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# Recent Financial Reporting Developments & Accounting for Compulsory Convertible Preference Shares

**May 2024**

# Agenda for today's discussion

## Compulsory Convertible Preference Shares (CCPS)

- CCPS - Nature of the instrument
- CCPS – Key terms
- CCPS – Key accounting and reporting complexities
- Some key concepts
- Equity v/s liability
- Evaluation of Ind AS 32 - CCPS
- Evaluation of Ind AS 32 - OCPS
- Key clauses for consideration
- Illustrative disclosures
- Key takeaways

## IFRIC Update

- March 2024 Closing Out
- IFRS 2024 Amendments
- IFRS Interpretations Committee - Agenda decisions
- IFRS Interpretations Committee – Tentative agenda decisions

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# Compulsory Convertible Preference Shares (CCPS)

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# CCPS - Nature of the instrument



Key element of funding specially for E-commerce/startup ecosystem.



Assurance to the investors of a fixed rate of return plus the opportunity for capital appreciation.



CCPS holder typically may have more rights than other investors.



Helps investors to maintain their stake and have a say even if their stake gets diluted later.



Helps founders to keep control of a company even if their stake is lower than that of investors.



Under Companies Act 2013, CCPS are considered as preference shares which holds preferential rights over equity shareholders. While in accounting, these could be classified as equity, liability or both.

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# CCPS - Key terms (Indicative)

B Ltd has issued 1000 CCPS on 31 December 20X0. Below are some key terms of the agreement:



**Conversion options :** Each CCPS shall be compulsorily convertible into 10 Equity Share of the Company. Each holder of CCPS may convert CCPS held by it in whole or part into Equity Shares at any time not later than 20 years from the date of issuance.

**Dividend rights:** CCPS carries a pre-determined 0.01% p.a. cumulative dividend. Subject to Applicable Law, CCPS shall be entitled to receive pro-rata in any dividends paid on the Equity Shares on an “As if” converted basis.

**Anti dilution:** In the event that the Company undertakes any form of Capital Restructuring, the number of Equity Shares that CCPS converts into shall be adjusted on a proportionate basis after giving effect to the Capital Restructuring. “Capital Restructuring” shall mean any form of restructuring by the Company of its share capital including consolidation, sub-division or splitting of its shares or issue of any bonus shares or issue of shares pursuant to any scheme of arrangement, including merger, amalgamation, or de-merger or any classification of shares or variation of rights into other kinds of securities.

**Contingent settlement options** : The investor intends to exit its investment in the company when the company makes an initial public offer (IPO) for its ordinary shares, which is expected to occur in three years. The preference shares therefore provide for automatic conversion into 12 equity shares of INR10 each for each INR100 preference share when the IPO takes place, provided the IPO takes place within three years. If the company does not complete an IPO within three years, the issuer is obliged to redeem the preference shares in cash for an amount equal to the amount invested plus a return of 13 per cent per annum.

