anti-dilution or buy-back rights as triggering events.

Introduction

India Inc. is witnessing a significant growth in the number of start-ups over the last few years. From e-commerce to electric vehicles, the Indian start-ups are the torch bearer for innovation and entrepreneurial spirit of India. Private-equity funding is the most common method of raising funds by a start-up. Other modes of raising funds include debt, investment by angel investors, government investment funds and grants, etc. Raising capital, acquiring customers, compliance with the regulatory requirements and corporate governance related matters are some of the potential issues being faced by the start-ups.

Investors invest in businesses using variety of instruments and one of the common ways to invest is Compulsorily Convertible Preference Shares (CCPS). Generally, these instruments allow the investors to convert at a future date based on an agreed ratio, the conversion option to be variable depending on the business performance. In certain cases, the conversion options are linked to future business performances, thereby allowing investors to get higher number of shares in the event the performance is not in line with projections, thereby protecting investors from loss in valuations.

Sometimes investor agreements contain a clause which protects the investor from the investee company raising capital from others at a valuation lower than the base at which the present investor invested into the company. This is referred to as the 'Down Round Protection'. This feature essentially helps ensure that if the company raises further capital at a valuation lower than its earlier investment level, the company will issue additional shares to compensate investor's value diminution. Essentially, it protects the investor from a downside risk in the event the business raises further capital at lower valuation, thereby diluting the investor's equity holding in the company.

This clause also protects an investor for adjustments arising from issuance of bonus shares/share splits, etc. Additionally, another feature of the CCPS could be that it includes a written put option (buy-back) that provides the investor with the right to sell CCPS at a specified date (or on occurrence of certain events) at a specified price (or at a variable price to be determined in future) to a given party. These are included in investment agreements to provide the investor with an option to sell his/her holding back to the company or the promoter, and thereby exiting from the company. These are generally triggered in the event the company is unsuccessful in doing an IPO within a specific period of time or any other event agreed at the time of the investment e.g., a strategic sale. These put options can be exercised on the company or the promoter depending on how the agreement between the investor and the company has been agreed upon.

Accounting and presentation of financial instruments - Equity or liability

Guidance under Ind AS

Ind AS 32, *Financial Instruments: Presentation* establishes principles for the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities, and equity instruments. In accordance with Ind AS 32, an instrument is an equity instrument if both the given conditions 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 unfavorable 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 its existing owners of the same class of its own non-derivative equity instruments.

An issued share option that gives the holder the right to buy a fixed number of the entity's shares for a fixed amount of cash or for a fixed stated principal amount of a bond is an equity instrument (fixed-for-fixed criterion).

Also, changes in the fair value of an instrument because of changes in market interest rates that do not affect the amount of cash or other financial assets to be received or paid, or the number of equity instruments to be received or delivered, do not impact classification as an equity instrument.

Accounting under Ind AS is determined not only by considering the legal form of the instrument but by also considering the underlying substance of the transaction. Accordingly, the company needs to evaluate the entire contract of the CCPS and all its features to determine if the instrument needs to be classified as a financial liability or equity.

Equity classification

Investments generally which are made through plain vanilla CCPS (i.e., do not contain any adjustment clauses that do not violate the fixed-for-fixed criterion) are classified as equity instruments since they represent residual interest in the entity. It is important to note that any specific features can cause the entire instrument to be classified outside of equity.

Liability classification

Investments made through instruments which contain an unconditional obligation to deliver cash or another financial asset would result in the instrument being classified as a financial liability. If the CCPS contain rights to convert into variable number of equity shares the same would represent a financial liability in accordance with the guidance given in Ind AS.

Down round protection

Down round protection clauses that only protect an investor from bonus/share splits would typically not require any separate accounting. However, other clauses that protect an investor against future fair value losses due to fresh equity issuances in future, would need to be evaluated.

A question arises about whether a feature that requires adjustment to an otherwise fixed conversion ratio when additional equity instruments are issued at a price below the initial conversion price - i.e., a 'down-round feature' that violates the fixed-for-fixed requirement - creates an obligation for the issuer to issue a variable number of own equity instruments. In our view, the classification of the instrument depends on whether the decision not to issue additional equity instruments that may

trigger the down-round feature is in the entity's control - i.e. there is neither any contractual nor statutory obligation that may require the entity to issue additional equity instruments that might trigger the down-round feature.

If the entity has control over issuing additional equity instruments and the CCPS contain no other feature that would be inconsistent with equity classification, then we believe that the entity should choose an accounting policy, to be applied consistently, to:

- Classify the CCPS entirely as equity because the entity has no contractual obligation to deliver a variable number of own equity instruments, or
- Recognise separately the equity host and an embedded derivative for the conversion option including the down-round feature measured at fair value through profit and loss because it does not meet the fixed-for-fixed requirement.

