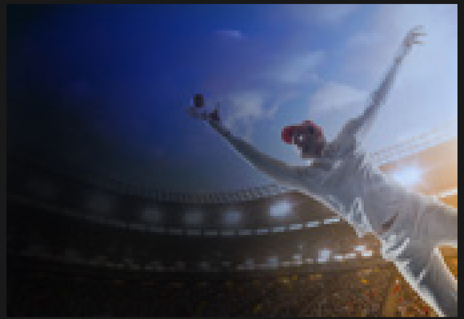
Accounting and Auditing Update

Issue no. 69/2022



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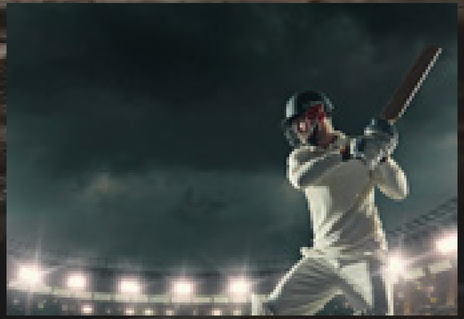

CHAPTER 4

April 2022

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Foreword

Cloud computing arrangements have seen a radical shift from the traditional way businesses think about Information Technology (IT) resources. A cloud service provider may provide different arrangements e.g. infrastructure as a service, platform as a service, or software as a service. These arrangements may involve two or more unrelated parties that contribute to providing the goods or services to a customer.
Under Ind AS, revenue recognition for such arrangements is governed by the principles of Ind AS 115, *Revenue from Contracts with Customers.* When another party is involved in providing goods or services to a customer, an entity would need to evaluate the nature of its promise to the customer i.e. is it the principal or an agent to this arrangement. In this edition of Accounting and Auditing Update (AAU), we highlight key principles to be evaluated while applying Ind AS 115 and evaluating principal versus agent considerations for accounting of revenue transactions in cloud computing arrangements. These considerations have been illustrated with the help of examples.

Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments provide guidance on classification, recognition, and measurement of financial guarantees. Financial guarantee contracts may have various legal forms, such as letter of credit, a credit default contract, or an insurance contract. When a parent entity provides corporate guarantee on behalf of its subsidiary company to external parties then the accounting falls within the ambit of financial instruments standards under Ind AS. Therefore, in our article on this topic, we have highlighted key principles from a recent Expert Advisory Committee's opinion of the Institute of Chartered Accountants of India to evaluate whether a corporate guarantee is a financial guarantee and accounting for financial guarantee in separate financial statements of a parent.

On 31 March 2022, the IFRS International Sustainability Standards Board (ISSB) has issued its first two Exposure Drafts (ED) relating to IFRS S1, *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2, *Climate-related Disclosures.* The comment period on both the EDs ends on 29 July 2022. They propose reporting across four content areas – governance, strategy, risk management, and metrics and targets – which are consistent with the Task Force on Climate-Related Financial Disclosures (TCFD) framework. ED on IFRS S1 proposes overall requirements for disclosing sustainability-related financial information. It is intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs. ED to IFRS S2 has been developed in response to the demand for globally consistent climate-related disclosures that meet the needs of users of general purpose financial reporting. We have provided a summary of the key proposals of the ISSB given in both the EDs.

Recently, the Ministry of Corporate Affairs has issued amendments to Ind AS. We have covered these amendments along with other important regulatory updates during the month of April 2022.

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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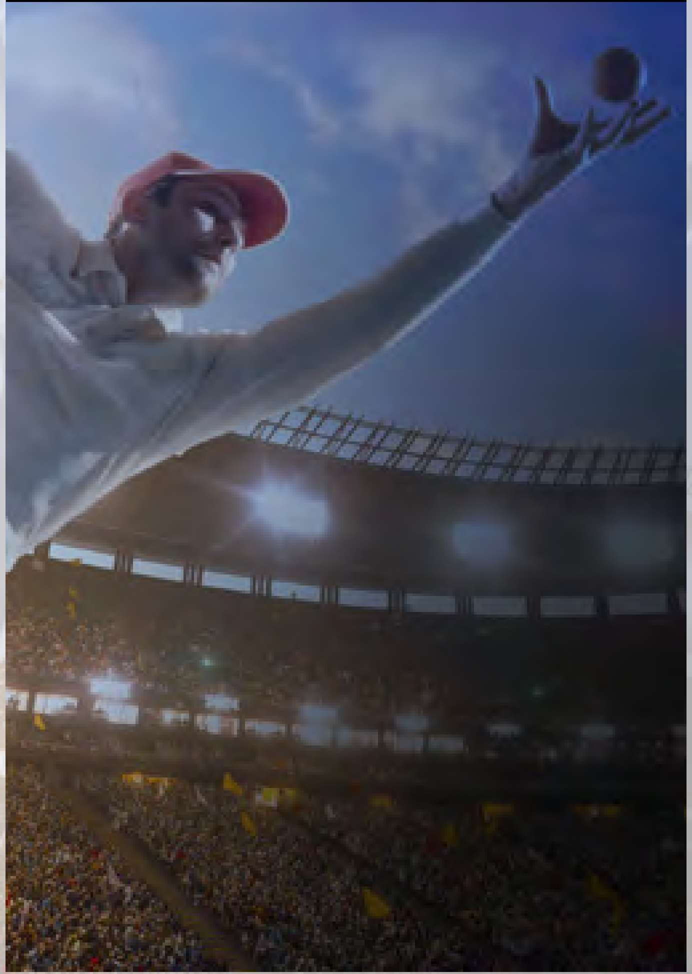
CHAPTER 1

