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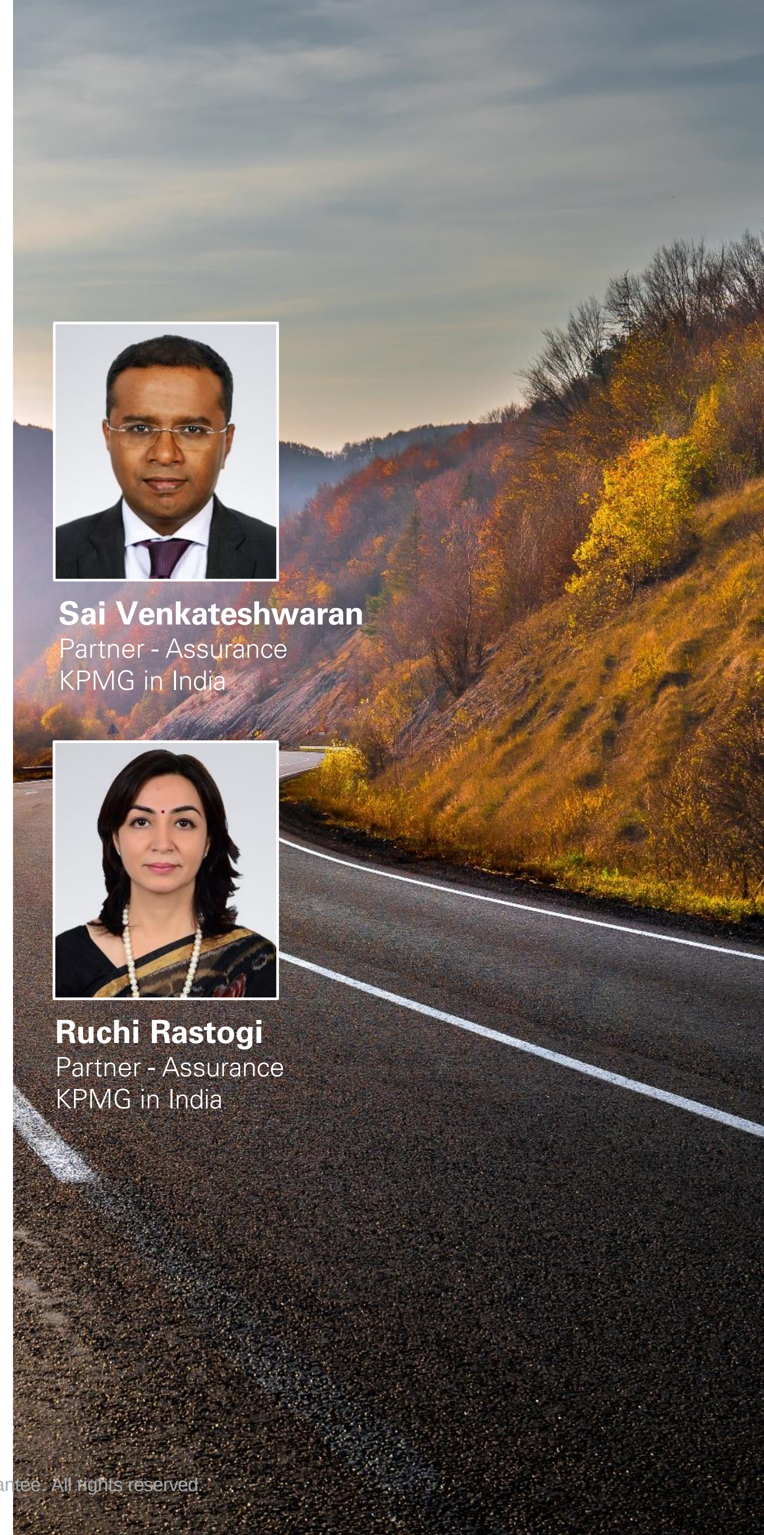
Editorial

Channel financing is a financing option that provides working capital loan to channel partners such as distributors, dealers or buyers who enter into a contract of purchase of goods or services with a corporate entity. Such an arrangement includes three parties: a company that supplies the goods or services (supplier), a channel partner purchasing those goods or services (distributor) and a financial institution. The arrangement typically allows the company (supplier) to be paid by the *financial institution* at a date earlier than when the channel partner pays to the financial institution. While accounting for the amount received from the financial institution, the supplier would need to determine whether it would extinguish the amount received with the amount receivable from the distributor or would it create a new liability. This would require an evaluation considering the principles of derecognition of a financial asset under Ind AS 109, Financial Instruments. Recently, the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) deliberated on the classification and presentation of the amounts received by an entity under the channel financing arrangement. This edition of our Accounting and Auditing Update (AAU) carries an article on channel financing arrangement to discuss some of the key factors to be considered while accounting and presenting funds received by a supplier by way of a channel financing arrangement.

Disclosures of provisions and contingent liabilities are sometimes restricted to a short note towards the back of the financial statements with a brief comment in the management report. However, even when a provision is not significant in amount, the circumstances to which it relates can be of great significance to investors owing to the levels of estimation uncertainty, judgements involved, or the forward-looking information it can provide about a company's exposures. The circumstances giving rise to the provisions and contingent liabilities are likely to have an impact over medium to long-term, such as climate change and other environmental obligations, or significant to the assessment of future business performance, for example, onerous contracts and regulatory penalties or compensation. Hence investors should be provided with high-quality disclosures pertaining to this area. This edition of our publication carries another article on key accounting and financial reporting issues, to discuss some of the key areas that regulators have highlighted and provided improvement points in the area of provisions, contingent liabilities and contingent assets, with the help of illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC).

There have been various regulatory developments in India and internationally during the month. Recently, the Securities Exchange Board of India (SEBI) approved the proposal on flexibility in the framework on Social Stock Exchange (SSE) with respect to the Non-Profit Organisations (NPOs). Further SEBI issued Frequently Asked Questions (FAQs) on registration as an ESG Rating Provider (ERP) and consultation paper on introduction of fast track public issuance of debt securities. Additionally, the Quality Review Board (QRB) under the Institute of Chartered Accountants of India (ICAI) conducted audit quality review of entities in India for the financial year 2022-23 and issued its report. The International Accounting Standards Board (IASB) has issued an exposure draft to IAS 32, *Financial Instruments: Presentation* to address the financial reporting challenges when instruments have debt and equity features. Our regulatory updates articles cover these and other important regulatory developments.

We would be delighted to receive feedback/ suggestions from you on the topics we should cover in the forthcoming editions of AAU.



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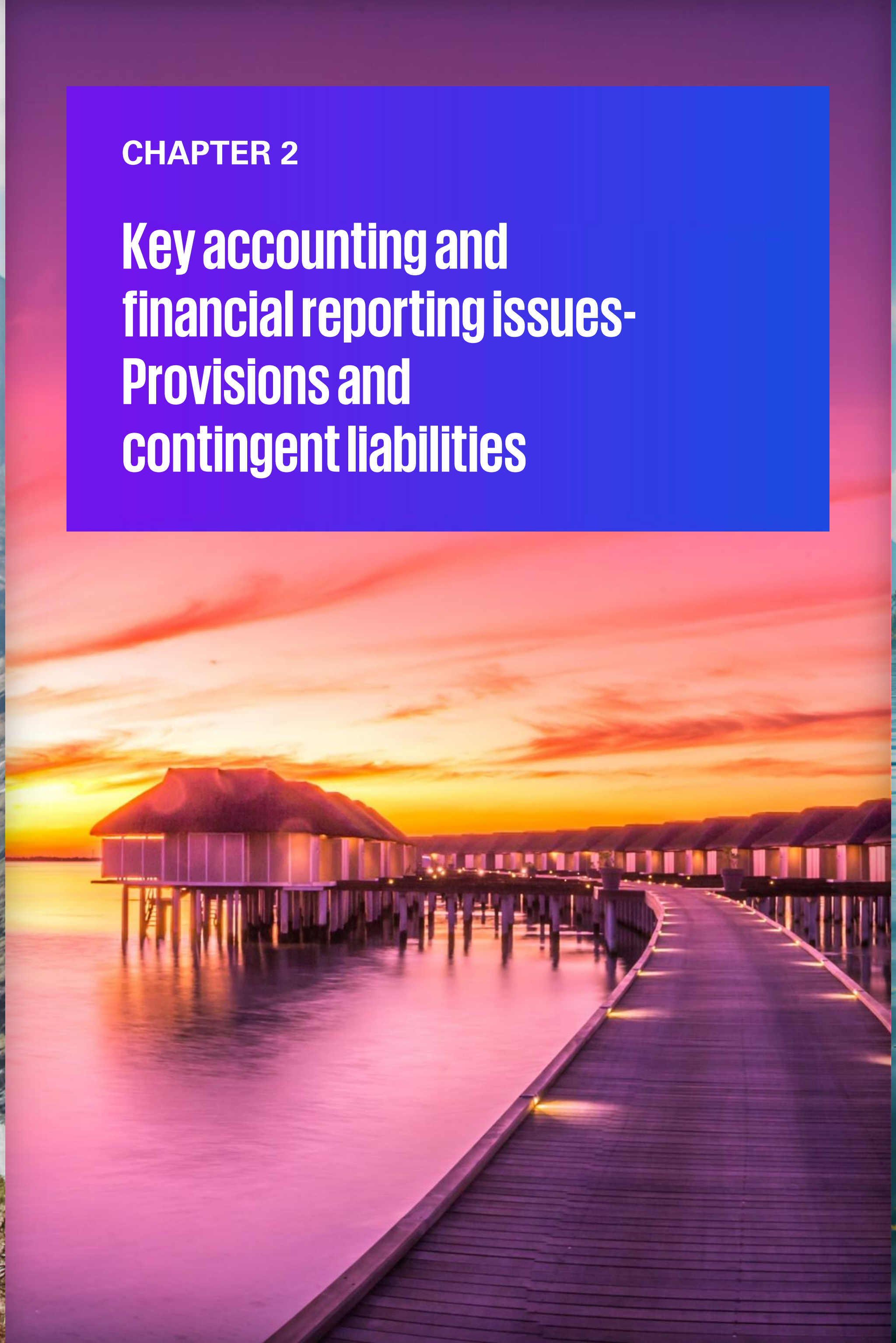
CHAPTER 1