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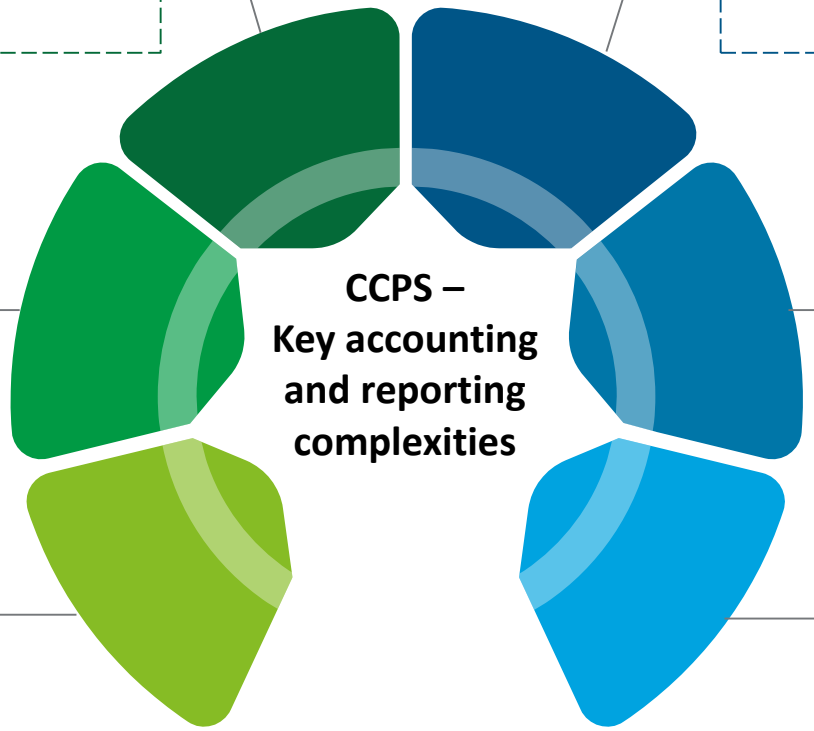
# CCPS – Key accounting and reporting complexities

*Complex terms and conditions mentioned in the agreement:*

- *Exit clause*
- *Multiple option on cash flows*
- *Linkages to IPO at times*
- *Evaluation of substance over legal form*
  - *Probability of different scenarios*
  - *Genuineness of the clauses*
  - *Economic substance*

*Classification issues – Equity, Liabilities or Compound Financial Instruments and its consequential impact on*

- *Income statements*
- *Key financial metrics and business impact such as equity structure, debt equity ratio, EPS, borrowing limits.*
- *Track record of profitability (for e.g. IPO)*




*Ensure regulatory compliances with Companies Act 2013, SEBI, FEMA*

*Periodic fair valuation of liabilities and its impact on the financial statement*

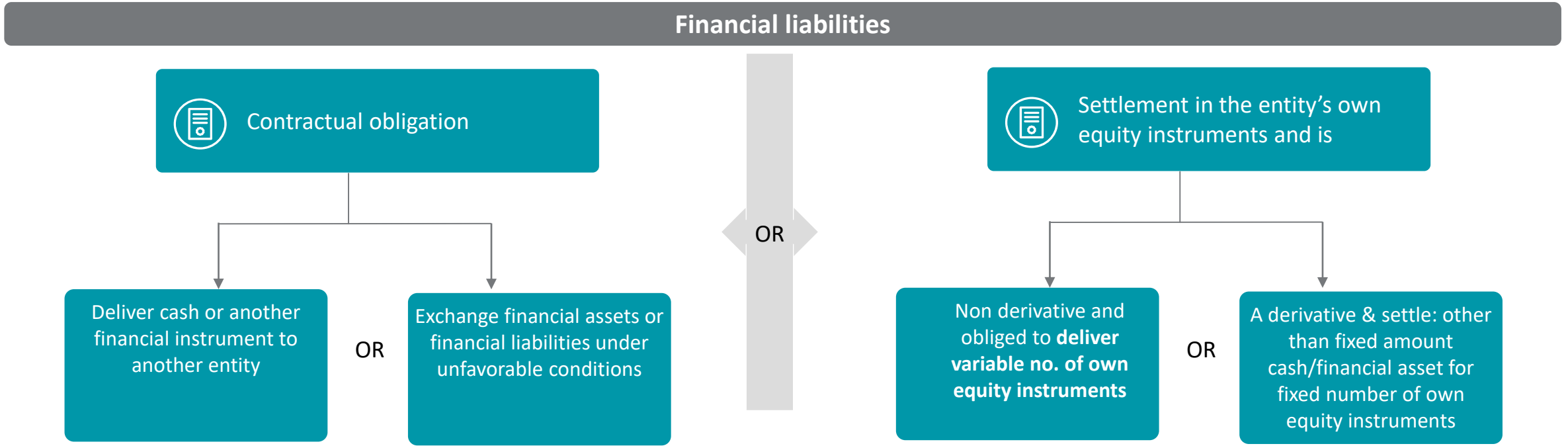
Modification of terms and conditions – will have prospective impact