Gross versus net accounting - Cloud computing arrangements

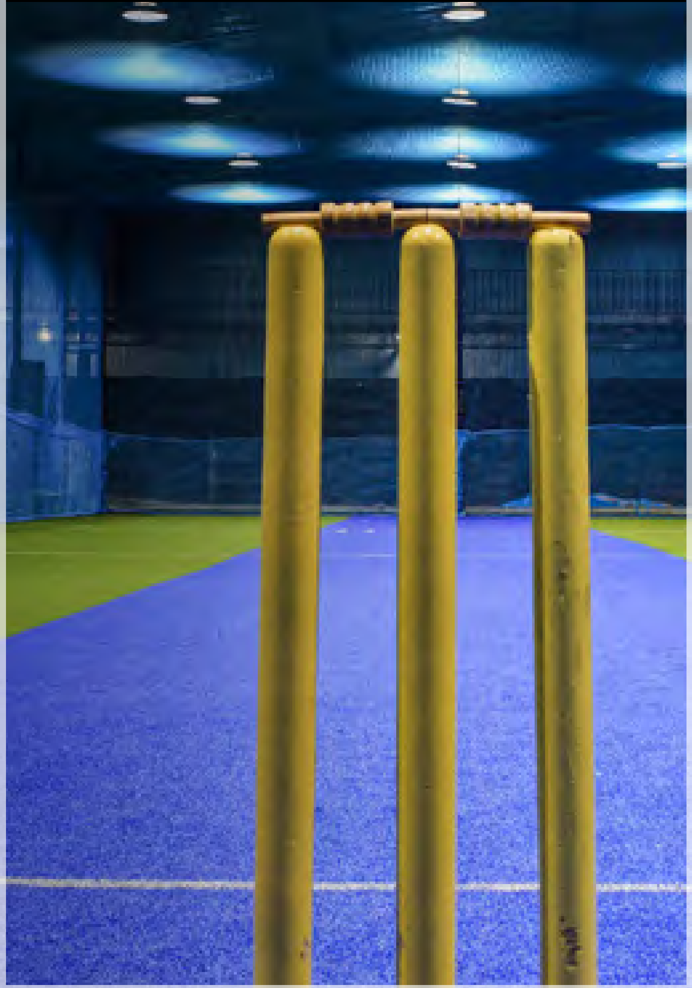


CHAPTER 2

Accounting for corporate guarantees in standalone financial statements of a parent company

CHAPTER 3

ISSB introduces the proposals on global baselines standards for sustainability disclosures



CHAPTER 4

Regulatory updates

CHAPTER 1

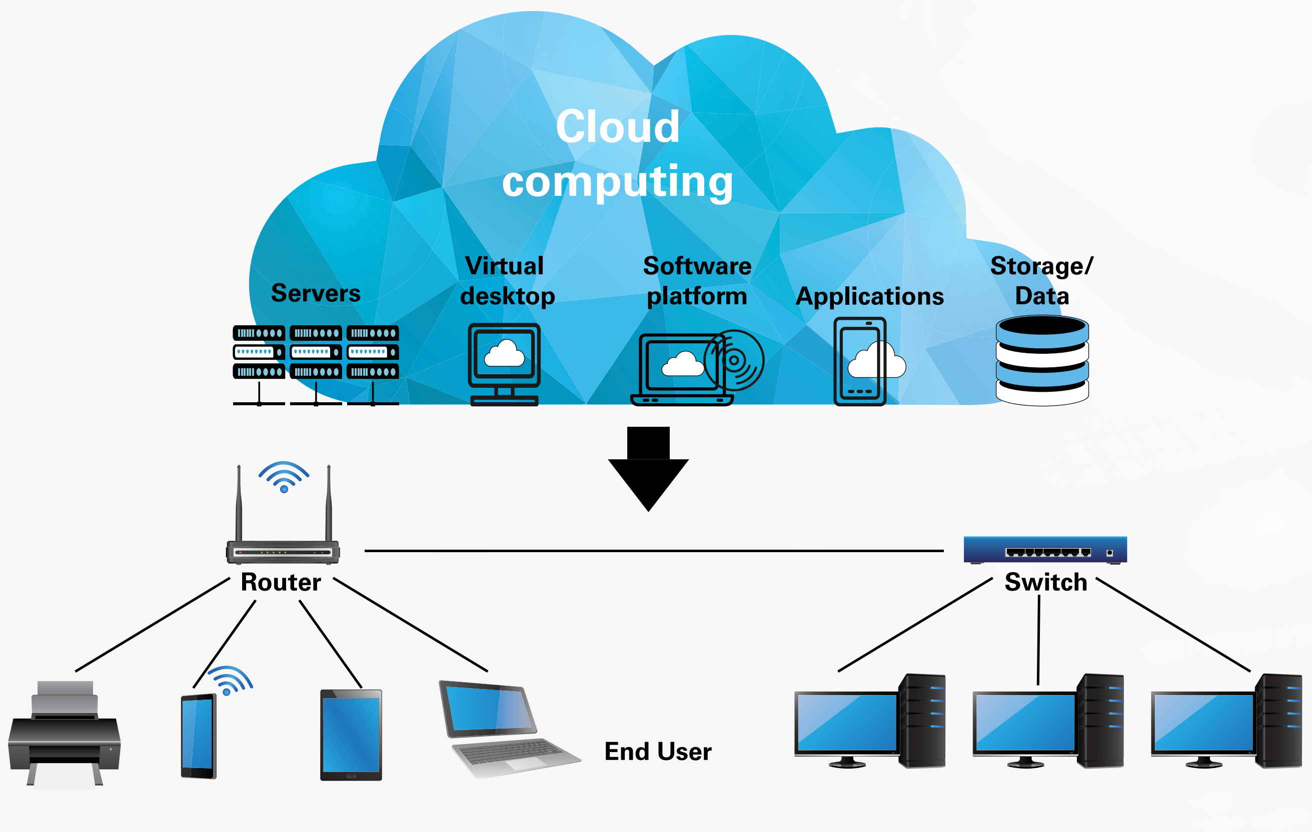
Gross versus net accounting - Cloud computing arrangements

This article aims to:

Highlight the challenges faced in evaluating principal versus agent considerations for accounting of revenue transactions in cloud computing arrangements with the help of examples.