Accounting for channel financing arrangement in the financial statements

CHAPTER 2

Key accounting and financial reporting issues- Provisions and contingent liabilities



CHAPTER 3

Regulatory updates

CHAPTER 1

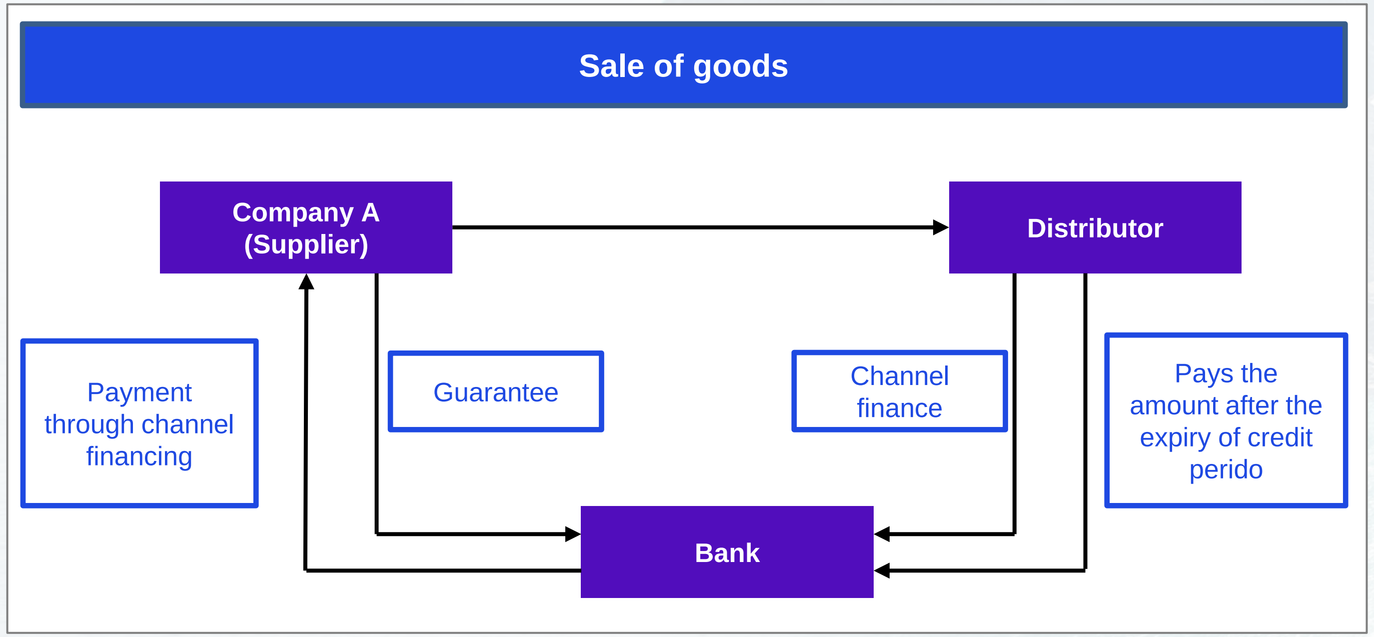
Accounting for channel financing arrangement in the financial statements

This article aims to:

Provide guidance on the presentation and disclosure of a channel financing arrangement in the financial statements of the supplier and covers a recent EAC opinion issued on the same topic.

Overview- what is a channel financing arrangement?

Channel financing is financing option that provides working capital loan to channel partners such as distributors, dealers or buyers who enter into a contract of purchase of goods or service with a corporate entity. As depicted in figure 1 below, the arrangement includes three parties: a company that supplies the goods or services (the supplier-Company A in figure 1 below), a channel partner purchasing those goods or services ('Distributor' in figure 1) and a financial institution ('Bank' in figure 1). The arrangement typically allows the company (supplier) to be paid by the financial institution at a date earlier than when the channel partner pays the financial institution.



(Source: KPMG in India's analysis, 2023 read with EAC opinion on Channel Financing dated 20 April 2023)

While accounting for the amount received from the financial institution, the supplier would need to determine whether it would extinguish the amount received with the amount receivable from the distributor or would it create a new liability[1]. For this purpose, the supplier would need to consider the principles of derecognition of a financial asset as per Ind AS 109, *Financial Instruments.*

The Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) deliberated on the classification and presentation of the **amounts received by an entity under the channel financing arrangement.**

This article aims to discuss some of the key factors to be considered while accounting and presenting funds received by a supplier by way of a channel financing arrangement.

1. When the supplier sells goods to the distributor, it would pass the entry- Debit- Receivable and Credit- Revenue. However, when it receives funds from the financial institution, it would pass the entry- Debit- Bank. The question is whether it would credit the receivable or create a new liability.

Facts of the case

Company A (the supplier), *inter alia*, is engaged in selling consumer durables in the form of domestic appliance to Dealers and Distributors (D&D) with an average credit period of 30 days. The supplier provides a discount of two percent if the channel partner, being the D&D, makes payment within one to three days and charges overdue interest if payment is not made within 30 days.

In most cases, the D&D are not able to make upfront payment to the supplier due to working capital constraints.

To bridge this gap and get upfront cash against its sales, the supplier has entered into a channel financing arrangement with banks which provides working capital limits to the channel partners ensuring upfront payment to the supplier.

It is to be noted, that the working capital arrangement (which is generally for a 12-month term) is between the D&D and the banks. The credit limits advanced to the D&D is based on the credit appraisal and parameters of the D&D. The credit limits are secured against the assets of the D&D and even the interest, penal charges and other charges would be borne by the D&D. Company A has merely provided a recommendation letter to the bank before sanction of the credit facility to the D&D, and it is **not** a party to the arrangement entered into between the bank and the D&D.

Company A has provided a First Loss Default Guarantee (FLDG) to the bank against the facility provided to the D&D. Accordingly, in case of a default by the D&D, proceedings for recovery of the amount would first be initiated against the D&D. If amounts cannot be recovered from the D&D, the bank would approach Company A for making good the loss.

How would this arrangement be accounted for by Company A?

Accounting for a channel financing arrangement by an entity

A. Evaluating whether the arrangement would result in derecongnition of the trade receivable

While accounting for the amount received from the bank, Company A would need to consider whether the arrangement meets the derecognition criteria as per Ind AS 109 i.e. whether Company A has transferred:

- Its right to receive cash flows from the D&D and
- Substantially all risks and rewards of ownership of the receivable to the bank.

This evaluation has been performed in figure 2.

Figure 2 – Analysis of transfer of risk and rewards of a financial asset

Derecognition conditions prescribed by Ind AS 109	Evaluating these conditions to the facts of the company
Have the rights to the cash flow from the assets expired?	No - Since Company A has not received amounts from the D&D
↓ No	
Has the entity transferred its rights to receive the cash flows from the asset?	Yes - The right to receive cash flows from the D&D has been transferred to the bank
↓ Yes	
Has the entity transferred substantially all risks and rewards?	No – The entity has provided an FLDG to the bank
↓ No	
Has the entity retained substantially all risks and rewards?	Yes – As per the FLDG provided to the bank, the bank has full recourse to Company A in case the D&D defaults.
↓ Yes	
Continue to recognise the asset	

(Source: KPMG in India's analysis, 2023, read with Insights into IFRS, 20th edition, issued by KPMG IFRG Limited in September 2023)

Based on the above analysis, it can be concluded that the company has retained all the risks and rewards of receivables from D&D in the form of the First Loss Default Guarantee (FLDG) arrangement it entered into with the bank. As a result, it cannot derecognise the receivables, rather it needs to recognise the amount received from the bank under the arrangement as an obligation in the financial statements.

B. Classification and presentation of liability recognised[2]

With the analysis performed in section A, it is clear that the amount received from the bank would be treated as an obligation in the financial statements. However, the question is, whether this obligation should be disclosed as a borrowing or as a liability.

In this regard, the EAC considered the facts of the case and the guidance provided in Schedule III (Division II) to the Companies Act, 2013 (2013 Act).

The EAC noted that there is a channel financing facility between the company and the bank. However, the credit limit arrangement is between the bank and the D&Ds. In case of default, the bank will first initiate the recovery process against the D&Ds and if the D&D is unable to honour its dues, the bank can invoke the terms of FLDG and recover the same from the company. Additionally, the terms of the arrangement specify that the company's drawing powers/ borrowing limits are not blocked for outstanding channel financing balances.

Further, Division II of Schedule III to the 2013 Act gives the option of presenting current financial liabilities as the following:

- Borrowings
- Trade Payables
- Other financial liabilities

Current borrowings include all loans payable within a period of 12 months from the date of the loan, and include loans payable on demand.

