



# Forex Losses On FCCBs - An Overview

Jt. cs. RAJESH RELAN

During the past few years, many Indian corporates have raised foreign currency resources through issue of Foreign Currency Convertible Bonds (FCCBs) to fund their organic and inorganic growth plans as these have proved to be very beneficial to the issuers as well as to the investors. However, the global financial meltdown has brought to the fore certain problems associated with FCCBs. This article endeavours to throw light on the accounting treatment of the Forex losses on FCCBs and the ways available to the companies to deal with the problem.

## INTRODUCTION

1. During the past few years, many Indian corporates have raised foreign currency resources through issue of Foreign Currency Convertible Bonds (FCCBs) to fund their organic and inorganic growth plans. FCCBs have proved to be very beneficial to the issuers as well as to the investors since it provides cheap funds to the issuing company on the one hand and on the other hand it provides an opportunity to the overseas investors to convert the Bonds into equity shares after a specified period at a pre-determined price. Thus, FCCB issues were seen as a win-win situation for the issuer as well as the investor. However, the global financial meltdown has brought to the fore certain problems associated with FCCBs. The two basic problems that have recently come to light are:—

- ◆ Conversion of bonds into equity shares is a remote possibility due to stock market crash as the current stock prices are just 20 per cent to 25 per cent of the conversion price.

- ◆ Depreciating rupee has increased the foreign financial liability of the issuing companies. This is because in case of FCCBs, the interest as well as the redemption proceeds have to be paid in the same foreign currency in which the FCCBs were raised.

Thus, FCCB issue exposes a company to the volatility in the foreign exchange markets. In the year 2007 when the Indian rupee appreciated sharply against the US dollar due to excessive inflow of foreign funds, then these companies enjoyed the situation since it meant reduction in their foreign liability when calculated in terms of Indian rupees. However, the situation just reversed in the year 2008 as there was a sharp depreciation in rupee against the dollar, which has led to steep increase in foreign liability of these companies.

Since conversion of FCCBs into equity shares is also a remote possibility, these companies are faced with herculean task of raising huge funds to redeem the FCCBs. In some cases like Wockhardt Ltd. and Firstsource Solutions Ltd., the amount to be raised is more than double of the present market capitalisation of these companies.

### ACCOUNTING TREATMENT OF FOREX LOSSES ON FCCBs

2. Different companies are following different methods for accounting of forex losses on FCCBs. These methods can be broadly classified as under :

- Accounting treatment under AS 11* - The Institute of Chartered Accountants of India has issued AS 11, 'Changes in Foreign Exchange Rates'. AS 11 requires that the exchange difference should be recognized as profit or loss in the profit and loss account of the period during which the exchange difference arises. Thus, the outstanding loans/borrowings in foreign currency at the end of each accounting period have to be translated into the Indian rupees and the resulting profit/loss on such translation has to be booked to the profit and loss account. Hence, during the financial year ended March 31, 2008 when the Indian rupee appreciated sharply against the dollar, the Indian companies were able to show higher net profits since these companies booked unrealised foreign exchange gains

in their profit and loss account. The situation has been exactly reverse since the beginning of the current financial year as the rupee has depreciated by around 25 per cent. Now these companies are under an obligation to book loss on account of increased foreign liability in their unaudited quarterly financial results.

Thus, these companies are perturbed with the trend of depreciating rupee. Some of the companies that are following AS 11 include Orchid Chemicals & Pharmaceuticals Ltd. and Rolta India Ltd. Orchid Chemicals & Pharmaceuticals Ltd., booked forex loss of Rs. 81.58 crore on FCCBs in the 2nd quarter ended September 30, 2008. Consequently, the company has shown a net loss of Rs. 40.66 crore in the quarter ended September 30, 2008 as compared to net profit of Rs. 63.27 crore during the corresponding quarter ended September 30, 2007.

- Accounting treatment under Schedule VI of the Companies Act* - Schedule VI of the Companies Act, 1956 requires that the carrying amount of an item of fixed asset should be adjusted for exchange difference arising on restatement or settlement of a liability assumed for acquisition of the same. In other words, Schedule VI permits companies to adjust the increase/decrease in foreign liabilities due to fluctuations in forex rates against the cost of fixed asset(s) for which the foreign funds were raised. Hence, the companies can straightaway bring the loss/gain arising due to exchange rate differences in respect of their foreign currency liability to their balance sheet. The companies can very well take the plea that a statutory requirement overrides the requirement of an accounting standard. Hence, by following the methodology prescribed under Schedule VI, the net profit of such companies remains unaffected by the foreign exchange fluctuations. Some of the prominent companies that are following Schedule VI approach include Reliance Industries Ltd., Reliance Communications Ltd. and Bharti Airtel Ltd. There are companies like RIL which are following Schedule VI consistently from the past many

years irrespective of the fact whether the rupee appreciates or depreciates. However, there have been instances where the companies have changed the accounting treatment to suit their needs, which is not appropriate.