A cloud computing arrangement

Cloud computing is the delivery of computing services including servers, storage, databases, networking, software, analytics, and intelligence over the internet (the cloud) to offer faster innovation, flexible resources, and economies of scale.



Cloud computing layout diagram

Cloud computing is a radical shift from the traditional way businesses think about Information Technology (IT) resources since it eliminates capital expense of buying hardware, software and setting up and running on-site data-centers, along with high speed ability with global reach and reliability.

These arrangements vary based on the types of services provided by Cloud Service Providers (CSP) to their customers, and the accounting for such arrangements will depend on the terms of the arrangement and specific complexities involved. Generally, there may be three types of cloud computing arrangements:

(i) **Infrastructure as a service (IaaS)** – Providing infrastructure support to customers eliminating maintenance of on-premises data centre, hardware costs, etc.

(ii) **Platform as a service (PaaS**) – Providing platform to companies without setting up/ managing underlying infrastructure, storage, network and databases.

(iii) **Software as a service (SaaS)** – Providing software application services to end users.

Cloud computing arrangements have been evolving and witnessing significant changes in technology, and exploring new markets. Although these developments present exciting new opportunities, they also pose new challenges with respect to accounting considerations, including those related to revenue recognition.

Revenue recognition

Under Ind AS, revenue recognition is based on the principles given in Ind AS 115, *Revenue from Contracts with Customers*. In certain cloud computing arrangements, an entity may involve two or more unrelated parties that contribute to providing a specified good or service to a customer or involve entities re-selling a product.

When another party is involved in providing goods or services to a customer, an entity would need to evaluate the nature of its promise to the customer i.e. is it the principal or an agent to this arrangement.

This determination often requires judgement, and evaluation of all facts and circumstances is likely to impact the amount and timing of revenue recognition.

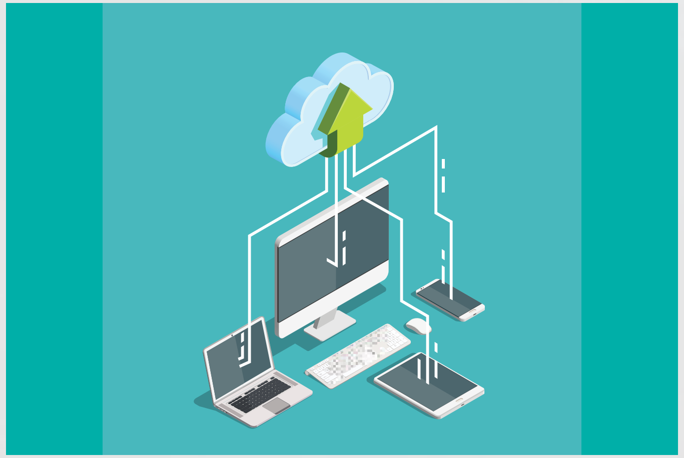
In order to recognise revenue a cloud computing service provider should first understand the relationships and contractual arrangements among the various parties. This includes identifying the specified good or service being provided to the customer and determining whether the company controls that good or service before it is transferred to the customer.

If an entity obtains control of another party's goods or services before transferring control to the customer, then the entity's promise is to provide the goods or services itself. Therefore, the entity is acting as a principal.

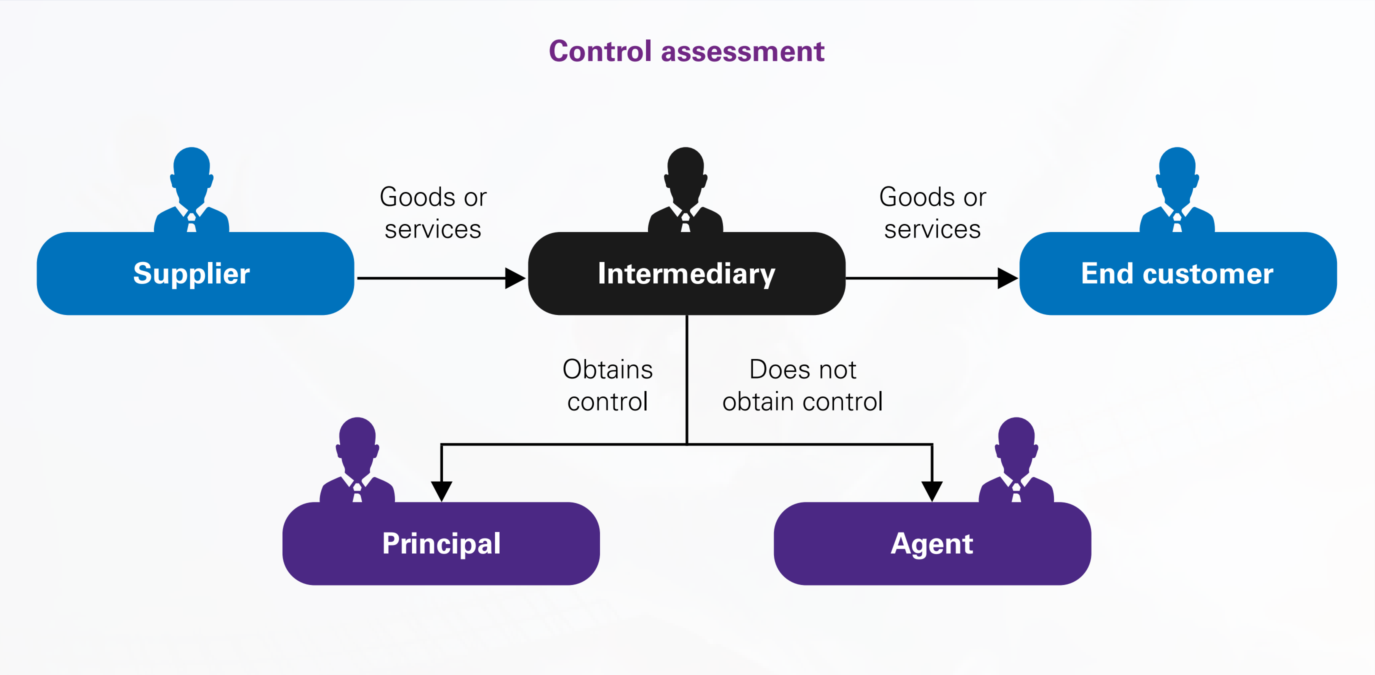
However, if the entity does not control the good or service before it is transferred to the customer, then the entity is acting as an agent and arranges for that good or service to be provided by another entity.

