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*Where the conversion ratio is linked to performance, could it be that the better the business performs, an accounting loss may ensue?*

### **CCPS: THE "PREFERRED" SECURITY, WITH A HIDDEN ACCOUNTING EDGE**

CCPS have become the preferred instrument for private equity investments in India because they can combine anti-dilution protection, liquidation preference, preferential dividend rights and bespoke conversion mechanics. These features make the instrument commercially attractive for an investor taking minority equity risk in a private company. Ordinary equity leaves two core exposures unaddressed: dilution risk if future capital is raised at a lower valuation, and distribution risk if exit or liquidation proceeds are allocated in a manner that erodes the investors' economics. CCPS are designed to mitigate those risks through contractual economics embedded in the instrument itself.

CCPS are also frequently used to bridge valuation gaps or manage valuation uncertainty. Where valuation cannot be agreed upfront, or cannot be determined with sufficient confidence, the conversion ratio may be made variable and linked to future performance metrics such as EBITDA, net worth or revenue. That structure creates precisely the accounting consequence the issuer is often seeking to avoid.

The commercial asymmetry is clear. The investor wants automatic downside protection and upside participation; the company wants the instrument to avoid liability classification, finance cost and fair value volatility through the P&L.

Not every CCPS creates this accounting problem. The classification outcome depends on the terms, and in particular on whether the conversion ratio is fixed at inception or remains variable. Where it is variable, the very feature designed to protect the investor may create the accounting result the company was trying to avoid.

### **THE ACCOUNTING FRAMEWORK: IND AS 32**

The accounting classification of CCPS is governed by Ind AS 32 (Financial Instruments: Presentation). Paragraph 15 requires the issuer to classify a financial instrument according to the substance of the contractual

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arrangement, not its legal form. The characterization of CCPS as share capital under the Companies Act, 2013, or as an equity instrument under FEMA, is therefore not determinative.

Paragraph 16 contains the operative test. An instrument qualifies as equity only if it contains no contractual obligation to deliver cash or another financial asset and, where it will be settled in the issuer's own equity shares, it is settled by exchanging a fixed amount of cash for a fixed number of shares. This is the fixed-for-fixed requirement. Failure of either limb may result in liability classification, depending on the precise terms of the instrument and the auditor's assessment.

The fixed-for-fixed requirement is often the hinge on which CCPS classification turns. At issuance, do the parties know with certainty how many equity shares will be delivered on conversion and for what consideration? If yes, the CCPS and its conversion feature may qualify for equity classification. If not, because the number of shares depends on a future event, price or performance outcome, the conversion feature may fail the fixed-for-fixed test.

### **Anti-dilution ratchets**

An anti-dilution ratchet adjusts the conversion price downward if the company raises capital at a lower valuation, allowing the investor to receive more shares on conversion than originally contemplated. Because the number of shares deliverable is not fixed at inception, the fixed-for-fixed test is not satisfied. In practice, however, the accounting consequence of an anti-dilution ratchet is often more containable: the resulting liability is typically carried at amortized cost rather than marked to fair value, making the P&L impact more predictable and less severe than a performance-linked conversion ratio.

### **Liquidation preference**

Liquidation preference does not ordinarily affect the conversion ratio. It creates a separate contractual obligation to deliver cash on a liquidation, sale, reconstruction or deemed exit event. The liability component is the present value of the cash obligation created by the liquidation preference or cumulative dividend, discounted at the market rate. The difference between the contractual dividend rate and the market rate at inception accrues each year as a finance cost in the P&L, even though no cash is paid. In most PE CCPS structures, the contractual dividend is set at or near nil precisely to minimize this charge.