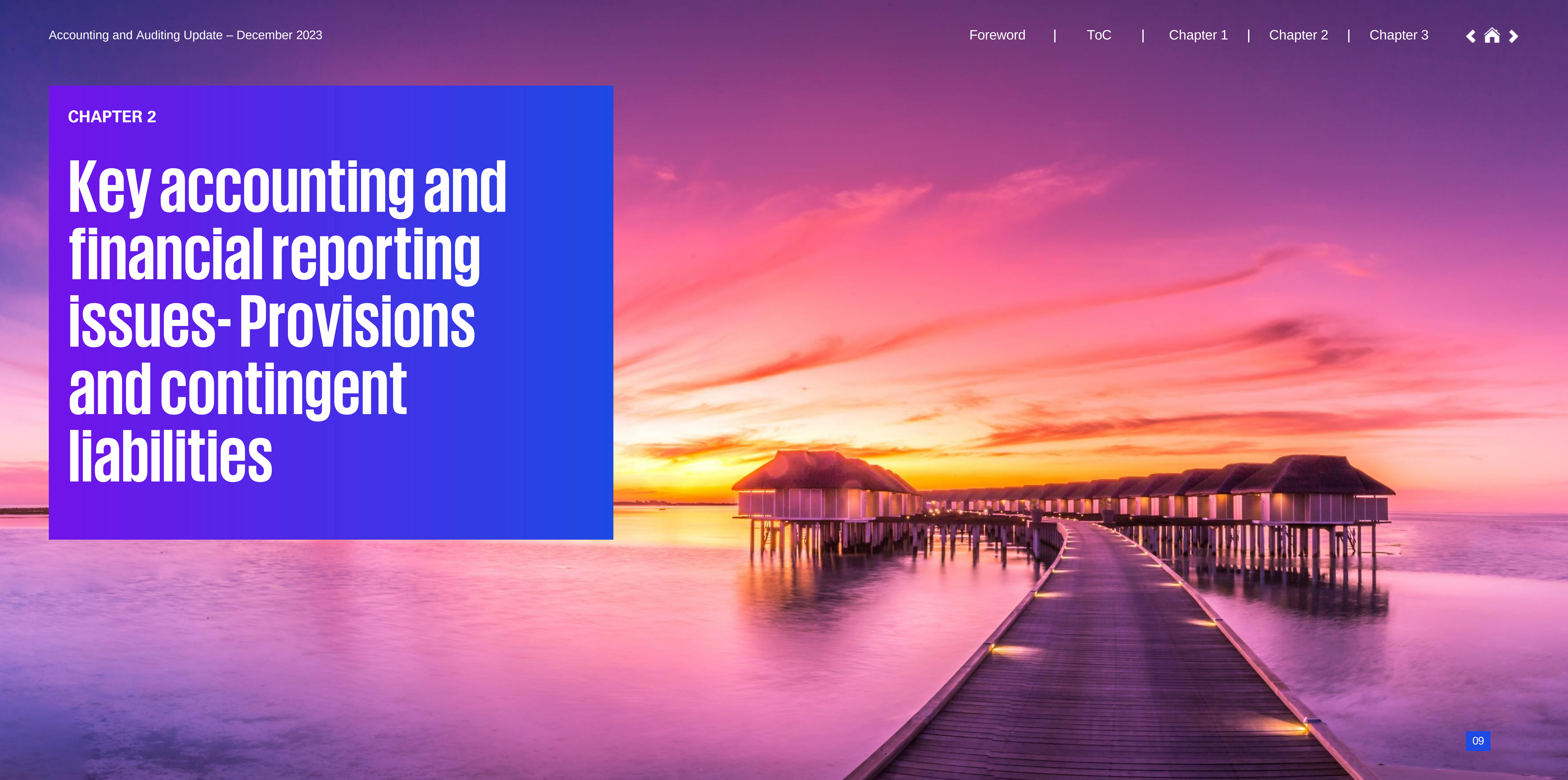
Based on an evaluation of the facts of the case and guidance provided in Division II of Schedule III to the 2013 Act., the EAC was of the view that the amount received by Company A under the channel financing facility is not of the nature of borrowings and the same should be presented and classified as 'other financial liability[3]' in the balance sheet. Further, appropriate disclosures should be given to explain the nature of the facility.

However, in case of default by the D&D which leads to an outstanding amount to be paid by the company to the bank on the reporting date, the amount will have to be reclassified as 'Loans repayable on demand from bank' under 'Current Borrowings' in accordance with the terms of the FLDG.

Key considerations

The analysis of the terms and conditions of each channel financing arrangement is critical and involves judgement in order to conclude on the fair presentation of such transactions in the financial statements. Entities should make detailed and appropriate disclosures explaining the nature and impact of such arrangements in the interest of the users of financial statements.

2. TIn the EAC opinion, the Company had performed a derecognition analysis for the receivables, accordingly, EAC did not opine on this. Instead EAC opined on whether the obligation created in the books of account would be presented as a liability or a borrowing..
3. This is because the credit period is 90 days.



CHAPTER 2

Key accounting and financial reporting issues- Provisions and contingent liabilities

Disclosures of provisions and contingent liabilities are sometimes restricted to a short note towards the back of the financial statements with a brief comment in the management report. However, even when a provision is not significant in amount, the circumstances to which it relates can be of great significance to investors owing to the levels of estimation uncertainty, judgements involved, or the forward-looking information it can provide about a company's exposures. The circumstances giving rise to the provisions and contingent liabilities are likely to have an impact over medium to long-term, such as climate change and other environmental obligations, or significant to the assessment of future business performance, for example, onerous contracts and regulatory penalties or compensation. Hence investors should be provided with high-quality disclosures pertaining to this area.

With this background, in this article, we will highlight some of the key areas that regulators have highlighted and provided improvement points in the area of **provisions, contingent liabilities and contingent assets**. We have also provided illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC) and illustrative disclosures issued by KPMG IFRG Limited in 2023.

Source

While preparing this article, we have referred to:

- The recent observations of the National Financial Reporting Authority (NFRA),
- The Ind AS observations of the Financial Reporting Review Board (FRRB) of the Institute of Chartered Accountants of India (ICAI),
- The report- Annual Review of Corporate Reporting (2022/23) issued by the Financial Reporting Council, and
- Recent ESMA[1] enforcement directions

1. European Securities and Markets Authority.

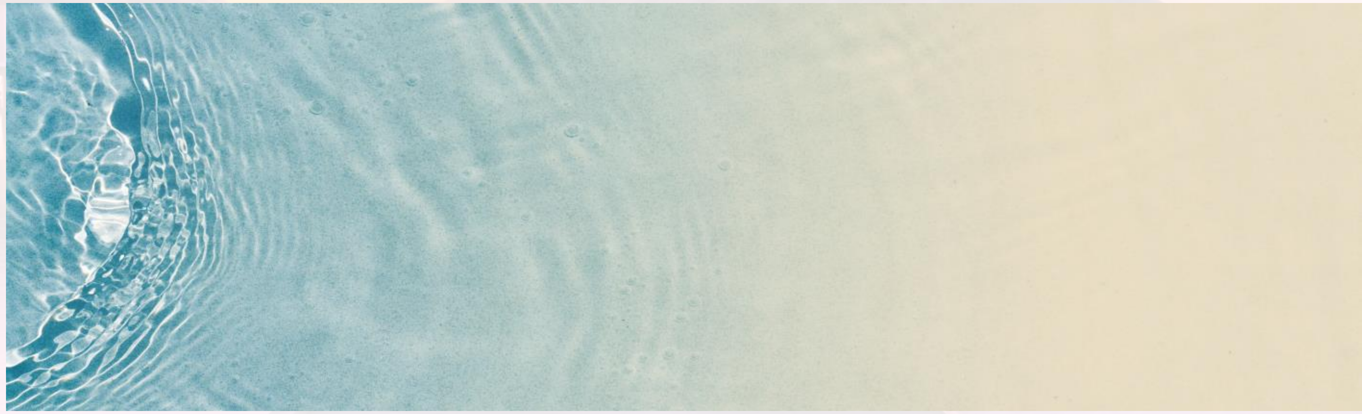
2. Up to 31 December 2022, IAS 1, Presentation of Financial Statements, required companies to disclose significant accounting policies. With effect from 1 January 2023, companies are required to disclose material accounting policy information. An entity should evaluate to determine its 'material' accounting policy information as per amendment in IAS 1.

Key issues and recommendations pertaining to provisions, contingent liabilities and contingent assets

Some of the key issues and recommendations pertaining to provisions, contingent liabilities and contingent assets is given below:

Accounting policies

As per IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, accounting policies are the specific principles, bases, conventions, rules and practices that an entity applies in preparing and presenting financial statements. Companies are required to disclose material accounting policy information[2] in the financial statements. While doing so, it should be ensured that concise and entity specific descriptions of the accounting policies adopted in respect of provisions and contingencies are disclosed.



Example of an accounting policy where a company disclosed a general accounting policy for provisions, but then provided more specific information about certain classes of provisions which are carried in the books of account

Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The unwinding of the discount is recognised as finance cost.

Warranties	A provision for warranties is recognised when the underlying products or services are sold, based on historical warranty data and a weighting of possible outcomes against their associated probabilities
Restructuring	A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring either has commenced or has been announced publicly. Future operating losses are not provided for
Site restoration	In accordance with the Group's published environmental policy and applicable legal requirements, a provision for site restoration in respect of contaminated land, and the related expense, is recognised when the land is contaminated
Onerous contracts	A provision for onerous contracts is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract, which is determined based on the incremental costs of fulfilling the obligation under the contract and an allocation of other costs directly related to fulfilling the contract. Before a provision is established, the Group recognises any impairment loss on the assets associated with the contract

(Source: Illustrative disclosures: Guide to annual financial statements issued by KPMG IFRG Limited, in September 2023)

Nature and timing of provisions

IAS 37 *inter alia* requires companies to provide a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.

In this regard, it is expected that all relevant information pertaining to provisions should be incorporated within the note on provisions or given by cross reference[3]. Duplication of information should be kept at a minimum. Further, the labelling of the provision should be clear, as that would allow the disclosure to be relatively brief, while still communicating the relevant information. For example, labels such as- dilapidation provisions arising from the terms of a lease contract or a constructive obligation arising from previously announced plans to restructure the company's operations explain the nature of the obligation. However, greater detail may be required for unusual provisions to explain why there is a constructive or a legal obligation.