When an entity is the principal to an arrangement then it would recognise revenue on a gross basis. Conversely, if it is an agent and should recognise revenue on a net basis.

The principal versus agent assessment is performed at the performance obligation level, not at the contract level. An entity should evaluate whether it is principal or agent for each performance obligation, it is possible an entity may act as a principal with respect to certain performance obligations and an agent with respect to others in the contract with multiple performance obligations.



Control assessment for revenue recognition



(Source: KPMG IFRG Limited's Publication Revenue - 1FRS 15 handbook published in June 2019)

An entity to provide the specified good or service, it must first control that good or service as it would appear difficult to provide the specified good or service to a customer if the entity does not first have (and control) that good or service to be provided. **Hence, control before transfer would be the determining factor when assessing whether an entity is a principal or an agent in an arrangement.** To determine if it controls a specified good or service before it is transferred to the customer, the entity acting as an intermediary applies the general guidance on transfer of control.

If the assessment based on the general guidance on transfer of control is not conclusive, then an entity considers the specific indicators of whether it acts as a principal. These indicators include, but are not limited to, the following:

(i) The entity is primarily responsible for providing specified goods or services

(ii) The entity has inventory risk

(iii) The entity has discretion in establishing prices for specified goods or services

There is no specific hierarchy for the indicators and an entity considers all of the indicators in making the assessment. The assessment of whether the entity controls the specified good or service before it is transferred to the customer does not depend on whether one or more of the above indicators are met or on a majority evaluation of the indicators. For instance, meeting two of the above three indicators, or not meeting two of the three indicators, is not alone persuasive to the control evaluation.

The indicators are intended to inform the control evaluation and, depending on the facts and circumstances, provide more or less relevant (i.e. persuasive) evidence to that evaluation. Therefore, meeting one (or more) of the indicators cannot override the other, more relevant/persuasive, evidence – whether provided by meeting or not meeting one or more of the other indicators or another source of evidence – as to whether the entity controls the specified good or service before it is transferred to the customer.

Few common scenarios in cloud computing arrangements and impact of principal versus agent considerations

Example 1: Cloud service arrangement with specified service as an input into a combined output

ABC Ltd. partners with third parties who own and operate web-based platforms. ABC creates IT environments for its customers on these platforms, secures the platform processing capacity for its customers and provides software to monitor and manage the cloud consumption on the platforms. ABC is an authorised reseller of three different cloud platforms and provides customer support on each cloud platform to ensure customer applications have maximum up-time (i.e. are always available on the cloud).

ABC enters into a contract with a customer to provide professional services required to implement a cloud-based solution and provide cloud capacity management. These services include identification and procurement of cloud computing capacity, a software interface (the ABC Software) to help customers monitor their cloud computing usage, as well as customer support and maintenance. The customer selects platform provider's product to be used in the services. However, the customer and platform provider do not enter into a contractual relationship and ABC accepts responsibility for the cloud platform.

ABC sets the price charged to the customer for the services, and platform provider is not involved in the negotiations and does not have visibility into the contract. However, given market competition for the cloud platform and rates at which platform provider sells separately, ABC is practically limited in the amount it can charge customer for the platform.

ABC's separate contract with platform provider requires it to pay platform provider even if customer does not pay ABC for the services.

Analysis

ABC concludes that it is providing a single specified service to customer because it is performing a significant service of integrating the platform, software, support and maintenance into a single performance obligation.

The specified cloud services are a single, integrated offering and ABC provides significant service to the customer by integrating all the items, including the third party cloud platform, into the combined output (i.e. the integrated cloud services) for which the customer has contracted.

ABC controls the right to access the cloud platform and then directs the use of that right by integrating that access with the other goods and services in providing a package of cloud services to the customer.

Hence, ABC concludes that it controls the package of cloud services before it is transferred to the customer.

The third-party web platform is merely one input into ABC's integrated cloud offering, which ABC controls and makes use of in fulfilling the specified service.

Although the customer has selected which platform provider's product to be used, it has not entered into any contractual relationship with such platform provider.

The customer has a contractual agreement with ABC for providing cloud services. Hence, ABC remains primarily responsible for providing the cloud services to the customer.

ABC has set the price charged to the customer for the cloud services. The platform provider is not involved in the negotiations and does not have visibility into the contract. Hence, ABC concludes that it has discretion in establishing price for the output of services.

Based on the facts of the example, the services provided by the platform provider creates an asset that ABC controls. ABC directs the use of this asset by integrating it with other promised goods or services to satisfy its performance obligation to the customer.

Hence, ABC is acting as a principal in the given arrangement and should record the gross amount charged to the customer as its revenue from operations.

Example 2: Cloud service arrangement with reserve capacity

ABC Ltd. (ABC) is a IT Service provider providing bouquet of web-hosting services such as hosting third party software on cloud or providing only cloud capacity or integration of both. ABC procures the cloud capacity from Cloud Ltd. Since, ABC has multiple customers, they therefore reserve cloud capacity with Cloud Ltd. by providing minimum commitment at the beginning of the year.