*Other business-related considerations such as future IPO, Tax implications, Cap table*

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# Some key concepts

**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.




**Equity -** A residual interest in the assets of an entity after deducting all of its liabilities.

**Compound financial instrument -** Financial instrument which contains both a liability and an equity component.

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# Equity v/s liability

Due to complex structure and clauses in the agreement **classification of CCPS** may be complex determination. The determination of whether it should be classified as debt or equity requires careful evaluation of all terms and conditions of CCPS.

## Liability characterisitics

- Discretionary dividends
- Settlement in entity's own **(fixed number)** equity instruments for fixed amount of cash/another financial asset
- Unconditional right to avoid delivering cash or another financial asset
- Puttable instrument (with some specific characteristics)
- Contingent settlement provisions (with some exceptions)

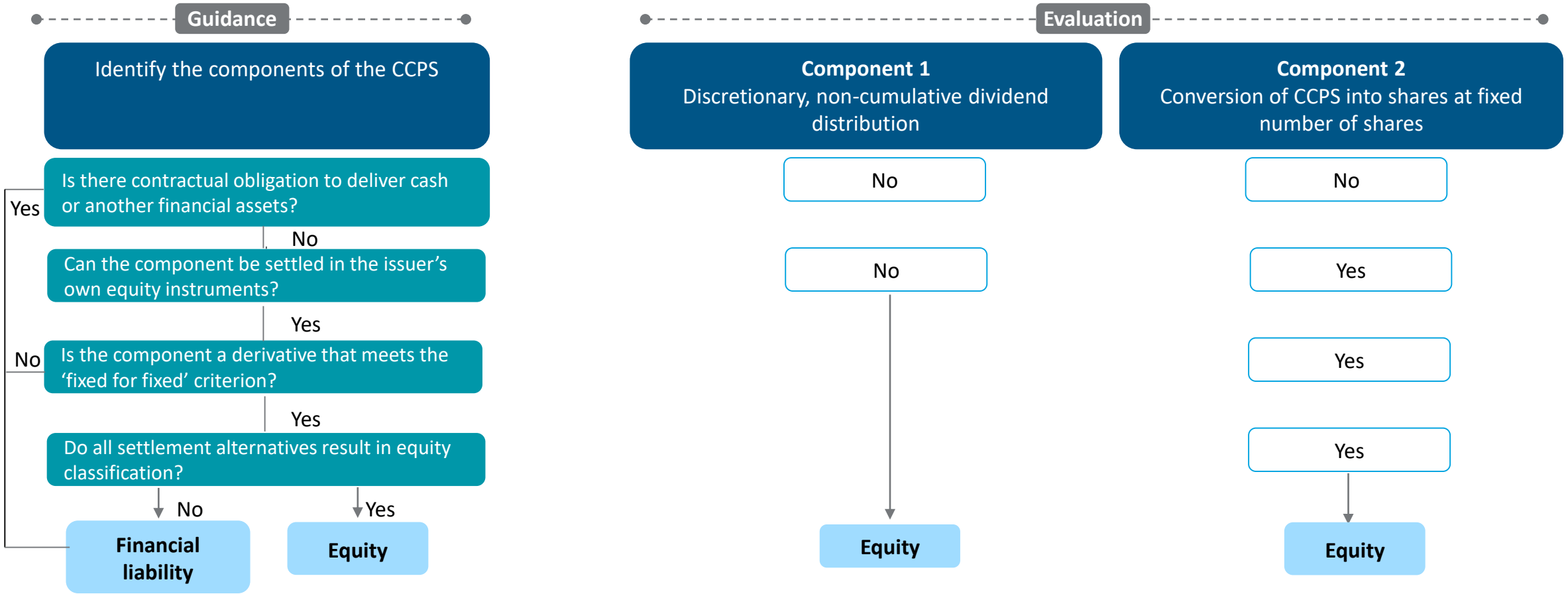
## Equity characterisitics

- No unconditional right to avoid delivering cash or another financial asset
- Settlement in entity's own (variable number) equity instruments
- Delivering or receiving fixed number of its own equity instruments for a variable amount of cash or financial asset
- Contingent settlement provisions (with some exceptions)
- One party has a choice over how it is settled

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# Evaluation of Ind AS 32 guidance - CCPS

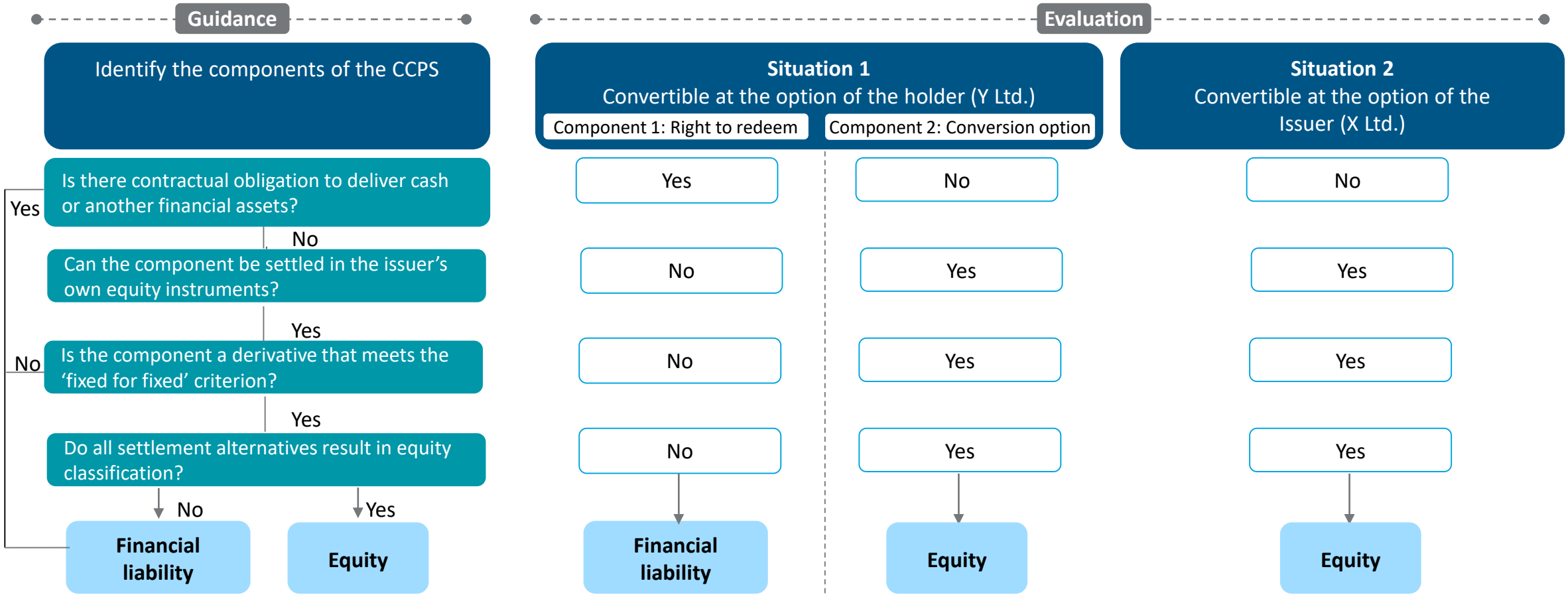
X ltd (issuer) has issued non-cumulative, 4% p.a. Compulsory convertible preference shares to Y Ltd. (holder) for a consideration of Rs. 40 lakhs. These preference shares are convertible to a fixed number of equity instrument of the issuer anytime up to a period of 3 years. The dividend payment is at the discretion of the issuer.