In addition to the nature of each material exposure, the timeframe over which it is expected to crystallise and the basis for determining the best estimate of the probable or possible outflow should also be disclosed. While providing disclosures of the expected timing of the provision, the following should be considered:

- Where the disclosures depend on other information, for example, the duration of a related contract term, this should be quantified
- Where the provision is large and covers a number of individual exposures (e.g. remediation at several sites or phases of decommissioning), more granular information about the timing should be provided. This is particularly relevant for long-term provisions.

3. Reliance should not be placed on information included in other documents or previous annual reports

An example of disclosure of the nature of a short-term and long-term provision

Provision for warranties *(generally a short-term provision)*
The provision for warranties relates mainly to paper sold during 2022 and 2023. The provision has been estimated based on historical warranty data associated with similar products and services. The Group expects to settle the majority of the liability over the next year. An expected reimbursement of warranty expense incurred of EURXX thousand has been included in 'other trade receivables' (refer note XX) following a supplier accepting responsibility for the defective products
Provision for site restoration *(generally a long-term provision)*
Under Romanian law, the Group's subsidiary in Romania is required to restore the contaminated land to its original condition before the end of 2025. During 2023, the Group provided EURXX thousand for this purpose. Because of the long-term nature of the liability, the greatest uncertainty in estimating the provision is the costs that will be incurred. In particular, the Group has assumed that the site will be restored using technology and materials that are currently available. The Group has been provided with a range of possible reasonably possible outcomes for the total cost, which range from EUR500 thousand to EUR700 thousand, reflecting different assumptions about pricing of the individual components of the cost. The provision has been calculated using a discount rate of 5.9 per cent, which is the risk-free rate in Romania. The rehabilitation is expected to occur in the next two to three years.

(Source: Illustrative disclosures: Guide to annual financial statements issued by KPMG IFRG Limited, in September 2023)

Contingent liability

IAS 37 has prescribed certain disclosures for contingent liabilities- which includes the following for each class of contingent liability:

- A brief description of the nature of the contingent liability,
- Where practicable, an estimate of its financial effect,
- An indication of the uncertainties relating to the amount or timing of outflow and possibility of any reimbursement.

Quantitative information about expected or maximum exposures to contingent liabilities should be disclosed, and where it is not practicable to provide an estimate of the financial effect, a clear and justified statement to that effect should be made. Negative confirmations can be helpful where users may otherwise expect the company to report an exposure.

Example disclosure 1- Disclosure, where the expected maximum exposure of the company has been disclosed. The disclosure also explains why it is not possible to determine the best estimate and expected timing of such outflows

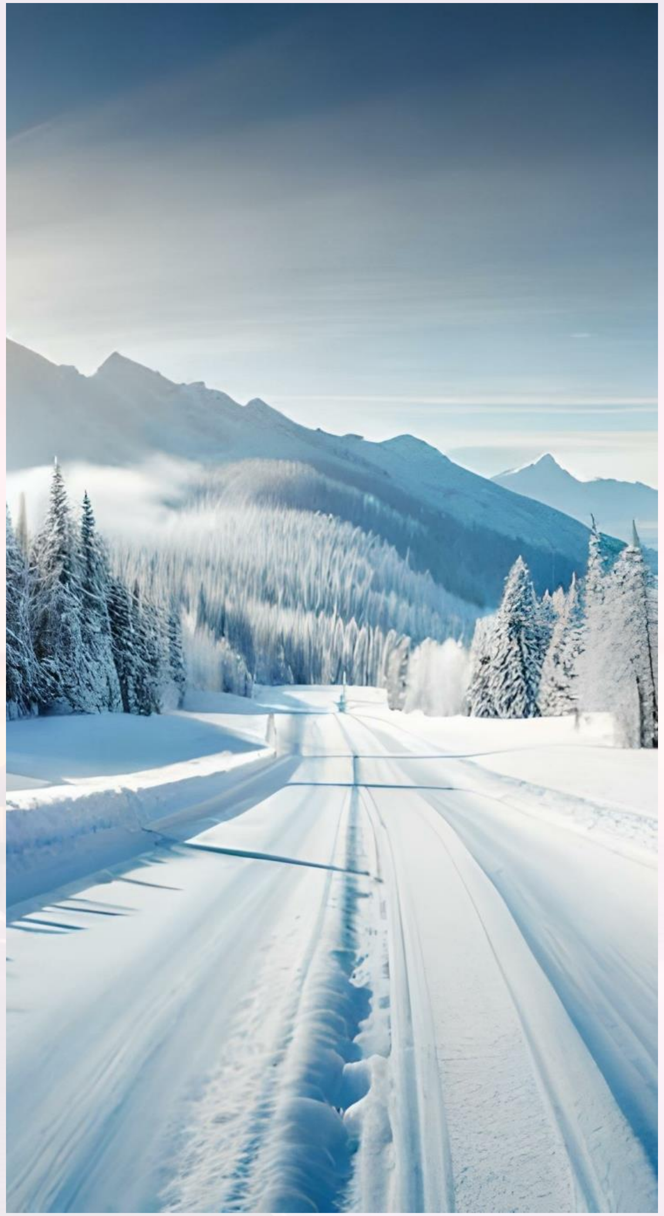
> There is an ongoing criminal investigation into the production of thermally cleaned soil at [Company]. This may or may not result in a prosecution and if so, we expect such a process will likely take many years, should it proceed. [Company] will defend its conduct strongly in such an event. Given that it is not even clear whether or what charges might be brought in the criminal case and the charge is expected to be lower than EUR1m we do not consider it appropriate at this stage to provide for this. Given these uncertainties, it cannot be ruled out that the outcome of the criminal investigation or the topic it concerns could result in liability for damages resulting from third party claims in the future.

(Source: Thematic review: IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’, issued by the FRC in October 2021)

Example disclosure 2- Disclosure, where the expected maximum exposure of the company and the amount recognised as a provision has been disclosed. The expected timeframe for resolution of the uncertainty and when the resulting outflow may occur has also been explained

> Renewi has provided EUR15m based on legal advice which represents management’s best estimate of the most likely outcome. It is noted that the potential maximum claim is €58m (excluding compound interest currently amounting to EUR5m), and therefore there is a potential further liability should the Group be wholly unsuccessful in its defence. A ruling from the European Commission is expected during FY22 but no monies would likely become payable until FY23.

(Source: Thematic review: IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’, issued by the FRC in October 2021)



Uncertainty in computation

As per IAS 37, the use of estimates is an essential part of computing provisions, as by their very nature and, provisions involve a high degree of uncertainty than many other items in the financial statements. While computing provisions, there could be uncertainty in the amount of economic outflow, uncertainty in timing of the outflow[4] or uncertainty in discount rates. These need to be appropriately disclosed in the financial statements.

Example disclosure 1: Uncertainty in amount of economic outflow

This disclosure explained that estimated outflow remained materially uncertain, owing to the number of cases not yet determined by the skilled person, and provided a range of possible outcomes.

A further assumption which has an impact upon the provision is the timing of benefits taken. The uncertainty regarding the timing of benefits taken by each member for the cases not yet determined by the skilled person has a potentially material future impact upon the provision. The range of outcomes for the provision, including anticipated costs, varies from GBP25 million to GBP36 million at each extremity of possible timing of benefits taken.

(Source: Thematic review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', issued by the FRC in October 2021)

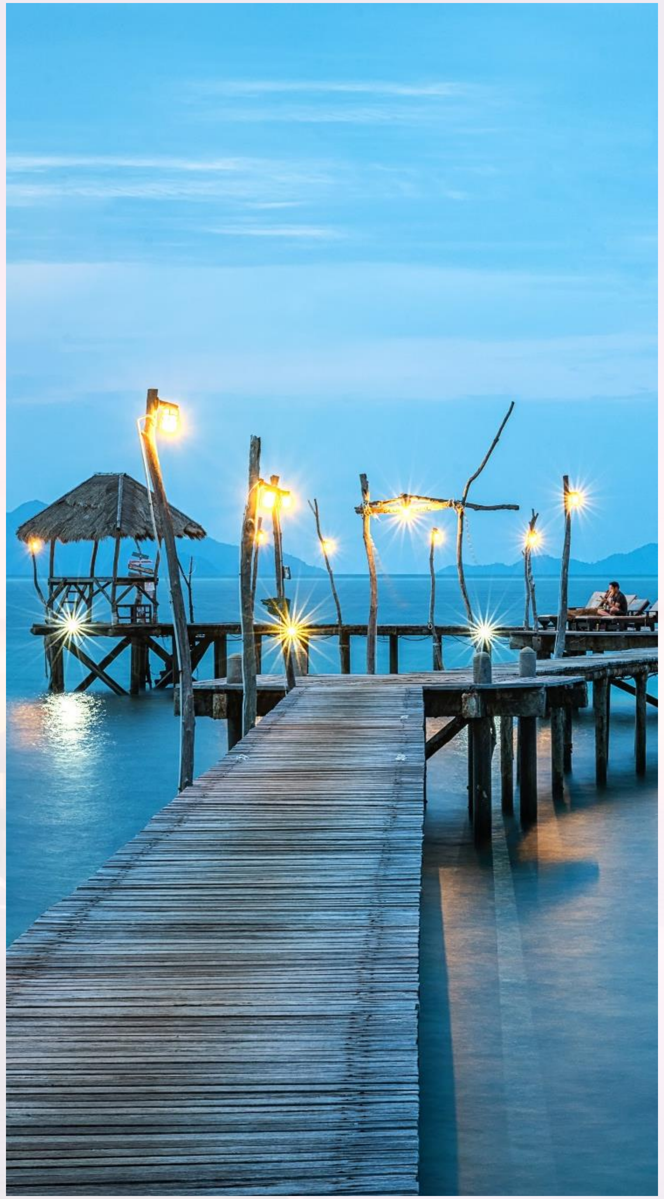
IAS 37 does not specifically require the disclosure of discount rates used to calculate the present value of estimated future outflows. However, regulators expect companies to disclose the discount rate and how it is calculated, where the effect of discounting is material. This disclosure aids comparability from one period to the next and across companies.