XYZ Ltd. (XYZ) owns multiple IT applications for its employees and end customers which are managed by its in-house IT team and wants cloud space for hosting its application. Since ABC is an established vendor with direct business relations with Cloud Ltd, XYZ approaches ABC for cloud capacity services to avail cost related benefits on account of scale of operations of ABC.

Analysis

In this example, ABC needs to assess whether it controls the specified service before it transfers the cloud capacity service to XYZ. In this case, ABC reserves cloud capacity from Cloud Ltd. and commits minimum capacity of cloud platform per year. Subsequently, ABC provides cloud services out of such reserved capacity to its customers.

ABC has the ability to direct the use of such reserved cloud capacity services before it is transferred to its customers as right to decide the allocation of reserved cloud capacity to its customers and the decision over customer selection resides with ABC.

Hence, ABC controls the specified cloud service before it transfers the cloud service to XYZ acting as a **'principal'** and therefore accounts for its revenue on gross basis.

Example 3: Cloud service arrangement with direct arrangement between Cloud Service Provider (CSP) and end customer

Company A is an IT service provider providing complex IT solutions for its customers. Customer B approaches A for transition from on premise data center server and storage to cloud. Apart from migration services, A will also provide post deployment services such as monitoring and managing the cloud consumption, deploying security controls, optimisation of cloud, etc. In a nut-shell, A will be securing cloud capacity for B, create an IT environment on an online platform, host the applications of B on the platform and provide all post deployment service stated above.

Company Z is a Cloud Service Provider (CSP) which provides various cloud related services. As a part of Z's business strategy, it appoints re-sellers for its services and insists on entering into a direct arrangement with the end customer of re-seller. Further, in case the end customer enters into a direct arrangement, Z gives an additional discount to the end customer, in contrast to an arrangement with an intermediary such as A or any other re-seller. Company A is a re-seller of company Z.

Company A generally provides these services as a combined integrated package using cloud capacity as input to the overall services. In this case customer B opted for a direct contract with Z, which helped in reducing the cost of the overall offering. Some of the other facts of the case are as follows:

- Customer B would also give a minimum revenue commitment to company Z whether or not the stipulated minimum cloud space is utilised.
- Company A and Company Z will enter into an arrangement mirroring that between B and Z whereby A would offer its services to customer B on cloud space of company Z. All the agreements will be entered simultaneously.
- With respect to administrative activities such as invoicing and collection, Z agrees with A and B, that invoicing for Cloud services will be done by Z to A and then A will invoice to B without markup. Z will pay to A, commission at the rate of one per cent of the invoice amount for recommending and implementing cloud services on its client.

Basis the above, it is evident that company A will be integrating cloud capacity availed from company Z and provide cloud migration, cloud capacity management and post deployment services as a package.

Analysis

In this example, company A as part of the overall service arrangement, arranges the cloud space for the customer from company Z and provides various related cloud services to customer B. There are two elements of this arrangement 1) commission income from company Z and 2) revenue from cloud migration, cloud capacity management and post deployment services by company A to customer B.

Company Z has entered into a direct contract with customer B, whereby B has also given a minimum revenue commitment to Z and Z will offer discount to B. This implies that if the minimum usage is not achieved, B would still pay the differential amount to Z. However, company A has no commitment to make good for this differential and only customer B has the commitment to pay for a certain quantum of cloud space provided by Z. This is also evidence of a direct nexus between B and Z without A being involved in this aspect.

Further, as per the agreement between company Z and company A, the cloud capacity services provided by Z can only be used for providing services to customer B, this highlights that company A doesn't have the right to direct the use of cloud capacity services, as there is a restriction on company A.

The responsibility of company A is basically managing transition of the on-premises data center server and storage of customer B to company Z's cloud space in an effective manner. It is also responsible for related post deployment services. In other words, the role of A is to provide combined service obligations with respect to cloud space being provided by Z and consumed by B.

The consideration given by customer B would be for:

— using the cloud space from Z

— receiving other related cloud services being performed by company A.

Company A receives a commission from company Z for recommending and implementing Z's cloud space to B. This is the first element of company A's income from the arrangement. Company A would invoice customer B for the provision by company Z for the relevant cloud space. Though the cloud services are being integrated to provide combined services, company A doesn't have control over the inputs i.e. cloud capacity services. Company A is working on behalf of customer B and is using the cloud from company Z on instructions of customer B. Hence, company A does not control the cloud space of Z before providing the overall cloud service to B. Therefore, while company A is invoicing for cloud services to customer B, however this is an administrative activity and it should recognise revenue on net basis for cloud capacity services.

As company A has the performance obligation for other cloud services, it would be considered as the principal for those services. Therefore, company A will charge a fee for services relating to migration, management and post deployment services on the aforesaid cloud space.

Conclusion

Cloud service arrangements often involve entities re-selling cloud services either separately or by integrating the cloud services into a combined output. For such arrangements, service providers should determine whether they are acting as a principal or as an agent

Evaluation of each specified good or service to be transferred to the customer is crucial for detailed understanding of the economic substance and would require use of judgement in determining the presentation of revenue as gross or net basis after considering the control-based principal-agent model. An entity may be a principal for some goods or services and an agent for other in a contract to transfer multiple goods or services.

CHAPTER 2

Accounting for corporate guarantees in standalone financial statements of a parent company

This article aims to:

Provide guidance on accounting for financial guarantees and covers a recent EAC opinion on accounting for corporate guarantees issued by a parent entity.