If an entity does not have control over issuing additional equity instruments due to specific laws or regulations, then such factors would require detailed evaluation[1].

Put options/buy back

Put options or buy back requirements could trigger when for instance, an IPO does not take place within the specified time, and the company cannot ensure that the IPO will actually occur. In such a scenario, since the exit mechanism by way of an IPO is a contingency i.e., an uncertain future event which is beyond the control of both the company and the investor in the CCPS, the CCPS would be potentially redeemable in cash. In this situation, the CCPS would contain a liability, regardless of the likelihood of cash settlement.

There could be a number of scenarios where buy back and put options could trigger and therefore, careful evaluation will be required to classify CCPS as equity or liability.

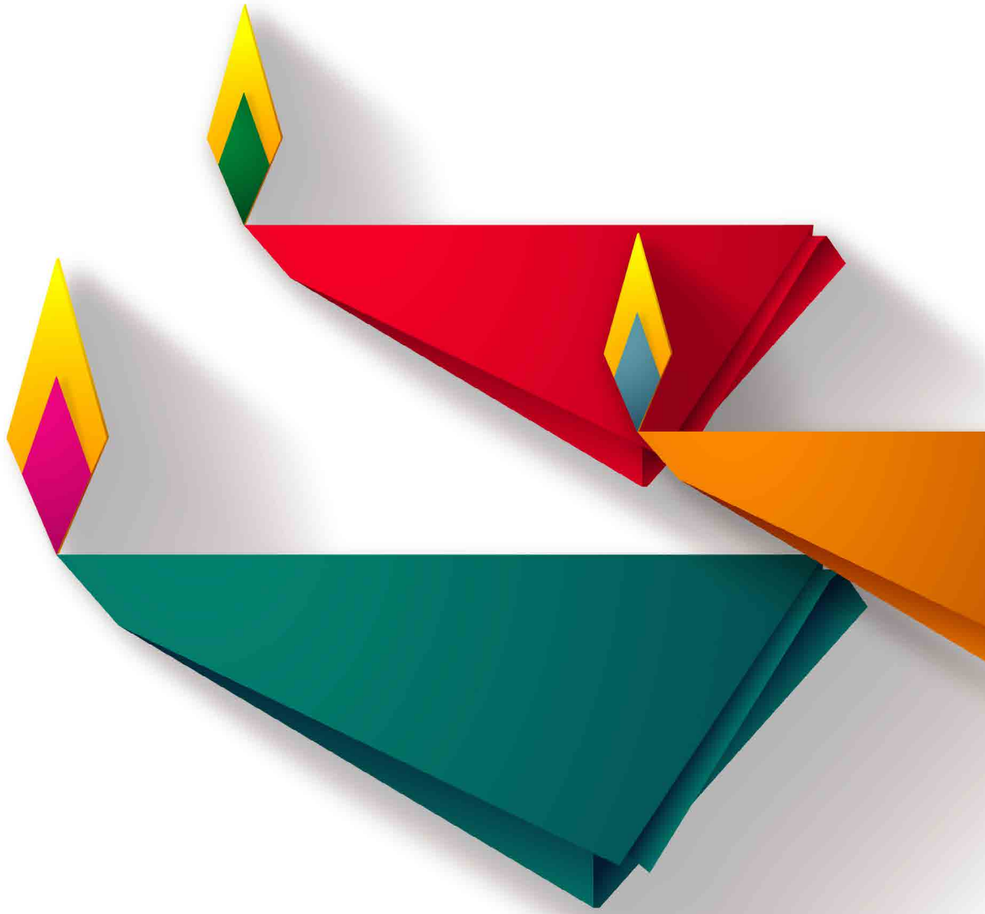
Conversion of financial liability to equity

In certain cases, an entity may amend the contractual terms of an instrument such that the classification of the instrument changes from a financial liability to equity.

This change would require detailed evaluation of the amended terms and conditions and may potentially have a large impact on the statement of profit and loss.

Conclusion

Accounting for CCPS particularly from a classification perspective can be quite complex when features like buy back or down round protection are attached to such instruments. The measurement of such instruments depends on their classification. Many start-up companies attract private equity/venture capital funding and therefore, it is important to understand the impact of accounting for such instruments under Ind AS. Companies should carefully assess facts and circumstances of each contract to evaluate appropriate classification and measurement.



1. Guidance taken from Insights into IFRS, 18th edition, 2021/22, Para reference 7.3.770