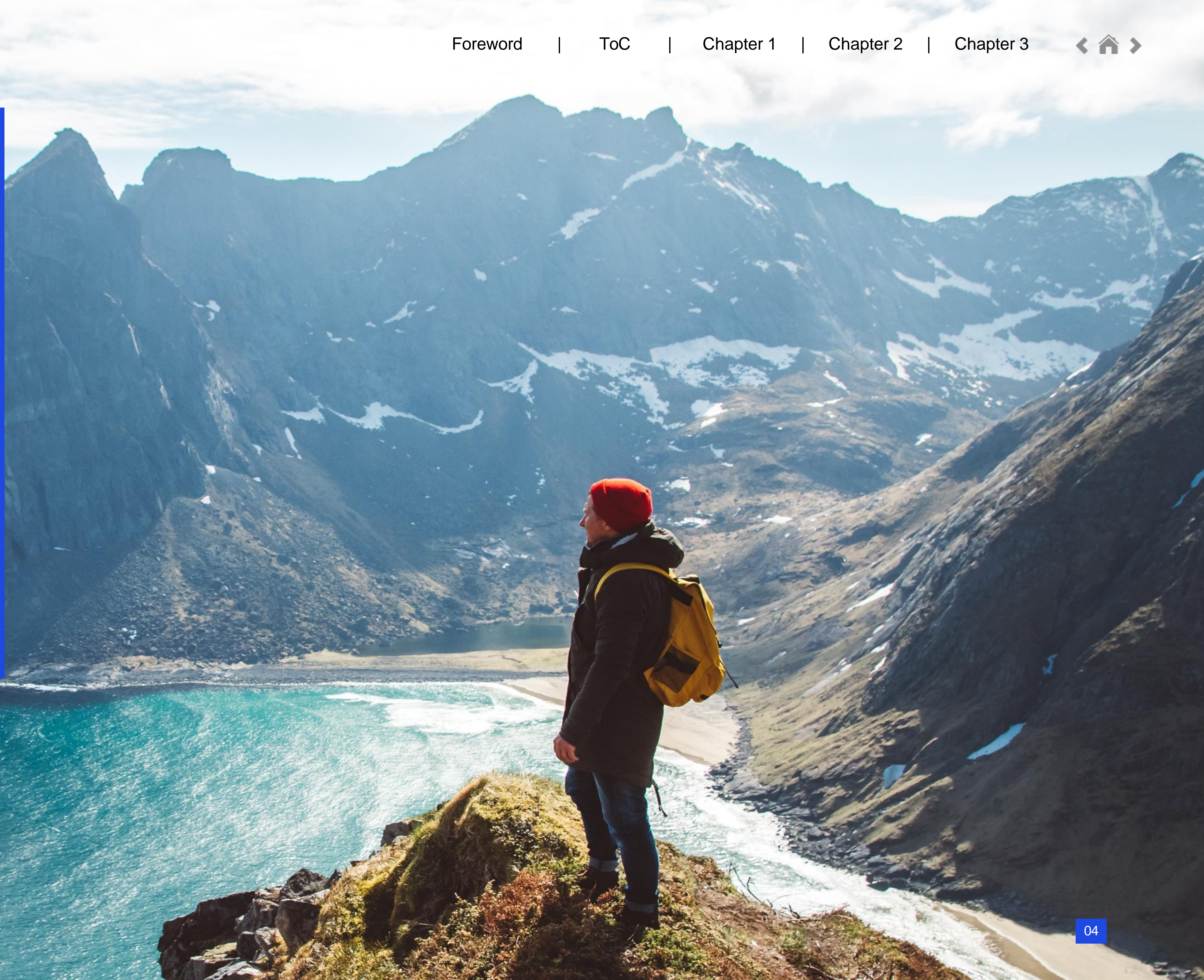
CHAPTER 1

Accounting for channel financing arrangement in the financial statements

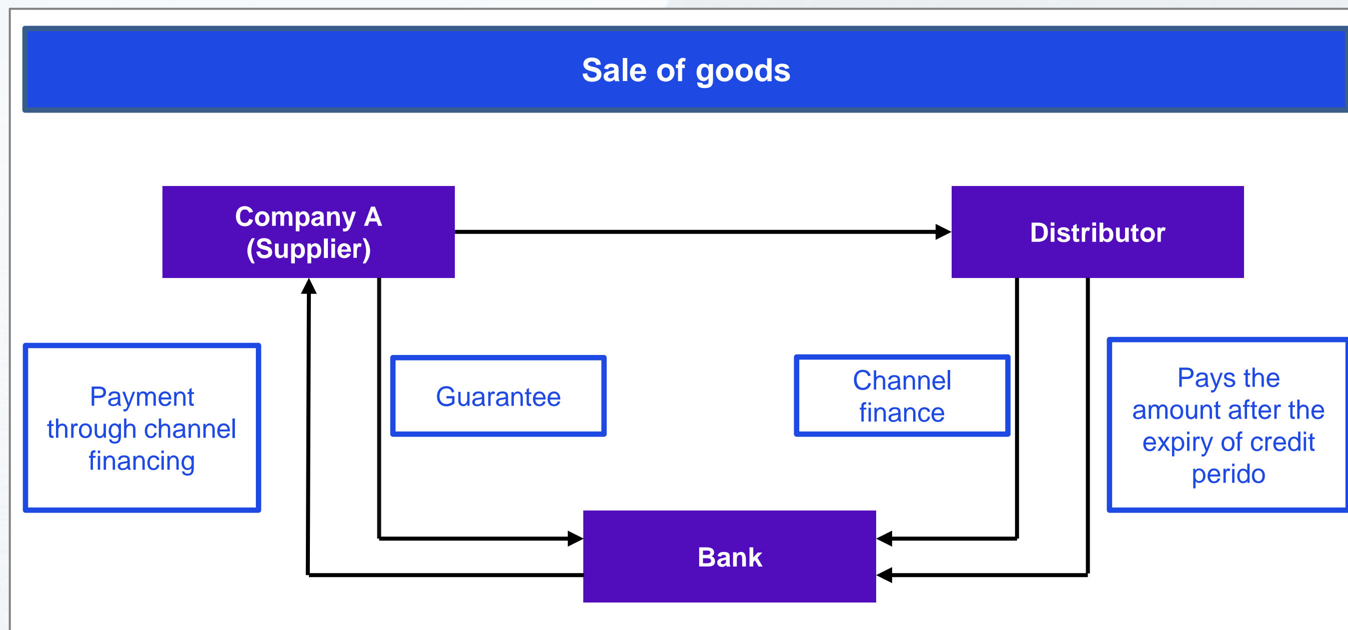
This article aims to:

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.

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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?

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Accounting for a channel financing arrangement by an entity