### **Performance-linked conversion ratios**

Where the conversion ratio is linked to a future performance metric such as EBITDA, net worth or revenue, the number of shares may not be determinable at inception. Depending on the terms, and the accounting view adopted, the conversion feature may need to be separated from the host instrument and measured at fair value through profit and loss ("**FVTPL**") at each reporting date under Ind AS 109. Its fair value may move with changes in projected performance between investment and conversion. Where this treatment applies, the accounting standard requires the issuer to mark to market every year the fair value; and as projected performance improves, the liability may grow and the P&L loss may increase.

Of these terms, performance-linked conversion ratios can carry the most significant

accounting consequence and require the greatest care at the structuring stage. Where the conversion ratio is linked to future performance metrics, the liability may need to be marked to FVTPL at each reporting date. In a growing business, that movement may be upward and the accounting loss may increase correspondingly. The better the business performs, the larger the annual accounting loss may become. The result, where this accounting treatment applies, is not evidence of financial stress; it is a direct consequence of commercial success, and it may compound for as long as the instrument remains outstanding.

Anti-dilution ratchets and liquidation preference also create classification consequences, but their P&L impact is generally more predictable and containable. By contrast, where a performance-linked conversion feature is required to be fair valued through profit and loss, the fair value movement moves with the business and, in a well-performing company, can overwhelm the operating profit being generated at the same time.

This is why conversion mechanics are often the most consequential structuring decision in a CCPS transaction. The key question is how to structure around them without losing the commercial protection they were designed to deliver.

### **STRUCTURING AROUND THE PERFORMANCE-LINKED CONVERSION PROBLEM**

The accounting consequence of a performance-linked conversion ratio may be a liability marked to FVTPL each year and increasing as the business grows. That consequence is not necessarily solved by adjusting the dividend rate or relocating liquidation preference or anti-dilution protection from the CCPS terms to the SHA, because the issue may arise from the conversion feature itself. The structuring question is therefore straightforward: how do the parties preserve the commercial objective of linking the investor's equity position to future performance, while avoiding or containing the accounting treatment that a variable conversion ratio may attract? This should be discussed with the company's auditors at the structuring stage, before the terms are finalized.

There are three broad approaches. None is cost-free.

#### **Fix the conversion ratio and address valuation uncertainty separately**

The cleanest accounting solution is to fix the conversion ratio at inception and address valuation uncertainty through a separate mechanism, such as a cash true-up, an adjustment in exit proceeds, or a contractual right in the SHA. If the conversion ratio is fixed, the fixed-for-fixed test is satisfied, and the instrument is more likely to qualify as equity for accounting purposes.

The difficulty lies in implementation. Alternative mechanisms may raise FEMA, tax and enforceability issues that must be navigated carefully. A cash true-up payable to a non-resident investor is subject to FEMA pricing and remittance rules. A SHA right to additional shares raises similar issues: any fresh issuance to a non-resident must comply with applicable fair value pricing guidelines, meaning the investor cannot simply receive 'free shares' for nil consideration.

#### **Narrow the performance period and lock the conversion date**

Where a variable conversion ratio is commercially essential, narrowing the period of variability reduces the duration of FVTPL exposure. If the performance metric is measured and the conversion ratio is fixed at the end of year one or year two, rather

than remaining open until a liquidity event, the instrument converts into a fixed number of shares at that point and the FVTPL treatment ends. The P&L absorbs fair value movements only for the period during which the conversion ratio remains variable, not for the entire life of the investment.

The cost is commercial: the investor accepts that the performance period is fixed and short, which may not fully capture the company's trajectory in an early-stage investment. But for both parties, certainty on the conversion ratio earlier in the life of the instrument is usually preferable to open-ended FVTPL volatility.

### **Accept the accounting consequence and manage the disclosure**

Where the variable conversion ratio is central to the deal and neither of the above approaches is acceptable, the potential accounting consequence must be accepted, discussed with the auditors and managed. The company's financial statements may carry a growing FVTPL liability and may also reflect an increasing annual finance cost. The practical response is disclosure: lenders, future investors and, ultimately, IPO auditors need to understand that the finance cost, if recognized, is non-cash, does not reflect operating performance, and will reverse or crystallize on conversion. That approach can work in a bilateral or controlled diligence context. It becomes harder to sustain within a listed structure.

