Netting off Interest Income against Interest Cost in Standalone Books of Parent Company

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. XYZ is one of India's leading diversified financial services groups. XYZ group offers a broad range of products and services spanning across asset classes and consumer segments. Its businesses are broadly divided into credit including retail finance and debt capital markets, commodities, financial markets, asset management and life insurance. XYZ Ltd. (also referred to hereinafter as the 'company') is the ultimate parent of XYZ group and has many subsidiary and associate companies. The company is a category 1 merchant banker registered with the Securities and Exchange Board of India (SEBI). The company's operations revolve around providing advisory services and merchant banking services (i.e., fee based services) and providing parental support to its group entities in carrying out their respective business activities by way of making investments in subsidiaries or arranging for funding for them.
2. The querist has stated that the company's principal business activity comprises of advisory and merchant banking activities that require minimal working capital. Further, investments in subsidiaries are made out of the capital funds of the company.
3. Subsidiaries of XYZ Ltd. need to borrow funds for their working capital needs. Since XYZ Ltd. enjoys better credit rating, it is able to raise funds at an optimal rate as compared to the rate at which its subsidiaries are able to raise funds. Although XYZ Ltd.'s need for borrowed funds is quite low, it borrows from banks and other lending institutions for lending to its subsidiaries for meeting the subsidiaries' working capital requirements. Such lending to subsidiaries is done at XYZ Ltd.'s average borrowing cost with no markup and consequently, there is no residual cost or gain to XYZ Ltd. XYZ Ltd.'s lending to its subsidiaries and associates at any point of time, is almost equal to the amount of its outstanding borrowings at that time. *Thus, in substance, it acts as a 'pass through' with respect to loans that it borrows for the exclusive use of its subsidiaries.* (Emphasis supplied by the querist.)
4. The querist has also stated that given the above stated economic rationale behind such fund raising and disbursal transactions, XYZ Ltd.'s borrowings and related costs have direct correlation with the funding requirement of the group companies. If funding requirements of the group companies increase, the company will borrow more from lender/institutions and vice versa. So, both these transactions are required to be viewed as linked and correlated. Since, the interest received by the company is equal to its cost of borrowing, the company believes it would be appropriate to offset interest income against interest cost in the presentation of income and expenses in the statement of profit and loss, as this reflects the actual substance of the transaction. Also, the actual net finance costs that would be reflected would be appropriate and attributable to the company's operations.
5. The key question is whether the presentation of the interest costs incurred on funds borrowed for onward lending to group companies net of the interest income earned from lending these funds to group companies is an appropriate presentation practice in light of existing accounting framework in India, insofaras it relates to the standalone financial statements/ financial results of XYZ Ltd.
6. *Company's analysis:*

Extracts from Accounting Standard (AS) 1, 'Disclosure of Accounting Policies':

> **"Considerations in the Selection of Accounting Policies**
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> ...
>
> 17. ...
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> *b. Substance over Form*
>
> *The accounting treatment and presentation in financial statements*

> *of transactions and events should be governed by their substance and not merely by the legal form."*

Extracts from the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India:

> "25. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, *relevance*, reliability and comparability."
>
> **"Relevance**
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> 27. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations."
>
> (Emphasis supplied by the querist.)

The company's primary business activity is not lending and consequently, interest income is not its primary source of revenue as it does not enjoy any spread on the monies lent to group companies. As mentioned above, it is a category 1 merchant banker and consequently, fee income is its primary income and is a substantially large contributor to its revenue mix. In a likely situation of its group companies being in a position to self-fund their capital needs, XYZ Ltd. would not have to raise funds and correspondingly not incur borrowing cost, except for a nominal amount for its own funding requirement. By virtue of clear linkage of the borrowings and subsequent disbursal, the company is of the view that both the legs of the transaction are linked, simultaneous and correlated and collectively reflect the substance of the transactions.

7. As per paragraph 4.1 of Accounting Standard (AS) 9, 'Revenue Recognition', ***"In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration."*** The arrangement that the company has with its group companies is akin to an agency relationship where it borrows primarily to lend to its group companies at the same rate of interest as the borrowing. Since the borrowing and lending is akin to agency relationship and does not contribute to the profits/losses of the company as the lending is done at a rate of interest which is the same as the cost of borrowing, it may not be appropriate to present the interest received on lending as revenue but would be more appropriate to net off the same against interest cost.