Introduction

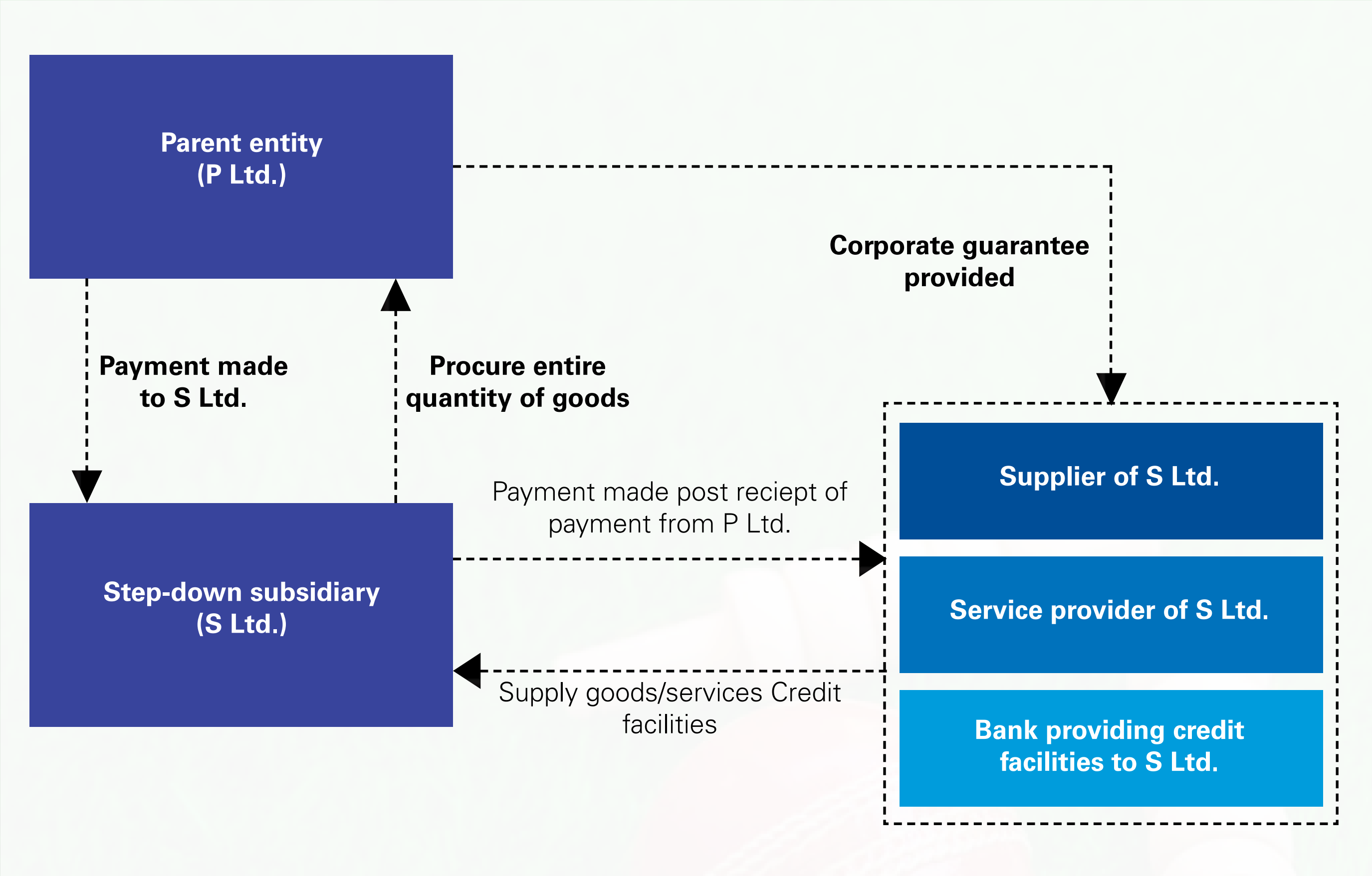
Indian Accounting Standards (Ind AS) 32, *Financial Instruments: Presentation*, and Ind AS 109, *Financial Instruments,* provide guidance on classification, recognition, and measurement of financial guarantees.

Ind AS 109 defines a financial guarantee as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make a payment when due in accordance with the original or modified terms of a debt instrument.

Financial guarantee contracts may have various legal forms, such as a guarantee, different types of letters of credit, a credit default contract, or an insurance contract. However, their accounting treatment does not depend on their legal form.

The Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) issued guidance on accounting for financial guarantees through its opinion on 'Accounting treatment in the company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the company being the parent company to banks/suppliers/ service providers on behalf of its step-down subsidiary company'. In this article, we aim to discuss the main principles enunciated in this opinion.

Case study: Facts of the case



(Source: EAC opinion on 'Accounting treatment in the Company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the Company being Parent Company to banks/suppliers/service providers on behalf of its Step-down subsidiary company' issued in ICAI journal in February 2022.)

A parent entity (say P Ltd.) entered into an agreement with its step-down subsidiary (say S Ltd.), to procure entire quantity of goods obtained by S Ltd. from its suppliers. For this purpose, P Ltd. issued corporate guarantee to S Ltd.'s suppliers (including service providers) and banks that provided credit facilities to S Ltd. (together termed as suppliers) for prompt payment by S Ltd. of all amounts that become due and payable. In case of default in payment of guaranteed obligation by S Ltd., P Ltd. would pay the suppliers and/or banks promptly.

Based on the structure of the contracts, S Ltd. can make timely payments to suppliers only if it receives timely payments from P Ltd. Since payment to third parties is solely within the control of P Ltd, no guarantee fee has been charged from S Ltd., and Expected Credit Loss (ECL) has not been recognised on the corporate guarantee contract.

Considering these facts, EAC (a) opined on the accounting treatment for corporate guarantees issued by P Ltd. in its separate financial statements, (b) determined whether any expected credit loss is to be recognised on the corporate guarantee contracts and (c) prescribed disclosure requirements for the guarantee.

Overview of the EAC opinion

The EAC provided the following clarifications with regard to accounting for financial guarantee contracts:

A. Whether a corporate guarantee is a 'financial guarantee'

For a contract to be accounted for as a 'financial guarantee', it should meet the definition of a financial guarantee under Ind AS 109. Accordingly, a contract needs to comply with the following conditions:

- The reference obligation is a debt instrument
- The holder is compensated only for a loss that it incurs
- The contract does not compensate the holder for more than the actual loss that it incurs.