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# Evaluation of Ind AS 32 guidance - OCPS

X ltd (issuer) has issued 6% p.a. Optionally convertible preference shares to Y Ltd. (holder) for a consideration of Rs. 40 lakhs. These preference shares are convertible to a fixed number of equity instrument of the issuer anytime up to a period of 3 years. If the option is not exercised, the preference shares are redeemed at the end of 3 years. Ignore dividend for ease of understanding.




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# Key clauses for consideration

| Clause | Details | Classification | |
|---|---|---|---|
| | | Equity | Liability |
| **Cumulative Dividend** | It gives assurance of receiving dividend before equity shareholders | Discretionary | Mandatory |
| **Contingent Settlement Provision** | This gives the investors benefit of pre-determined timeline for exit and provides clarity on investment liquidity | If certain conditions are satisfied | Obligation to settle the instrument on happening of the event |
| **Anti-Dilution** | To protect the value of investment of the investors in case of subsequent down-round. | Maintaining existing conversion ratio in situations like Stock split, bonus, amalgamation, merger, etc. | Protection from down round |
| **Conversion option** | This gives the investors opportunity to convert their investment into equity shares. | Conversion into fixed number of equity shares | Conversion into variable number of equity shares |

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# Illustrative disclosures provided by some companies (extracts)

During financial year 2018-19, the Company had transitioned from IGAAP to Ind AS financial reporting, on transition the Company was required to adopt as per Ind AS 32 Financial Instruments: Presentation, that requires to classify CCCPS (including premium) as a financial liability as at the respective balance sheet dates i.e. as at April 01, 2017, March 31, 2018 and March 31, 2019 given that it contains a buy back right available to the majority holders as per the Shareholders Agreement with the CCCPS holders. However, the Company classified the CCCPS (including premium) as equity in its first Ind AS financial statement as at April 01, 2017, March 31, 2018 and March 31, 2019. Further, the Company did not recognise as gain/ loss in respect of such CCCPS during the year ended March 31, 2018 and March 31, 2019. As on September 27, 2019, the majority preference shareholders having the ability to trigger the put option irrevocably waived these rights of buy back. The Company had obtained the legal opinion, which confirmed that based on the above waiver obtained from the majority shareholders, the buyback clause is neither enforceable nor exercisable. The management had continued to carry the aforesaid preference shares as equity classification at the respective balance sheet dates and it did not

recognise any gain/ loss in respect of such CCCPS during the year ended March 31, 2020. In this regard, the statutory auditors had carried qualified their audit opinion in their independent

(c) Terms/rights attached to 0.01% Compulsory Convertible Cumulative preference shares The holders of CCPS shall have the right (but not the obligation) to convert the CCPS in whole or part into equity shares at any time within 20 Years from the date of issuance of CCPS or Qualified IPO, whichever is earlier subject to the terms and conditions of the shareholders/ subscription agreement. The CCPS shall carry a pre-determined cumulative dividend rate of 0.01% per annum. The holders of CCPS shall be entitled to attend meetings of all shareholders of the Company and will be entitled to have such voting rights on an, as if converted basis of Equity. During the year ended March 31, 2021, the company has converted CCPS into equity shares based on the contractual terms. (d) Terms/rights attached to 0.1% Compulsory Convertible Non-Cumulative preference shares The holders of CCPS shall have the right(but not the obligation) to convert the CCPS in whole or part into equity shares at any time within 20 Years from the date of issuance of CCPS or Qualified IPO, whichever is earlier subject to the terms and conditions of the shareholders/ subscription agreement. The CCPS shall carry a pre-determined non-cumulative dividend rate of 0.1% per annum. The holders of CCPS shall be entitled to attend meetings of all shareholders of the Company and will be entitled to have such voting rights on an as if converted basis of Equity. During the year ended March 31, 2021, the Company has converted all the CCPS into equity shares based on the contractual terms.