Example disclosure 2: How estimation of discount rate is affected by the key currencies in which the company transacted

… the present value of [restoration] provisions has been calculated using discount rates of between 4.5 per cent and 4.9 per cent in Kazakhstan … and 6.4 per cent in Kyrgyzstan … Management estimates the discount rate for its provisions in Kazakhstan based on sovereign bond yields denominated in US dollars adjusted for the differential inflation between the Tenge and the US dollar, which is lower in the long term.

Management has not calculated its provisions using Kazakhstan sovereign bond yields denominated in Tenge, as these bonds have largely been purchased by local institutions and there are limited bonds with maturities which are comparable to the remaining life of each mine.[5]

(Source: Thematic review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', issued by the FRC in October 2021)



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4. The uncertainty in timing of outflow could have a material effect on:
   – the amount payable due to cost inflation;
   – the present value of outflows, through discounting; and
   – presentation of the provision (or parts of it) as a current or non current liability in the statement of financial position.
5. Companies should consider whether their disclosure explains each of the following matters, where this is material to understand the estimation uncertainty:
   – how the discount rate has been determined from benchmark rates, and what adjustment (if any) has been applied for cash flow risk, especially where the risk profile (and hence rate adjustment) has changed from the prior period;
   – the use of different rates for different provisions and how this relates to the risks inherent in each liability;
   – use of a real discount rate where projected cash flows have not been increased for inflation or a nominal rate where inflation has been applied in forecasting; and
   – why an adjustment (if made) for own credit risk is justified in the specific context of the liability

Significant judgements and sources of estimation uncertainty

IAS 1 requires companies to disclose information about the assumptions it makes about the future , and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. This disclosure focuses on short-term effects of uncertainty and complements the requirements of IAS 37 (which requires companies to indicate uncertainties about the amount or timing of outflows of provisions). Companies may deal appropriately with these two aspects of uncertainty disclosures in a single note.

Companies should take care not to omit relevant disclosure about estimation uncertainty when reporting the significant judgements made in preparing their financial statements.

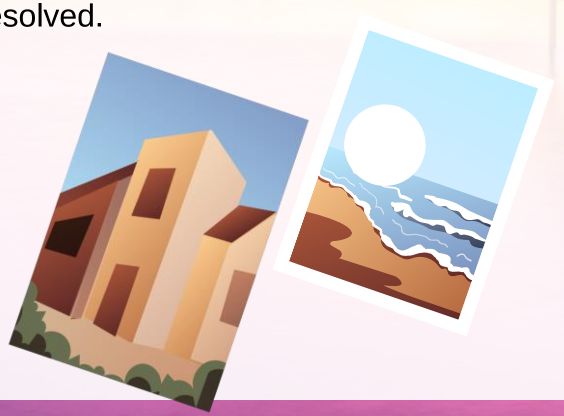
IAS 1 sets out the kinds of information that enable users to understand management's assumptions and the effect of estimation uncertainty as follows:

– The nature of the assumption or other estimation uncertainty;

– The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity

– The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and

– An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.



Example disclosure: Management's assumptions and key sources of estimation uncertainty for provisions

Provisions for restoration and decommissioning obligations are made based on the best estimate of the likely committed cash outflow. Management seek specialist input from third party experts to estimate the cost to perform necessary remediation work at the reporting date. These experts undertake site visits in years where scoping identifies there is a change in operations in the year which could suggest a change in these estimates, or at sites that have not been visited recently*. Desktop reviews are undertaken to inform the estimates for other sites. If the cost estimates increased by 10 per cent the value of provisions could change by GBP1.2m. The useful lives of quarrying sites are based on the estimated mineral reserve remaining and manufacturing facilities linked to the useful life of site property, plant and equipment. Changes to these useful lives do not have a significant impact on the provision[#].

The estimation of inflation and discount rates is also considered to be judgemental and can have a significant impact on net present value. Management reference information from the Bank of England when making such estimates. If the discount or inflation rate were changed and the spread between them increased by 1 per cent the value of provisions could change by GBP2.5m[$].

Notes:

* : This company clearly sets out its methodology for estimating the outflow, using current costs as determined by third party experts from site visits where there is likely to be greater uncertainty owing to changes in operations or passage of time.

#: Sensitivity disclosure addressed changes in estimated costs and the spread between the discount rate and inflation.

The comment on useful lives of quarrying sites and of property, plant and equipment at manufacturing facilities is informative even though changes to these lives do not have a significant effect. The disclosure provides a reasonable indication that the expected timing of outflows, estimated from current costs, is not a critical source of uncertainty compared to the absolute amounts estimated or the rate at which future outflows are discounted to present value.

$: This disclosure noted the source for the 'time value of money' (risk free) component of the discount rate. The accounting policy for provisions explained that the discount rate is adjusted for risks specific to the liability

(Source: Thematic review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', issued by the FRC in October 2021)

Reimbursement asset

As per IAS 37, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement would be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement would be treated as a separate asset.

It is to be noted that the amount recognised for the reimbursement should not exceed the amount of the provision.

Example disclosure: Overall net position of provision after factoring in the reimbursement asset.

US asbestos-related provision	2020 (million pounds)	2019 (million pounds)
Gross provision	72.7	50.6
Effect of discounting	(8.2)	(6.2)
Discounted US asbestos-related provision	64.5	44.4
Insurance asset	52.4	43.4
Net US asbestos-related liability	12.1	1.0

The net provision and insurance asset are presented in the accounts as follows

	2020 (million pounds)	2019 (million pounds)
Provisions – current	7.2	7.1
Provisions – non-current	57.3	37.3
Trade & other receivables	7.2	7.0
Long-term receivables	45.2	36.4

(Source: Thematic review: IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’, issued by the FRC in October 2021)

CHAPTER 3

Regulatory updates

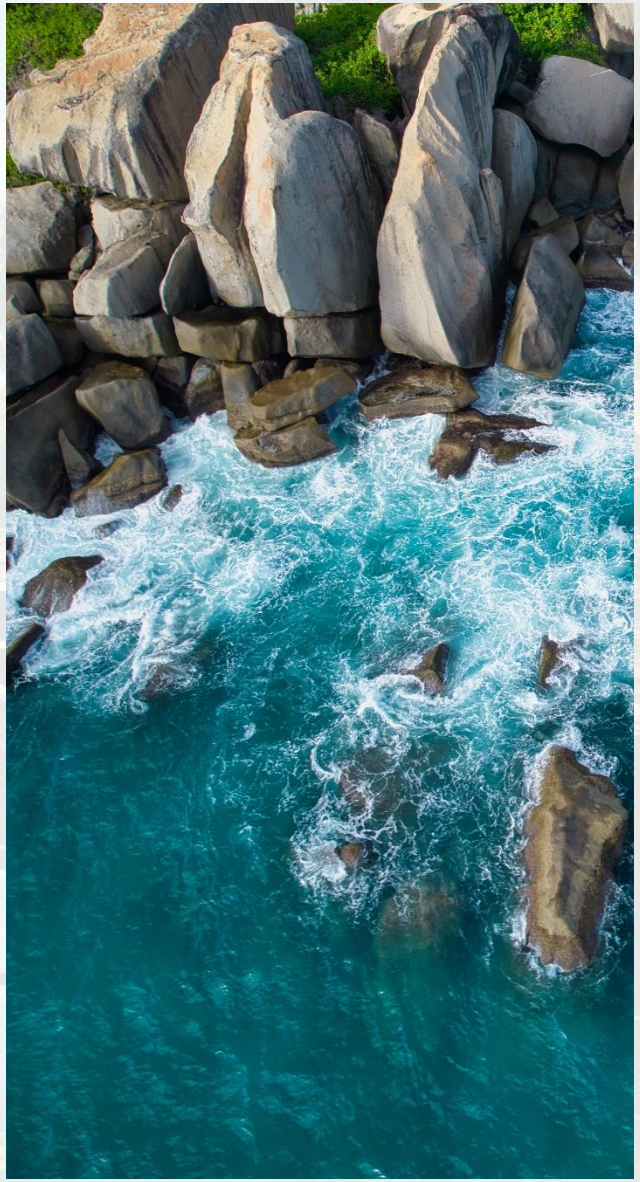
Flexibility in the framework for Social Stock Exchange (SSE) for NPOs

On 25 November 2023, the Securities Exchange Board of India (SEBI) conducted a board meeting to approve, *inter alia*, the proposal on flexibility in the framework on Social Stock Exchange (SSE) with respect to the Non-Profit Organisations (NPOs).

Following are the key approvals from the board meeting decision:

- **Minimum issue size for Zero Coupon Zero Principal Instruments (ZCZP):** In case of public issuance of ZCZP by NPOs, SEBI has approved the reduction of the minimum issue size from INR1 crore to INR50 lakh.
- **Minimum application size for issuing ZCZP:** The application size for NPOs issuing ZCZP has been reduced from INR2 lakh to INR10,000. This would result in wider participation of subscribers, including retail.
- **Social Impact Assessor:** It has been approved to substitute the term 'Social Auditor' with 'Social Impact Assessor'. This would provide comfort to NPOs and would convey a positive approach towards the social sector.
- **Disclosure of past social impact:** Permitted NPOs to disclose past social impact report in the fund-raising document as per the NPO's existing practice. However, they are required to disclose certain key parameters such as number of beneficiaries, cost per beneficiary and administrative overhead.
- **Expansion of scope:** Permitted entities registered under Section 10(23C) and Section 10(46)[1] of the Income-tax Act, 1961 (IT Act) to be eligible to be registered and raise funds through issuance and listing of ZCZP on SSE.