While Ind AS 32 or Ind AS 109 do not define a 'debt instrument', the EAC was of the view that it implies a contractual right to receive cash arising on account of a debtor-creditor or lender-borrower relationship.

In the extant case, there is a debtor-creditor relationship between S Ltd. and its suppliers. Further, the suppliers of S Ltd. have a right to receive compensation for the loss incurred by them, if S Ltd. fails to make the payments.

Accordingly, the corporate guarantee issued by P Ltd. meets the definition of financial guarantee under Ind AS 109. The EAC also noted that the contingent right of the suppliers of S Ltd. to receive payment and the contingent obligation of P Ltd. to make payment in case S Ltd. fails to make payment met the definition of financial guarantee contract under paragraph AG8 of Ind AS 32[1].

Accordingly, the corporate guarantee contract would be considered as a financial guarantee and account for the same in accordance with Ind AS 109[2].

B. Accounting for financial guarantees in separate financial statements of a parent

The EAC believes that the financial guarantee provided to an external party on behalf of a subsidiary is required to be accounted for in the separate financial statements of the parent company as per Ind AS 109. This is notwithstanding the fact that a subsidiary's financial performance and position may be dependent on the business that is generated with the parent company, and the parent entity is the ultimate beneficiary of the subsidiary's operation.

In the extant case, although all guarantees that have been provided by P Ltd. on behalf of S Ltd. are in furtherance of P Ltd.'s business, wherein P Ltd. is the ultimate beneficiary for these guarantees, it would still account for these financial guarantees in its separate financial statements.

C. Accounting for financial guarantee contract

Ind AS 109 prescribes the accounting for financial guarantee contracts on initial recognition and subsequent measurement. These provisions are given below:

(i) Initial recognition of financial guarantee

As per Ind AS 109, a financial guarantee contract is initially recognised at fair value. If the financial guarantee contract was issued in a standalone arm's length transaction to an unrelated party, then its fair value at inception is likely to equal the premium received unless there is an evidence to the contrary.

The EAC was of the view that this requirement is also applicable in respect of a guarantee issued by a parent on behalf of its subsidiary, and where no fee or commission is charged by the parent for issuance of such a guarantee.

Accordingly, in the extant case, in its separate financial statements, P Ltd. should initially recognise a liability (such as unearned financial guarantee commission) at fair value. The guarantee obligation has been undertaken by P Ltd. in its capacity as the ultimate parent of S Ltd., and as per the facts of the case, it is not charging any guarantee commission or other consideration to S Ltd. Since P Ltd. has the right to future economic benefits arising from overall investments in S Ltd., upon initial recognition of the financial guarantee liability, P Ltd. should recognise deemed investment in S Ltd. and the same should be accounted for as per requirements of Ind AS 27, *Separate Financial Statements*.

Impact of credit risk on fair value of financial guarantee

The EAC was of the view that the extent of credit risk[3] that the financial guarantee contracts carry would not affect the initial recognition of the financial guarantee liabilities. However, this may be one of the factors that P Ltd. may consider for the purpose of fair valuation at the time of initial measurement and for measuring the Expected Credit Loss (ECL) at the time of subsequent measurement.

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1. As per paragraph AG8 of Ind AS 32, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower.
2. Issuers of financial guarantee contracts have an irrevocable option (which can be applied for each contract) to treat the financial guarantee contracts as insurance contracts and apply the accounting provisions applicable to insurance contracts. However, where such option is not chosen, provisions of Ind AS 109 would be applied while accounting for financial guarantees
3. This refers to the history of default by the entity for the benefit of whom the financial guarantee contract has been issued.

(ii) Subsequent measurement

Subsequently, a financial guarantee contract is measured at the higher of:

- The amount of loss allowance (ECL) determined in accordance with Ind AS 109, and
- The amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115

Some of the clarifications issued by EAC with regard to recognition and measurement of financial guarantees is given below:

Whether recognition of trade payables and financial guarantee obligation for same transaction results in overstating a company's liabilities

In the extant case, P Ltd. recognised a trade payable for goods purchased from S Ltd., and also recognised a loss allowance for guarantee given on behalf of S Ltd. for the same transaction. In this regard, EAC noted that the trade payable for the goods purchased from S Ltd. and the financial guarantee issued by P Ltd. to third party on behalf of S Ltd. are separate financial liabilities emanating from separate transactions. P Ltd. has obligations towards different parties in the two transactions, therefore EAC was of the view that recognising the two financial liabilities and providing for loss allowance on the financial guarantee contract would not result in duplication or overstating of liabilities.

Recognition of ECL

As per Ind AS 109, ECL is a probability-weighted estimate of credit losses (i.e., the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

Cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor, or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfall for the asset subject to guarantee.

Considering this, EAC noted that as per Ind AS 109, ECL should be considered for financial guarantee contracts at the time of subsequent measurement.

In the extant case, even though failure to pay third parties is solely within the control of P Ltd., there could be a time lag in payment made by P Ltd. to S Ltd. and payment made by S Ltd. to its suppliers, which could result in recognition of ECL, in such a case, in EAC's view such time lag could result in recognition of ECL.