If one compares the method prescribed under Schedule VI with AS 11, then it becomes clear that AS 11 is a more prudent approach since it not only displays the effect of increase/decrease in the foreign currency liability on the balance sheet of the company but also on the profit and loss account and thus enables investors to take well-informed decisions.

(iii) *Accounting treatment under AS 30* - In order to resolve the above mentioned controversy in the accounting of forex liability, the ICAI has issued a new Accounting Standard 30 which is recommendatory with effect from April 1, 2009 and would become mandatory with effect from April 1, 2011. AS 30 allows companies to bring such losses to balance sheet, subject to the condition that the foreign currency loan/FCCB proceeds were used for acquiring a foreign operation that is not integral in nature. The rationale behind AS 30 seems to be that if both the liability and the asset are in the same foreign currency, then it provides a natural hedge and there is no harm in bringing the impact of the forex gain/loss straightaway to the Balance Sheet. Although AS 30 is recommendatory with effect from April 1, 2009, yet few companies like Firstsource Solutions Ltd. have started preparing their accounts in accordance with AS 30.

In this case, Firstsource Solutions had issued FCCBs worth USD 275 million to fund its acquisition of Med Assist Holdings. The price set for conversion of FCCBs into equity shares is Rs. 92 per share and the FCCBs are maturing in December 2012. At present, the company's share is trading at Rs. 14. The exchange rate was Rs. 39.60 per dollar when the company completed its FCCB issue. Thus, the total liability of the company together with interest in December 2012, when the FCCBs would have matured for

redemption would have been Rs. 1,500 crores. However, as a result of depreciation of rupee, the aforesaid liability, as per current exchange rate, has shot up to Rs. 1,900 crores.

The rupee depreciated so sharply in the quarter ended June 30, 2008 that the loss on account of restatement of dollar denominated FCCBs into Indian rupees was much more than the profit earned by the company during the aforesaid quarter. The profit before tax from operations was Rs. 37.60 crores whereas the loss on account of restatement of FCCBs was Rs. 80.16 crores. The result was net loss of Rs. 42.60 crores. If the same accounting policy had been followed during the quarter ended September 30, 2008, then the loss would have been Rs. 96 crores since the fall of rupee in September quarter was far more severe than the June quarter. Thus, the circumstances forced the company to think innovatively and change its accounting treatment for forex losses on FCCBs through early adoption of AS 30.

## WAYS TO DEAL WITH THE PROBLEM

There are limited ways and means to deal with the problem of forex losses on FCCBs. Two possible ways have been discussed below :

(i) *Hedging of foreign currency liabilities* - Hedging of foreign currency liabilities has its own advantages and disadvantages. The basic advantage is that the companies become immune to the volatility in the forex markets. Thus, they can concentrate on their business rather than worrying about the movement in forex rates. Till now most of the companies have preferred not to hedge their forex exposure on account of redemption of FCCBs since they were of the view that the Indian economy is making its rapid strides ahead, which would continue to push the rupee upwards against the US dollar. In other words, the companies were optimistic that their cash outflow in rupee terms to redeem the FCCBs (excluding interest) would be less than the amount garnered through FCCB issue. No doubt, there are costs associated with the hedging of forex

risks but it is just like the individuals pay premium on the life insurance and mediclaim policies for securing their future.

In case of hedging, any gain on account of appreciation in rupee is partly offset by the premium paid for obtaining the forward cover to hedge the foreign exchange liability. Similarly, depreciation of rupee will also not result in any loss since the company has already taken the forward cover.