**Conversion of CCPS**

Our Company has pursuant to the Board resolution and Shareholders' resolution, each dated October 27, 2023, sub-divided equity shares having face value of ₹10 each into Equity Shares having face value of ₹1 each. Further, our Company has pursuant to the Board and Shareholders' resolutions, each dated October 27, 2023, approved the issuance of 5,81,80,800 bonus Equity Shares in a ratio of 255 Equity Shares for one Equity Share held by our Shareholders as on the record date of November 1, 2023. Further, pursuant to the sub-division and the bonus issuance, the amendments to the terms of the Preference Shares stipulated under the SHA were approved pursuant to Board and Shareholders' resolution, each dated December 19, 2023, which provided for appropriate adjustments to the conversion ratio of outstanding Preference Shares such that each holder of the outstanding Preference Shares receives such number of Equity Shares that it would have been entitled to receive immediately after the occurrence of sub-division, bonus issue, consolidation of shares, and other corporate actions ("**Capital Restructuring**"), had the option to convert the outstanding Preference Shares been exercised immediately prior to the occurrence of such Capital Restructuring. Further, in case of a bonus issue of Equity Shares, the number of Equity Shares to be issued on any subsequent conversion of the outstanding Preference Shares shall be increased proportionately and without payment of additional consideration thereof by the holders of the outstanding Preference Shares. Accordingly, the conversion ratio which accounts for the appropriate adjustment to the terms of the Preference Shares pursuant to the sub-division and bonus issue stands adjusted to 2,560:1, i.e., 2,560 Equity Shares for one Preference Share held by such Preference Share holder.

Prior to filing of the RHP with the RoC, outstanding (i) 11,350 Series A Preference Shares and (ii) 5,247 Series B Preference Shares will be converted into an aggregate of 4,24,88,320 Equity Shares.

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# Key takeaways

- **Understanding of the terms and conditions** of the agreement entered and its implication on the income statement and balance sheet
- **Favorable or unfavorable conversion terms** can affect company's capital structure and decision-making process
- **Comply with regulatory requirements and notified accounting standard** to ger rid of any intricacies.
- **Consult with accounting expert and statutory auditors** to make informed decisions.




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# IFRIC Update

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# March 2024 Closing Out

## Key Takeaways

**Amendments effective for annual reporting periods beginning on/after 1 April 2023:**

- *Deferred Tax related to Assets and Liabilities arising from a Single Transaction* narrowed the scope of the initial recognition exemption in Ind AS 12 so that it does not apply to transactions that give rise to equal amounts of taxable and deductible temporary differences.
- *Disclosure of Accounting Policies* requires entities to disclose material accounting policy information instead of significant accounting policies. Information is material if users of financial statements need it to understand other material information in financial statements.
- *Definition of Accounting Estimates* defines accounting estimates as "monetary amounts in financial statements that are subject to measurement uncertainty."



**Amendments correspond to those in IFRS**

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# March 2024 Closing Out

## Key Takeaways

**IFRS Amendments effective for annual reporting periods beginning on/after 1 January 2023:**

*International Tax Reform—Pillar Two Model Rules* includes a mandatory exception where an entity neither recognizes nor discloses information about deferred tax assets and liabilities related to Pillar Two income taxes. The amendments require an entity to disclose:

- The fact that it has applied the exception;
- Its current tax expense (income) related to the Pillar Two income taxes; and
- Known or reasonably estimable information that would help users of financial statements to understand the entity's exposure to Pillar Two income taxes arising from that legislation.