(Source: SEBI PR No. 27 /2023 dated 25 November 2023).



FAQs on ESG Rating Provider

In July 2023, SEBI issued amendment to the SEBI (Credit Rating Agencies) Regulations, 1999 (CRA Regulations), thereby introducing Chapter VIA on ESG[2] Rating Provider (ERPs). These regulations are applicable to a person engaged in, or proposes to engage in, the business of issuing ESG ratings. Subsequently, on 12 July 2023, SEBI issued a master circular which laid down the procedural/disclosure requirements and obligations for ERPs. Further, in August 2023, SEBI issued Frequently Asked Questions (FAQs) on registration as an ERP.

The FAQs provide clarification on various aspects of ERP registration such as disclosure requirements for ERPs, shareholding restrictions, sharing of resources, eligibility criteria, applicability of circulars, etc.

Recently, on 12 December 2023, SEBI issued revised FAQs. Some of the key considerations from revised FAQs are as follows:

- **Scope of ESG ratings:** Regulation 28B(1)(b) of the CRA Regulations defines ESG ratings. The FAQ has clarified that ESG ratings include all types of rating and scoring

1. Section 10 (23C) for Charitable and education institution and Section 10(46) provides provision relating to body/authority/board/trust/ commission established or constituted by or under a Central/State/Provincial Act or constituted by the Central/State Government with the object of regulating or administrating any activity for the benefit of general public

2. Environmental, Social and Governance (ESG)

products that encompass both rule-based and algorithmic scores and are calculated as per the published methodology as well as those that involve some application of judgment or discretion. This is also in accordance with the International Organization of Securities Commissions (IOSCO's) Report on ESG Ratings and Data Products Providers issued in November 2021.

- **Registration requirements in India:** Regulation 28C states that a person could act as an ERP only after obtaining a certificate from SEBI. Further, the Fourth Schedule to the CRA Regulations lay down the applicability criteria of the CRA Regulations depending on the location of the ESG rating user and the rated asset class (Indian/Global) in the securities market.

  The FAQs have clarified that the regulations would not apply to a foreign ERP outsourcing or using back/middle office support in India for providing ESG rating services to users outside India.

  It is further clarified that an overseas ERP offering ESG rating products covering Indian asset classes to Indian clients should obtain certificate of registration from SEBI by establishing a locally incorporated entity. In case the application is made before 3 January 2024, such an overseas ERP could continue offering its services till the time the registration is granted by SEBI. Once the registration is granted, the services should be rendered from the locally incorporated entity.

- **Difference between 'Indian' and 'Global' asset classes:** The 'Indian' asset classes are the asset classes listed in the Indian securities market while 'Global' asset classes pertain to asset classes in overseas markets.

- **Whether ERPs can provide internationally-aligned ratings alongside Indian specific ratings:** It is clarified that ERPs are permitted to offer any ESG rating or scoring products, including ratings/scores based on international frameworks **in addition** to the ESG rating products that incorporate the ESG aspects of the Indian market. Therefore, it is not necessary to make any adjustment to the existing rating methodologies or to provide comparable sector-specific ratings.

- **Definition of 'Core ESG Rating':** From FY 2023-24 onwards, over a glide path of four years, the top 1,000 listed entities in India are mandated to undertake reasonable assurance of the Business Responsibility and Sustainability Report (BRSR) Core. The master circular for ERPs states that the 'Core ESG Rating' must be based on third-party assured data. The details of the same are prescribed in Chapter II to the master circular.

- **Determination of 'Indian ESG rating user':** It is clarified that an 'Indian ESG rating user' is any individual, entity or organisation **within India** that utilises ESG rating services for decision making, investment analysis, compliance, or research purpose related to ESG investment, performance and practices. Therefore, a foreign ESG rating user that outsources or uses back/middle office support in India would be considered 'outside India' as per the Fourth Schedule to the CRA Regulations. The CRA Regulations would not apply to ESG rating services provided to such users.

- **Applicability of the regulatory requirements to ERPS using 'subscriber-pays' business model and 'issuer-pays' business model:** As per the CRA Regulation, the contractual obligations between the issuer and the ERP are required to be specified and complied with in an 'issuer pays' model. Whereas, in a 'subscriber-pays' model, there are no such contractual obligations. Therefore, requirements/provisions laid down in the regulations/master circular pertaining to or arising out of such contractual obligations would not apply to an ERP following 'subscriber-pays' model. However, it is important to note that, certain requirements are regulatory and are to be complied with by all ERPs, irrespective of the business model.

(Source: SEBI FAQs on 'FAQs on Registration as an ESG Rating Provider (ERP)' dated 12 December 2023).

Proposal to introduce fast track public issuance of debt securities

SEBI has issued a consultation paper on 9 December 2023 which aims to promote the ease of doing business. The consultation paper has proposed certain changes to SEBI (Listing Obligations and Disclosure Requirements) 2015 (LODR Regulations) and SEBI (Issue and Listing of Non-Convertible Securities), 2021 (NCS Regulations). It has also introduced the concept of fast-track public issuance and listing of debt securities.

The key takeaways are as follows:

I. Proposed relaxations from provisions of NCS and LODR Regulations

Following are some of the key proposals to promote ease of doing business:

- **Reduction in denomination for privately placed debt securities (NCDs) and Non-Convertible Redeemable Preference Shares (NCRPS):** It has been proposed to reduce the denomination of face value of privately placed NCDs or NCRPS to INR10,000 *(earlier INR1 lakh).* However, such NCDs and NCRPS should be plain vanilla, interest/dividend bearing instruments with a simple structure (i.e. without any credit enhancements or structured obligations).

  Further, considering an increase issuance of Securitised Debt Instruments (SDI), the SDIs that are issued through private placement and listed could either have a face value of INR 1lakh or INR10,000.

  In both the above cases, the issuer should appoint a merchant banker to carry out a due diligence for issuance of such securities and for the disclosures in the private placement memorandum.

- **Inserting web-link and QR code for the audited financials in the offer document:** As per the existing provisions of the NCS Regulations, an issuer seeking to list its NCS on a recognised stock exchange should provide audited financials for last three financial years and stub period financials in the offer document.

  However, it has now been proposed that such an issuer that has outstanding NCDs as on the date of the issue document or issue opening date, could insert a QR code for the web-link for such audited financials of last three financial years and stub period financials in the offer document.

- **Disclosure of certain information upto the latest quarter for listing of NCS:** As per Schedule I of the NCS Regulations, certain information with respect to related party transactions, remuneration of directors, borrowings, etc. is to be disclosed for the current financial year.

  However, the consultation paper has proposed to disclose such information up to the latest quarter of the current financial year.

- **Standardisation of shut period/record date:** As per the NCS Regulations, the record date should be disclosed in the summary sheet of the offer document.

  The record date is the date on which the investor should be the owner of the debt securities for corporate action whereas the shut period is the number of days between the record date and interest payment date/redemption date.

  To reduce the inconsistency in the duration of the shut period, it is proposed to standardise the record date/shut period at 15 days before the due date of payment of interest/redemption.

- **Due diligence certificate by the Debenture Trustee (DT):** Regulation 40 of the NCS Regulations and the Master Circular for Debenture Trustees, specify two different formats of due diligence certificate to be submitted by the DTs.

  It has been proposed to harmonise and align the two formats. Annexure-I to the consultation paper includes the proposed formats.

- **Publishing financial results in newspapers:** As per Regulation 52(8) of LODR Regulations, a listed entity is required to publish the financial results in the newspaper within two working days of the conclusion of the board meeting.

  However, it is proposed to make this requirement optional i.e. provide discretion to the listed entity to publish the financial results in the newspapers.

II. Introduction of concept of fast track public issuance and listing of debt securities

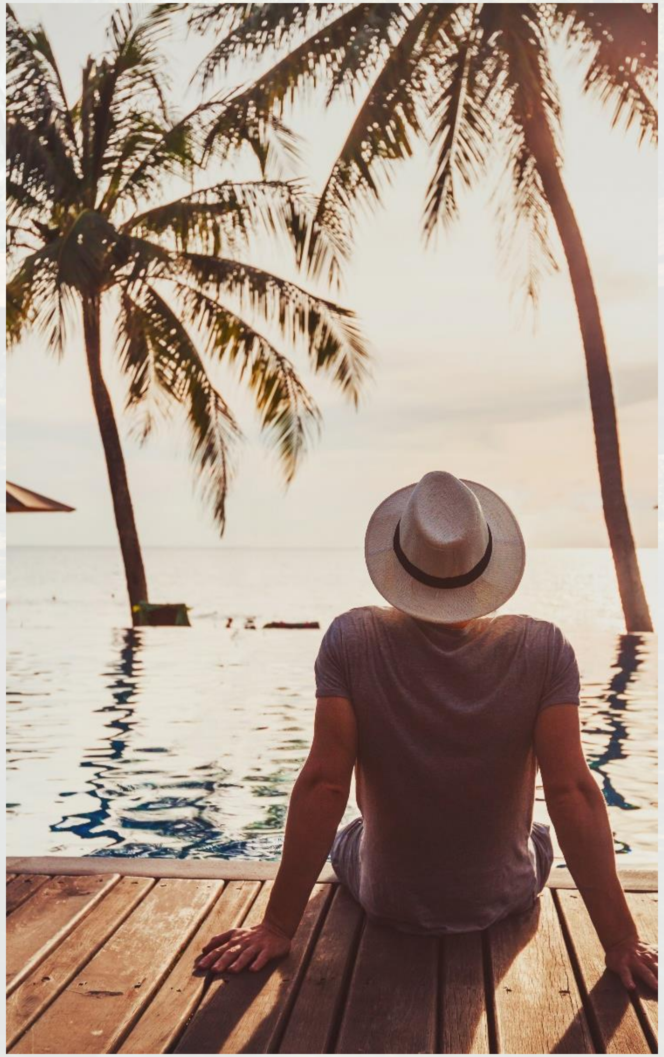
As per the NCS Regulations, eligible issuers could raise funds through a public issuance of debt securities or by way of a private placement of non-convertible securities. It has been observed that there is a scope in the corporate debt market to boost participation of non-institutional investors and increase the investor base through public issuance of debt securities.