- (ii) *Buyback of FCCBs* - Due to the global financial meltdown, there is severe liquidity crunch in the international financial markets. This has triggered distress sale of FCCBs of Indian companies by FIIs. Moreover, the current share price of most of the companies is just 25 per cent to 30 per cent of the conversion price. Both these factors have led to the collapse of FCCB prices. Indian FCCBs are trading at the international stock exchanges like NYSE, Luxembourg and Singapore Stock Exchanges at hefty discount of 40 per cent to 50 per cent to the issue price. This has significantly increased the Yield-to-Maturity (YTM) since YTM is inversely proportional to the price of bonds quoted on stock exchanges. Since the current price is way below the conversion price, these companies have little option but to raise huge funds to redeem the FCCBs at the time of maturity. The Government has also acknowledged this problem and in order to deal with the situation the RBI has issued a circular dated December 8, 2008 that allows companies to buyback the outstanding FCCBs subject to the fulfilment of certain conditions. The provisions contained in the RBI circular are given below :

(A) *Automatic route:*

Premature buyback of FCCBs has been allowed, under the automatic route, i.e, without the prior approval of the RBI. Accordingly, the designated authorised dealer (Category - I Bank) can allow buyback of FCCBs, subject to the fulfilment of the following conditions:

- (i) The buyback value of the FCCB should be at a minimum discount of 15 per cent on the book value;
- (ii) the funds used for the buyback shall be out of existing foreign currency funds held either in India (including funds held in EEFC account) or abroad and/or out of fresh ECBs raised in conformity with the current ECB norms; and
- (iii) where the fresh ECB is co-terminus with the outstanding maturity of the original FCCB and is for less than three years, the all-in-cost ceiling should not exceed 6 months *libor plus 200 bps*, as applicable to short-term borrowings. In other cases, the all-in-cost for the relevant maturity of the ECB, as laid down in A.P. (DIR Series) No.26, dated October 22, 2008 shall apply.

(B) *Approval route:*

The RBI will consider the proposals from Indian companies for buyback of FCCBs under the approval route, subject to the compliance with the following conditions:

- (i) The buyback value of the FCCB shall be at a minimum discount of 25 per cent on the book value;
- (ii) the funds used for the buyback shall be out of internal accruals, to be evidenced by Statutory Auditor and designated AD Category - I bank's certificate; and
- (iii) the total amount of buyback shall not exceed USD 50 million.

(C) *General conditions:*

In addition to the conditions set out above, the following additional conditions shall be applicable for the proposals both under the automatic and the approval route:

- (i) The FCCB should have been issued in compliance with the extant guidelines;
- (ii) the FCCB should have been registered with the RBI; the LRN number obtained and ECB 2 returns submitted up to date;
- (iii) no proceedings for contravention of FEMA are pending against the company;
- (iv) the right for buyback is vested with the issuer of FCCBs. However, the actual buyback is subject to the consent of the bond holders;
- (v) the FCCBs bought back/repurchased from the holders must be cancelled and should not be re-issued or re-sold;
- (vi) the buyback will not have any effect on the bond holders not opting for the buyback;
- (vii) the Indian company shall open an escrow account with the branch or subsidiary of an Indian bank overseas or an international bank for buying back the FCCBs to ensure that the funds are used only for the buyback.



Indian companies up to March 31, 2009. Moreover, the entire procedure of buyback must be complete by March 31, 2009. It would be appropriate if such facility is provided to the corporates from time to time so that the companies can utilize their forex reserves as well as their internal accruals to reduce their forex liability, thereby safeguarding themselves from the volatility in the forex markets.

## CONCLUSION

4. During the bullish time, FCCB was a hot favourite instrument of the companies, financial intermediaries and the overseas investors. However, FCCB has become a milestone for the companies as well as the overseas investors due to the global financial meltdown and the stock market crash. The different accounting practices being currently followed by the companies for accounting, the forex losses on FCCBs need to be regulated so that the investors can get a true and fair view of the real impact that depreciation of Rupee has on the financial health of the companies.

The relaxation provided by the RBI in the form of buyback of FCCBs is a laudable move since it will not only enable the overseas investors to encash their FCCB holdings prior to the redemption date but also benefit the companies as FCCBs can be bought at a substantial discount to the issue price. The scheme is closing on March 31, 2009, thus, it would be appropriate if the same is extended for some more time so that the companies can take full advantage of the same.

Some of the companies that have taken steps for buyback of FCCBs include Reliance Communications Ltd., Bharat Forge Ltd., Amtek Auto Ltd., Electrosteel Castings Ltd., Jubliant Organosys Ltd., Mahindra & Mahindra Ltd. and KLG Systel Ltd.

Reliance Communications Ltd. (RCom) has become the first company to complete buyback of its FCCBs as per the aforesaid RBI circular. R Com has bought back FCCBs at a discount of approximately 50 per cent to the issue price. The facility of buyback of FCCBs is available to the