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# IFRS – 2024 amendments

## Key Takeaways

**Amendments to Accounting Standards/Sustainability Disclosure Standards effective for annual reporting periods beginning on/after 1 January 2024:**

Together, *Non-current Liabilities with Covenants and Classification of Liabilities as Current or Non-current:*

- Introduce a definition of "settlement;"
- Clarify classification of liabilities as current or non-current;
- Specify that classification is unaffected by expectations about an entity's right to defer settlement of a liability for at least twelve months;
- Specify the impact of covenants on an entity's right to defer settlement for at least 12 months; and
- Introduce a requirement to disclose information which enable to understand the risk that non-current liabilities with covenants may become repayable within 12 months.

*Lease Liability in a Sale and Leaseback* requires a seller-lessee to subsequently measure lease liabilities in a way that does not result in recognition of a gain or loss that relates to the right of use it retains.

*Supplier Finance Arrangements:*

- Describes the characteristics of a supplier finance arrangement;
- Introduces additional disclosure requirements, in particular to require an entity to disclose information about the effects of supplier finance arrangements (liabilities and cash flows) and the entity's exposure to liquidity risk.



New standards -Annual reporting period beginning on or after 1 January 2027; earlier application permitted

IFRS 18 – Primary Financial Statements

IFRS 19 - Subsidiaries without Public Accountability

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# IFRS Interpretations Committee – Agenda decisions



Complete list of IFRS Interpretations Committee agenda decisions can be found on IFRS Foundation website

**Selected agenda decisions of IFRS Interpretations Committee in 2023/2024:**

| Date of issue | Standard | Topic |
|---|---|---|
| **Apr 2024** | **IAS 37** | **Climate-related Commitments** |
| Apr 2024 | IFRS 3 | Payments Contingent on Continued Employment during Handover Periods |
| Jan 2024 | IAS 27 | Merger between a Parent and Its Subsidiary in Separate Financial Statements |
| Oct 2023 | IFRS 9 | Guarantee over a Derivative Contract |
| Oct 2023 | | Homes and Home Loans Provided to Employees |
| Jan 2023 | IFRS 17<br>IFRS 9 | Premiums Receivable from an Intermediary |
| **Apr 2023** | **IFRS 16** | **Definition of a Lease—Substitution Rights** |

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# IFRS Interpretations Committee – Tentative agenda decisions



Complete list of IFRS Interpretations Committee agenda decisions can be found on IFRS Foundation website

## Tentative agenda decisions of IFRS Interpretations Committee in 2023/2024:

**IFRS 8 Operating Segments**

Disclosure of Revenues and Expenses for Reportable Segments

**IAS 21 The Effects of Changes in Foreign Exchange Rates and IAS 29 Financial Reporting in Hyperinflationary Economies**

Consolidation of a Non-hyperinflationary Subsidiary by a Hyperinflationary Parent

**IFRS 9 Financial Instruments**

Application of the 'Own Use' Exception in the Light of Current Market and Geopolitical Questions

IASB is reconsidering to make amendments as opposed to agenda decision.

**IFRS 9 Financial Instruments and IFRS 16 Leases**

Lessee accounting for lease payments forgiven

**IFRS 7 Financial Instruments: Disclosures**

Disclosure of deferred difference between fair value and transaction price

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# Climate-related commitments

Companies are making voluntary climate-related commitments. Issues are emerging on the related financial reporting implications – in particular, when does a liability arise

Constructive obligation + Recognition criteria = Liability

- Has the company made a public statement about its climate related commitments?
- Has the public statement created a valid expectation?
  - Language of the statement
  - Specificity and status of plans
  - Timing of actions to fulfil commitment
  - Publicly available evidence of progress

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# Climate-related commitments

## Fact pattern

- In 20X0, an entity publicly states its commitment:
  - to reduce its future greenhouse gas (GHG) emissions by at least 60% of their current level by 20X9; and
  - to offset its remaining emission in 20X9 and thereafter, by buying carbon credits and retiring them.
- The entity also publishes a detailed transition plan.
- Management is confident that the entity can make all these modifications and continue to sell its products at a profit.
- In addition, the entity takes a number of other actions that publicly affirm its intention to fulfill its commitments.