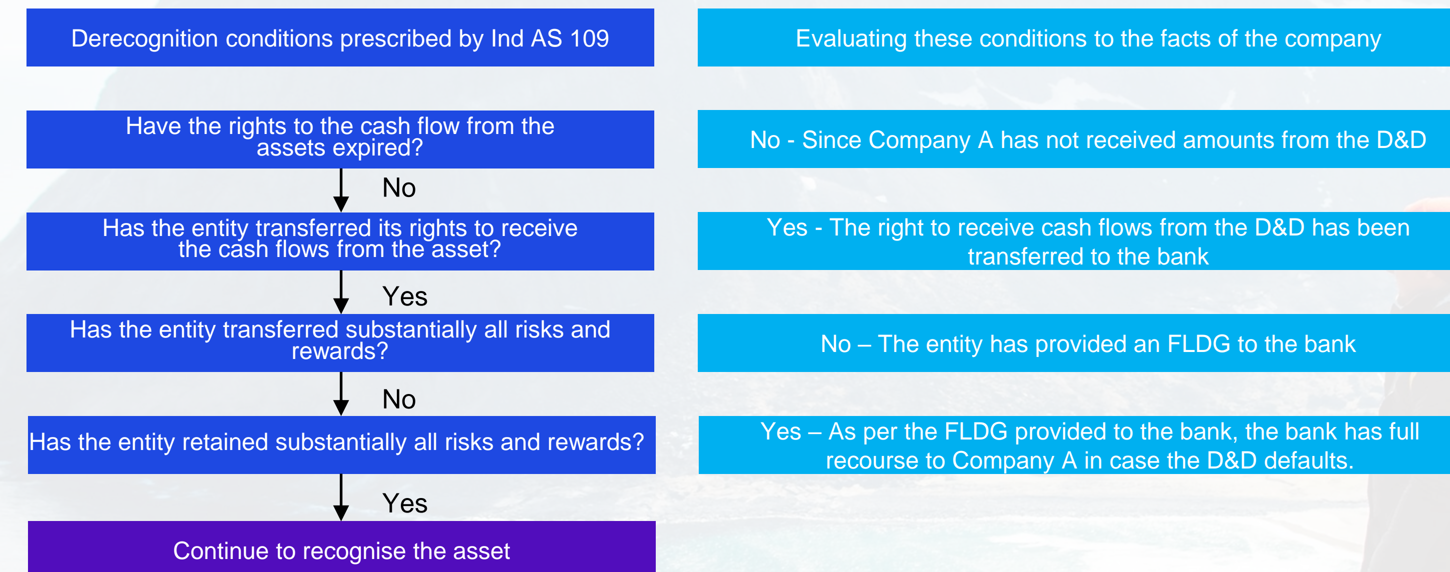
A. Evaluating whether the arrangement would result in derecongnition of the trade receivable

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.

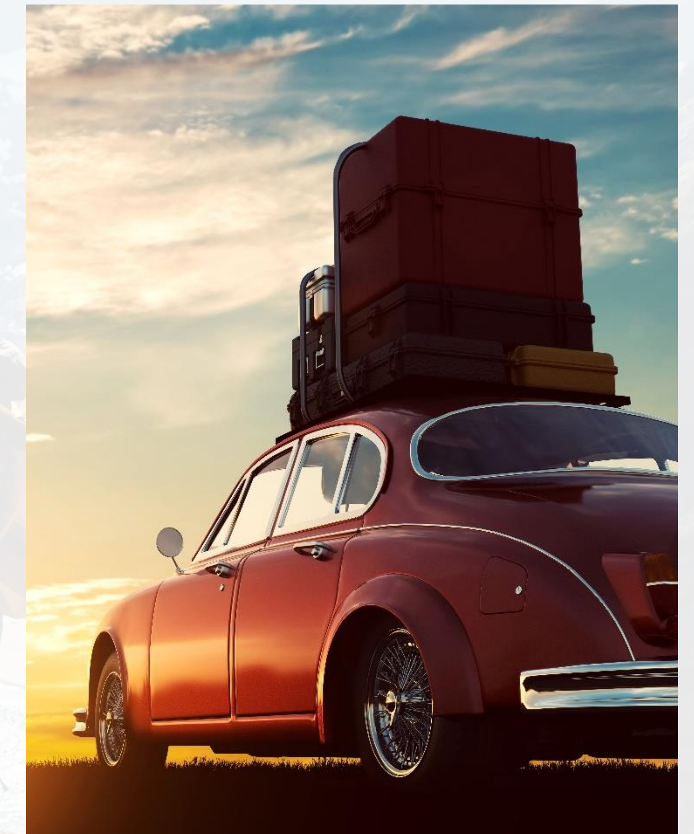
This evaluation has been performed in figure 2.

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



(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.



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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.

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