8. The querist believes that the following further guidance under International Accounting Standards is relevant in this context:

   Paragraph 34 of IAS 1, 'Presentation of Financial Statements', issued by the International Accounting Standards Board (IASB) reads as follows:

   > "34. IAS 18 *Revenue* defines revenue and requires an entity to measure it at the fair value of the consideration received or receivable, taking into account the amount of any trade discounts and volume rebates the entity allows. *An entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. An entity presents the results of such transactions, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction. ..."*

   In the instant case, the company's business is that of merchant banking and not of lending. Thus, it may not be appropriate to present interest received on loans to subsidiaries as revenue and instead it would be more appropriate to present the same as a 'net off from interest expenses'. Further, paragraph 13 of IAS 18, inter alia, recognises that the revenue recognition criteria *"are usually applied separately to each transaction"*. However, it goes on to say that *"the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole"*. As stated earlier, the borrowing is done purely for lending to subsidiaries with interest cost passed on without any margin. Thus, it may be appropriate to consider interest

received from subsidiaries, net of the interest paid on the borrowing.
(Emphasis supplied by the querist.)

9. From the above literature, it appears that if interest income and interest expenses are disclosed gross in the financial statements, it may neither be a correct nor an appropriate reflection of the key business activity of the company. It would rather lead to an interpretation that the company is into borrowing and lending activity, which will be an incorrect representation of its operations and business, particularly, when there is simply no loss or gain arising from this activity.
10. Based on the above facts and analysis, the company believes that presentation of net interest cost is appropriate. Further, the company provides a suitable note in its financial statements explaining the rationale for such netting off.

B. Query

11. Based on the facts and the analysis as above, the querist has sought the opinion of the Expert Advisory Committee as to whether the presentation of net interest cost by the company is appropriate under the accounting framework in India.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to appropriateness of the presentation of net interest cost in the financial statements. The Committee has, therefore, examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment and presentation of funds borrowed by the company for its own utilisation, presentation of borrowings from the financial institutions and lending to subsidiaries in the financial statements, presentation of interest cost and interest income in the consolidated financial statements of the company, disclosure requirements as per Accounting Standard (AS) 18, 'Related Party Disclosures' and Schedule III to the Companies Act, 2013, accounting treatment of interest in the books of subsidiaries, etc. The Committee wishes to point out that although International Accounting Standards (IASs) have been referred to by the querist, since the query is raised from the perspective of accounting framework in India, the opinion expressed hereinafter, is purely from the existing accounting framework applicable in India.
13. The Committee notes that the existing Indian accounting framework does not contain specific accounting principles for setting off of items of income and expenses. Accordingly, the Committee notes the general principles of presentation of items of income and expenses. In this context, the Committee notes that one of the major considerations governing the selection and application of accounting policies is 'Substance over Form' which is explained in paragraph 17 (b) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006, as follows:

> *"b. Substance over Form*
> The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form."

From the above, the Committee notes that the accounting treatment should be governed by the substance of the transactions and events and not by their legal form. The Committee also notes that the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, inter alia, states as follows:

> "46. Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information."
> "71. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. ..."

From the above, the Committee notes that income and expenses should be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. Further, such presentation should reflect the substance of the transactions and events and should also portray true and fair view of the state of affairs.

14. In this context, the Committee notes from the Facts of the Case that the company's operations revolve around providing advisory services and merchant banking services (i.e., fee based services) and providing parental support to its group entities in carrying out their respective business activities by way of making investments in subsidiaries or arranging for funding for them. Further, since XYZ Ltd. enjoys better credit rating, it is able to raise funds at an optimal rate as compared to the rate at which its subsidiaries are able to raise funds and although XYZ Ltd.'s need for borrowed funds is quite low, it borrows from banks and other lending institutions for lending to its subsidiaries for meeting the subsidiaries' working capital requirements at XYZ Ltd.'s *average* borrowing cost with no markup and consequently, there is no residual cost or gain to XYZ Ltd. From this, the Committee notes that in order to provide parental support to its subsidiaries, XYZ Ltd. borrows funds generally for meeting the working capital needs of all of its subsidiaries and not on behalf of the subsidiaries (as in the case of agency relationship), for which it charges average borrowing cost of such borrowed funds from its subsidiaries. The Committee is of the view that in the extant case, there are two separate transactions, viz., borrowings from banks and other lending institutions and another, lending to its subsidiaries. Further, the Committee is of the view that since the company is borrowing funds from banks and other lending institutions in its own name, the company is solely responsible for the payment of interest as well as the principal amount. However, collection/recovery of the amount lent to the subsidiaries is a separate transaction different from the borrowing of funds. Accordingly, considering the above substance of the transactions and events in the extant case, the Committee is of the view that the interest/borrowing cost incurred by the company and the interest recovered from its subsidiaries should be presented separately in the statement of profit and loss and not as a set-off against each other.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that the presentation of net interest cost by the company is not appropriate under the accounting framework in India, as discussed in paragraph 14 above.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on August 11, 2015. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty four volumes. A CD of Compendium of Opinions containing thirty four volume has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.

Corrigendum

Attention of readers is invited to Opinion *"Accounting Treatment of Pension Liability Post Separation"* given by Expert Advisory Committee published in December 2015 issue of the journal *The Chartered Accountant* at page no. 818. The Committee finalised the Opinion on April 23, 2015 which was wrongly mentioned as June 3, 2015. The error is regretted.