## Accounting issue

Whether an entity's commitment to reduce or offset its greenhouse gas emissions creates a constructive obligation for the entity?

If so, should a provision be recognised?

Is the amount recognised as an asset or expense when the provision is recognised?

## Accounting treatment

Whether an entity's statement of its commitment creates a valid expectation that it will fulfill its commitment depends on the facts of the commitment and the circumstances.

If the statement creates a constructive obligation:

- the entity does not recognise a provision when it makes the statement in 20X0 - the constructive obligation is not a present obligation as a result of a past event.
- the entity does not recognise a provision between 20X0 and 20X9 as it does not have a present obligation as a result of a past event until it emitted GHG it has committed to offset.
- as the entity emits GHG in 20X9 and in subsequent years, it will incur a present obligation to offset these past emissions. If the entity has not yet settled that obligation and a reliable estimate can be made of the amount of the obligation, the entity recognises a provision.

- If a provision is recognised, the amount is recognised as expenses, rather than assets, unless it give rises to or forms part of the cost of an item that qualifies for recognition of an asset.

**Other accounting and disclosure implications**

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# Definition of a lease—Substitution rights

| Fact pattern | Accounting issue | Accounting treatment |
|---|---|---|
| • 10-year contract for use of 100 batteries in electric buses.<br>• Supplier has practical ability to substitute alternative assets.<br>• If battery is substituted, supplier compensates customer for revenues lost/costs incurred.<br>• It is expected that supplier benefits economically from substituting a battery used for three years or more. | At which level customer evaluates whether contract contains a lease when contract is for use of more than one similar asset. | • Each battery is specified.<br>• Battery would be implicitly specified at time it is made available for customer's use. |
| | How to assess whether contract contains a lease when supplier has particular substitution rights. | **Conditions in IFRS 16:B14 for substitution right to be substantive:**<br>a. Supplier has **practical ability to substitute** alternative assets throughout period of use; and<br>b. Supplier would **benefit economically** from exercise of its right to substitute asset. |
| | | • Supplier is not expected to benefit economically from exercising its right to substitute.<br>• Condition in paragraph B14(b) does not exist.<br>• **Supplier does not have substantive right to substitute throughout period of use, as it does not meet both conditions in paragraph B14.** |
| | | • Whether supplier's substitution right is substantive throughout period of use can require judgment.<br>• Each fact pattern **needs to be carefully considered.** |

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# Disclosure of revenues and expenses for reportable segments

**Tentative agenda decision**

| Accounting issue | Accounting treatment |
| --- | --- |
| Whether an entity is required to disclose the specified amounts in IFRS 8 Operating Segments paragraph 23 for each reportable segment if those amounts are not reviewed separately by the CODM? | Paragraph 23 of IFRS 8 requires an entity to disclose the specified amounts for each reportable segment when those amounts are included in the measure of segment profit or loss reviewed by the CODM, even if they are not separately reviewed by the CODM, or when those amounts are regularly provided to the CODM, even if they are not included in the measure of segment profit or loss. |
| How does an entity determine 'material items' in IFRS 8.23(f)? | In applying paragraph 23(f) of IFRS 8, an entity:<br>a) applies paragraph 7 of IAS 1 and assesses whether the disclosure of information is material in the context of its financial statements taken as a whole;<br>b) applies the requirements in paragraphs 30–31 of IAS 1 in considering how to aggregate information in the financial statements;<br>c) considers both qualitative and quantitative factors, representing the nature or magnitude of information, or both, in assessing whether an item of income and expense is material; and<br>d) considers an item of income and expense for disclosure without regard to whether that item is presented or disclosed applying a requirement in IFRS Accounting Standards other than paragraph 97 of IAS 1. |

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