## **BEYOND THE CAP TABLE: ACCOUNTING RAMIFICATIONS IN M&A AND IPO READINESS**

### **Bolt-on Acquisitions**

In a bolt-on acquisition, a target may already have CCPS issued to investors on its cap table. If those instruments have been treated as equity in the target's financial statements without a rigorous fixed-for-fixed analysis, the seller may assume that all CCPS holders simply participate in equity value on exit.

Where CCPS carry a variable conversion ratio, the instrument may need to be treated as a debt-like claim in the enterprise value bridge. A buyer that models the CCPS as participating equity, without testing whether the fixed-for-fixed requirement is satisfied and whether the instrument is in substance a liability, may be paying for equity value that does not exist. CCPS terms should therefore be evaluated as part of financial diligence and reflected in the purchase price model.

### **Platform Consolidation**

Where a platform company acquires control of multiple targets, each target's CCPS classification flows into the consolidated accounts. An instrument managed at target level may create consolidated liabilities, finance cost or fair value volatility in the platform's P&L. For a PE-backed platform with an IPO in view, the consequence is more acute. The SEBI ICDR Regulations require restated financial statements for the three financial years preceding the DRHP filing. If CCPS across the group have been misclassified as equity, the restatement may introduce liability components and associated P&L movements across three years, affecting multiple ratios and metrics that will be scrutinized during the DRHP review process.

### **The Listed Company Problem**

The challenge is sharper where the company is consolidated into a listed parent or

where the platform itself is listed. In a listed company, the FVTPL movement flows into the consolidated P&L and is visible to public shareholders, analysts and stock exchanges. Public shareholders, unlike sophisticated PE investors or institutional lenders who can be walked through the conversion terms, encounter the accounting loss in a quarterly or annual result and may not have the context to distinguish a non-cash FVTPL charge from operational deterioration. An analyst may reduce an earnings estimate, and a public shareholder may question a loss-making quarter caused by an FVTPL movement in a subsidiary's CCPS. The disclosure solution that works in a bilateral negotiation with a lender does not translate cleanly to a listed environment, where the audience is broad and the ability to provide individualized context is limited. Where consolidation with a listed entity is in view, whether at investment or at a future date, the structure of the conversion terms is not merely an accounting question. It is also a market disclosure and perception issue, and should be resolved at the outset, when the investment is made.

### **NO PERFECT ANSWER: CHOOSE THE COST, THEN STRUCTURE CONSCIOUSLY**

CCPS should not be treated as a standard-form instrument that automatically delivers both full investor protection and clean equity treatment. In many transactions, it can deliver one but not both.

If the investor retains the variable conversion ratio in the instrument, the company bears the accounting cost. If the company requires a fixed conversion ratio and clean instrument terms, the investor bears the enforcement and implementation cost, and must satisfy itself that the SHA mechanics, FEMA implementation and contractual remedies deliver protection that is genuinely equivalent to what the instrument would have provided.

If neither party addresses the issue at the time of investment, someone else may address it later. An acquirer may identify it in diligence and adjust the purchase price; a DRHP auditor may identify it in restatement and introduce prior-period accounting losses. The central question in CCPS structuring is therefore not only what protection the investor receives. It is which objective the parties choose to prioritize, investor protection or clean accounting treatment, and which party knowingly bears the legal, FEMA, accounting and commercial cost of that choice. The accounting position should be tested with the company's auditors while the terms are being structured, not after the instrument has been issued.

*This publication is for educational purposes only and does not constitute legal, accounting or tax advice. Accounting, FEMA, tax and enforceability outcomes depend on the instrument's terms, transaction structure, applicable standards and regulations, and auditor interpretation. For transaction-specific advice on CCPS structuring, classification or M&A considerations, please contact the author.*

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