In this regard, SEBI has issued the following key proposals to fast track the public issuance and listing of debt securities:

- **Requirement of prospectus or GID-KID:** Proposed to introduce General Information Document (GID) and Key Information Document (KID) for fast-track public issues.
- **Eligibility of the issuers for fast-track public issuance:** The consultation paper has laid down the eligibility criteria for issuers eligible for fast-track public issuances.
- **Filing time for draft GID:** The consultation paper has proposed two working days for seeking public comments on the draft offer document.
- **Disclosures in GID and KID:** For fast-track public issuance of debt securities, the GID should consist of all the disclosures as specified under Schedule I of NCS Regulations whereas the KID should contain the following information:
  a. **Part A:** All disclosures that are relevant for a public issue but not in the GID e.g. material changes from the GID, material developments, risk factors if any, not disclosed in the GID,
  b. **Part B:** Details of the offer of the debt securities.
- **Digital statutory advertisement**: To advertise the pubic issue, it is proposed to replace the requirement of advertising in newspapers with electronic modes such as the issuer's website, stock exchange's website, debenture trustee's website, etc.
- **Period of subscription:** The fast-track public issue of debt securities would be kept open for minimum of one working day and a maximum of 10 working days. In case of any revision in the price band or yield, the period would be extended by one more working day.
- **Minimum subscription:** As per the existing provisions of NCS Regulations, the minimum subscription for a public issue should not be less than 75 per cent of the base issue size. It is proposed to eliminate this requirement for banks and entities in the financial sector when such entities are undertaking fast track public issue of debt securities.
- **Retention of over subscription:** Proposed to fix retention limit upto a maximum of five times of base issue size. This would provide more flexibility to the issuers in fund raising.
- **Listing timelines:** Proposed to reduce the timeline for listing of debt securities in case of fast-track public issue from T+6 to T+3.

The last date to provide comments on the above consultation paper ends on 30 December 2023.

(Source: SEBI Reports 'Consultation paper on review of provisions of NCS Regulations and LODR Regulations for ease of doing business and introduction of fast track public issuance of debt securities' dated 9 December 2023)



Stricter requirements for consumer credit and bank credit to NBFCs

Recently, on 16 November 2023, the Reserve Bank of India (RBI) through its notification revised the regulatory measures towards consumer credit and bank credit to Non-Banking Financial Company (NBFC).

This notification is applicable to commercial banks (including small finance banks, local area banks and regional rural banks) and NBFCs (including Housing Finance Companies (HFCs)). Following are key considerations from revised requirements:

a. **Consumer credit exposure of commercial banks:** The consumer credit exposure of commercial banks (outstanding as well as new), including personal loans would attract a risk weight of 125 per cent (*earlier 100 per cent*[3]). This excludes housing loans, education loans, vehicle loans and loans secured by gold and gold jewellery.

b. **Consumer credit exposure of NBFCs:** The consumer credit exposure of NBFCs (outstanding as well as new) categorised as retail loans would now attract a risk weight of 125 per cent (*earlier 100 per cent*[4]). This excludes housing loans, educational loans, vehicle loans, loans against gold jewellery and microfinance/ Self Help Group (SHG) loans.

c. **Credit card receivables:** Credit card receivables of Scheduled Commercial Banks (SCBs) would attract a risk weight of 150 per cent (*earlier 125 per cent*[5]) while that of NBFCs would attract a risk weight of 125 per cent (*earlier 100 per cent*[6]).

d. **Bank credit to NBFCs:** Regarding the exposures of SCBs to NBFCs, RBI has increased the risk weight on such exposure by 25 percentage points (over and above the risk weight associated with the given External Credit Assessment Institutions (ECAI)[7]) for all cases where the existing risk weight as per external rating of NBFCs is below 100 per cent. This excludes loans to HFCs and loans to NBFCs which are eligible for classification as priority sector in terms of the extant instructions.

e. **Strengthening credit standards:** As per the notification:

   i. Regulated Entities (REs) should review their existing sectoral exposure limits for consumer credit and should implement Board approved limits for the various sub-segments under consumer credit. The limits should be prescribed for all unsecured consumer credit exposures. Further, the compliance of the limits fixed should be monitored on an ongoing basis by the Risk Management Committee. REs should comply and implement with this requirement by 29 February 2024.

   ii. All top-up loans extended by REs against movable assets which are inherently depreciating in nature, such as vehicles, should be treated as unsecured loans for credit appraisal, prudential limits and exposure purposes.

The above-mentioned revised measures, other than point no. (e)(i), are applicable from 16 November 2023.

(Source: RBI notification no. RBI/2023-24/85 DOR. STR.REC.57/21.06.001/2023-24 dated 16 November 2023)

3. Para 5.13.3 of 'Master Circular – Basel III Capital Regulations' and circular 'Risk Weight for Consumer Credit except credit card receivables' dated September 12, 2019
4. Paragraph 84 of the Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 dated October 19, 2023
5. Para 5.13.3 of 'Master Circular – Basel III Capital Regulations'
6. Applicable to two NBFCs permitted to issue credit cards , viz. SBI Cards and Payment Services Private Limited and BOB Financial Solutions Limited
7. Para 5.8.1 of the 'Master Circular – Basel III Capital Regulations' dated May 12, 2023, read with the circular 'Risk Weights for exposures to NBFCs' dated February 22, 2019

Report on audit quality review issued by ICAI

The Quality Review Board (QRB) under the Institute of Chartered Accountants of India (ICAI) conducted audit quality review of entities in India for the financial year 2022-23. The report highlights overall trends, key findings, analysis of reviewed audit files in terms of technical standards, analysis of observations in audit files under major industries, findings in major focus areas for reviews, summary of observations in other areas, matters of general guidance for audit firms, etc.

These findings have been categorised under the following sections:

i. Standards on auditing

ii. Accounting standards and

iii. Other relevant laws and regulations.

(Source: ICAI announcement 'QRB Report on Audit Quality Review - 2022-23' issued on 21 November 2023)

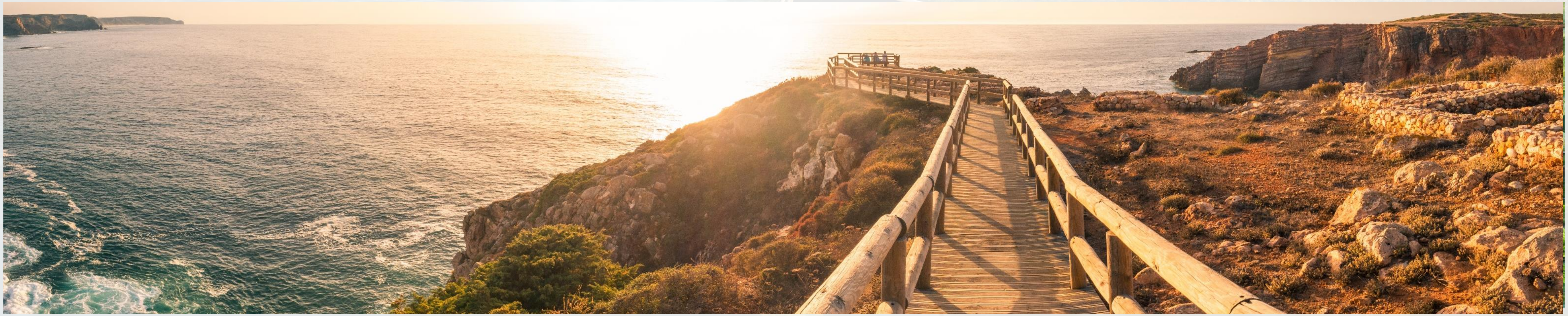
Exposure draft of standards on auditing for LLPs

As per Section 34A of the Limited Liability Partnership Act, 2008 (LLP Act), the Central Government may, in consultation with the National Financial Reporting Authority (NFRA), prescribe the Standards of Auditing (SAs) as recommended by the ICAI, for a class or classes of Limited Liability Partnerships (LLPs).

In this regard, ICAI submitted its recommendations stating that the 35 SAs applicable to audit of companies shall apply mutatis mutandis to audit of LLPs. Therefore, the Auditing and Assurance Standards Board (AASB) of ICAI has issued an exposure draft of SAs for LLPs.

The last date to provide comments ends on 6 January 2023.

(Source: ICAI announcement 'Exposure Draft of Standards on Auditing for Limited Liability Partnerships' issued on 22 November 2023)



International standards on auditing of less complex entities

The International Auditing and Assurance Standards Board (IAASB) has issued the International Standard on Auditing (ISA) for audits of financial statements of Less Complex Entities (LCE).

This standard is a standalone global auditing standard which has been designed specifically for smaller and less complex businesses and organisations. It is built on the foundation of ISAs. Further, it contains all the requirements necessary to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error.

The applicability criteria of ISA for LCE is as follow:

- **Specific prohibitions:** The use of ISA for LCE is prohibited for the following classes of entities:
    i. When prohibited by laws or regulations
    ii. Listed entities
    iii. Entities with public interest characteristics i.e.
    iv. Groups audits where:
        a. Any of the group's individual entities or business units meet the abovementioned criteria or
        b. Component auditors are involved, except when the component auditor's involvement is limited to circumstances in which a physical presence is needed for a specific audit procedure for the group audit.
- **Qualitative characteristics:** The standard provides a qualitative list that describes an LCE's characteristics. The characteristics relate to an entity's:
    i. Business activities and model
    ii. Organisational and ownership structure
    iii. Finance function and IT
    iv. Financial reporting framework and accounting estimates
    v. Consolidation process.
- **Quantitative thresholds:** The quantitative threshold would be determined by legislative or regulatory authorities or relevant local bodies in each jurisdiction.

The ISA for LCE is effective for audits of financial statements for periods beginning from 15 December 2025.

(Source: IAASB news 'New Standard for audits of Less Complex Entities Issued By IAASB' dated 6 December 2023).

Exposure draft on financial instruments with equity characteristics

IAS 32, *Financial Instruments: Presentation* states that a company that issues financial instruments should distinguish between debt instruments from equity instruments. Over years, the financial instruments issued have become more complex resulting in reporting challenges for companies. In this regard, the International Accounting Standards Board (IASB) has issued an exposure draft to IAS 32, that aims to address the financial reporting challenges when instruments have debt and equity features.

The key takeaways from the proposals are as follows:

i. **Amendment to IAS 32:** It is proposed to clarify some of the underlying principles on classification and provide application guidance. The proposal are as follows:

Area	Key changes proposed
'Fixed-for-fixed' condition (e.g. equity conversion options in a convertible bond, share warrants)	Specific types of adjustments to the number of equity instruments or the amount of cash to be exchanged (e.g. certain adjustments to the conversion ratio or exercise price) would not violate the condition.
Reclassification between financial liabilities and equity	Reclassification would be required when the substance of a contract changes because of a change in circumstances outside the contract (e.g. a change in the functional currency).
Contingent settlement provisions	Clarification on whether to reflect the probability of the contingent event occurring when recognising a financial liability. Guidance on the meaning of terms 'liquidation' and 'not genuine'.
Obligations to purchase own equity instruments (e.g. put options over non-controlling interest)	Clarification on whether: • To derecognise own equity instruments subject to these obligations, and • The requirements in paragraph 23 of IAS 32 to recognise a financial liability for the present value of the redemption amount would apply when settlement will be made using a different type of own equity instrument. Subsequent remeasurement of the financial liability would be recognised in profit or loss
Effects of laws or regulations on the contractual terms	Clarification on how these would affect classification
Settlement of obligations subject to shareholders' decision	New guidance on factors to consider in evaluating whether the shareholders' decision can be treated as that of the company.

ii. **IAS 1, *Presentation of Financial Statements* and IFRS 7, *Financial Instruments: Disclosures:*** It is proposed to expand the disclosure and presentation requirements in IFRS 7 and IAS 1 respectively for certain financial liabilities and equity instruments.

Some of the proposed disclosure are as follows:

- Terms and conditions such as debt-like characteristics in equity instruments (e.g. dividends on preference shares that are based on a fixed rate) and equity-like characteristics in financial liabilities;
- The priority of all financial liabilities and equity instruments on liquidation of a company;

- Potential dilution of ordinary shares (e.g. the maximum number of shares to be delivered if convertible bonds are converted and share options are exercised);
- Amounts initially allocated to the liability and equity components of compound instruments;
- Specified quantitative information about financial instruments that contain an obligation to purchase own equity; and
- Information about financial liabilities containing contractual obligations to pay amounts based on a company's performance or changes in its net assets.

With respect to presentation, it is proposed to provide separate presentation of certain line items attributable to ordinary shareholders of the parent and to other owners of the parent in the balance sheet and income statement.

The last date to provide comments on the above exposure draft is 29 March 2024.

(Source: IFRS news 'IASB consults on improved accounting requirements for financial instruments with both debt and equity features' dated 29 November 2023 and KPMG IFRG Limited's article 'Financial liability or equity?' dated 4 December 2023)

New segment reporting guidance issued by FASB

As per Topic 280, *Segment Reporting*, a public entity is required to disclose entity-wide and segment information in the notes to financial statements. However, investors observed that there has been limited information reported about a segment's expenses.

In this regard, the Financial Accounting Standard Board (FASB) issued an Accounting Standards Update (ASU) on 27 November 2023 to improve the reportable segment disclosure requirements through enhanced disclosures about significant segment expense.

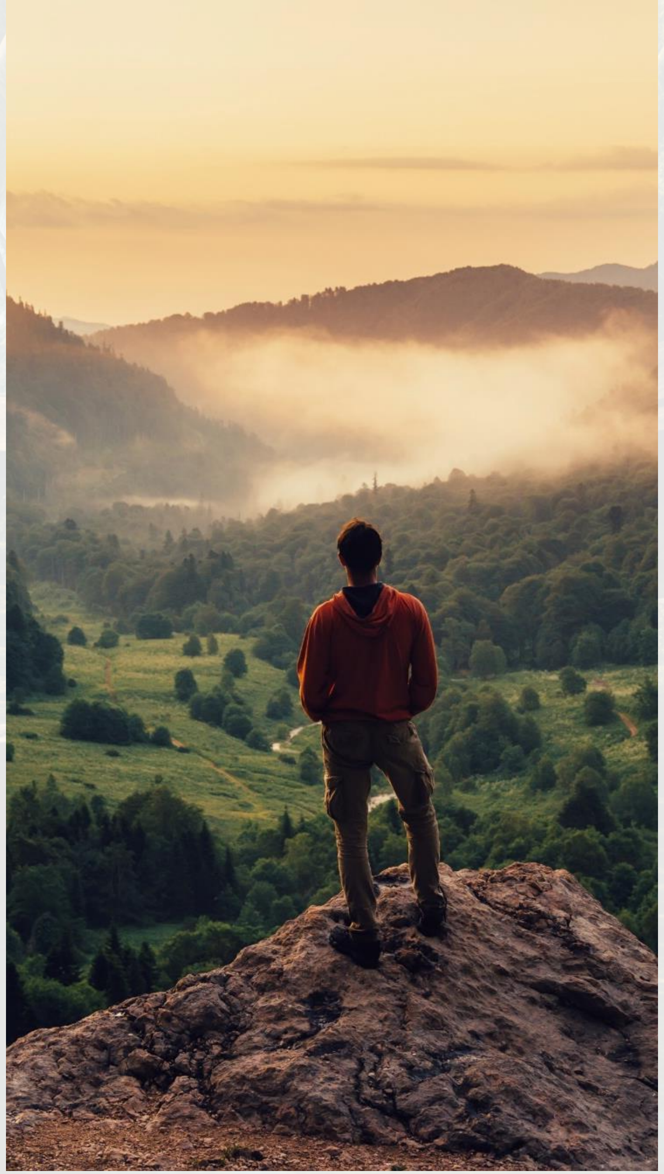
The key amendments are as follows:

- **Significant expense categories and amounts:** Public entities should disclose significant segment expenses that are regularly provided to the Chief Operating Decision Maker (CODM) and included within each reported measure of segment profit or loss.
- **Other segment items:** The ASU requires a public entity to disclose an amount for other segment items by the reportable segment and a description of its composition. The other segment items category is the difference between segment revenue less significant expenses disclosed and each reported measure of segment profit or loss.
- **Interim period disclosures:** Disclosures regarding a reportable segment's profit or loss and assets are to be provided on an annual and interim basis.
- **Multiple measures of a segment's profit or loss:** If the CODM uses more than one measure of a segment's profit or loss in assessing segment performance and deciding how to allocate resources, then the public entity could report one or more of such additional measures of segment profit.

  However, at least one of the reported segment profit or loss measures should be the measure that is most consistent with the measurement principles used in measuring the corresponding amounts in the public entity's consolidated financial statements.
- **CODM's use of reported measure(s) of segment profit or loss:** Public entities are now required to provide a narrative explanation of how the CODM uses each reported measure of a segment's profit or loss in assessing segment performance and deciding how to allocate resources.
- **CODM's title and position:** Public entities are required to disclose the title and position of the individual or the name of the group or committee identified as the CODM.
- **Single reportable segment entities:** It is clarified that a public entity that has a single reportable segment would provide all the disclosures in Topic 280 (i.e. existing and disclosure requirements covered in the ASU).

The above amendments are is effective for fiscal years beginning after 15 December 2023, and interim periods within fiscal years beginning after 15 December 2024.

(Source: FASB media advisory 11-27-23 issued on 27 November 2023 and KPMG LLP's US article on 'FASB issues ASU Improvements to reportable segment disclosures' issued on 29 November 2023).



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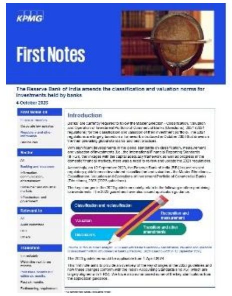

The Reserve Bank of India amends the classification and valuation norms for investments held by banks

Banks are currently required to follow the Master Direction - Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021 (2021 regulations) for the classification and valuation of their investment portfolio. With significant developments in the global standards on classification, measurement and valuation of investments (i.e. IFRS), the linkages with the capital adequacy framework as well as progress in the domestic financial markets, there was a need to review and update the 2021 regulations.

Accordingly, on 12 September 2023, the Reserve Bank of India (RBI) issued revised regulatory guidelines on investment classification and valuation - the Master Directions - Classification, Valuation and Operations of Investment Portfolio of Commercial Banks (Directions), 2023 (2023 guidelines).

This issue of the First Notes provides an overview of the of the key changes in the 2023 guidelines and how these changes conform with Ind AS (which are largely aligned with IFRS).

To access the First Notes, please click here.

Voices on Reporting – Quarterly updates publication

On 26 October 2023, KPMG in India released its Voices on Reporting – Quarterly updates publication (for the quarter ended 30 September 2023) which provides a summary of key financial reporting, Environment, Social and Governance (ESG) and regulatory updates from the Securities and Exchange Board of India (SEBI), the Ministry of Corporate Affairs (MCA), the Reserve Bank of India (RBI) and the Institute of Chartered Accountants of India (ICAI).

To access the publication, please click here.

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