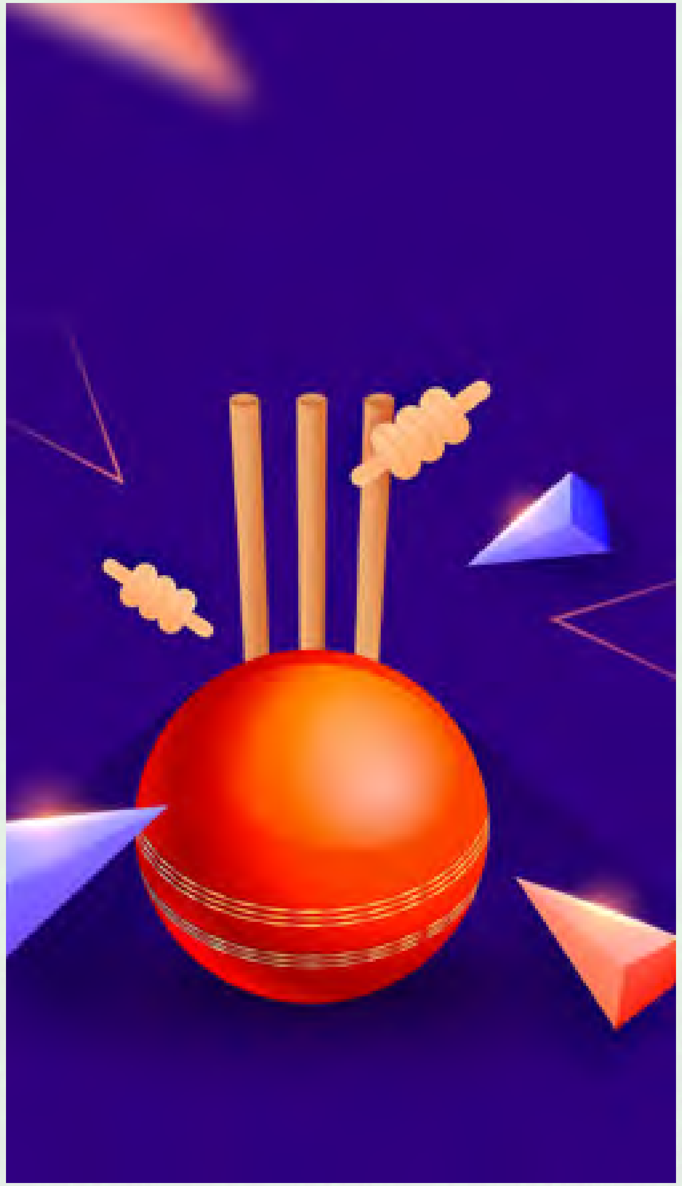
D. Presentation and disclosures

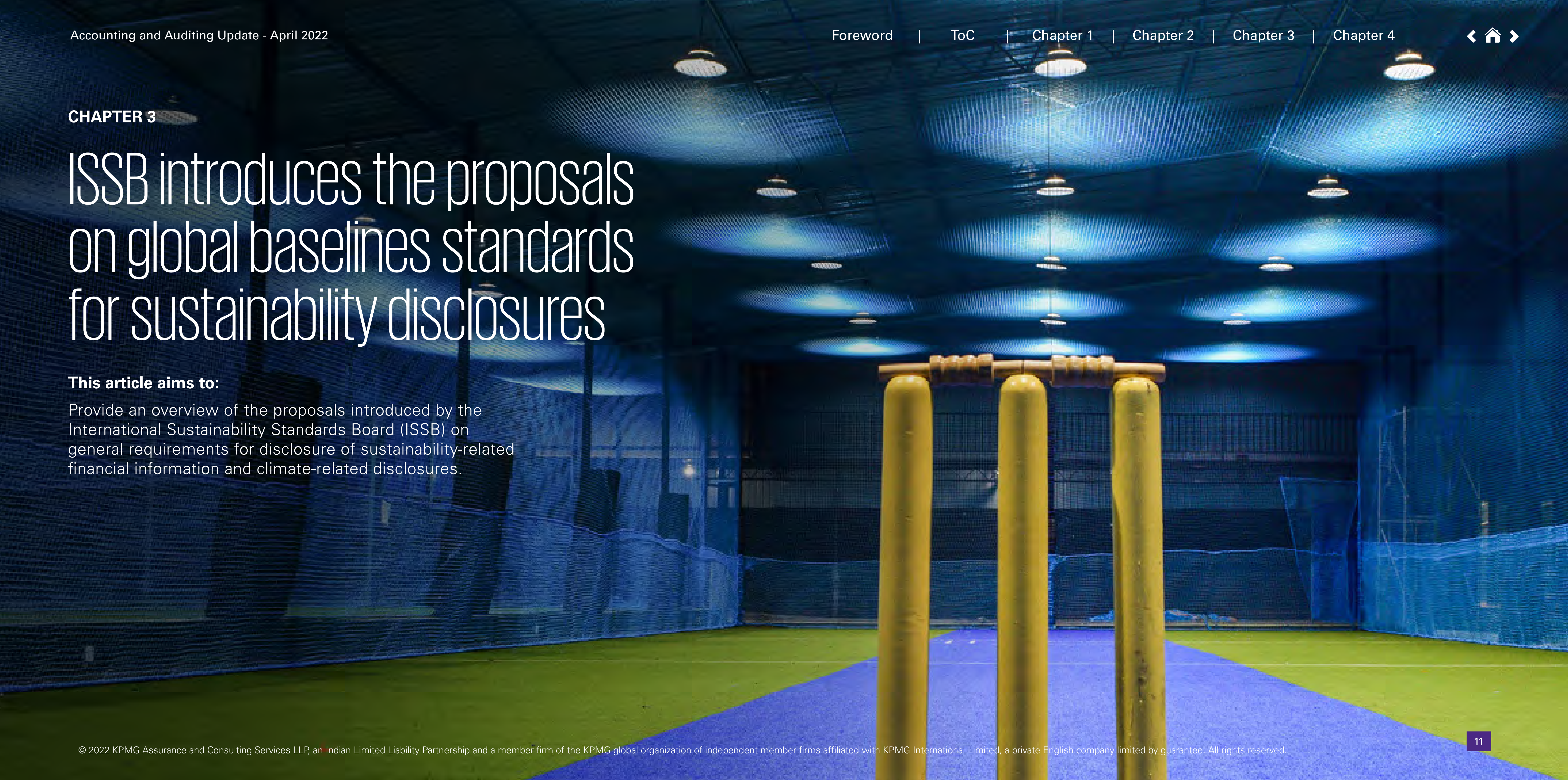
The EAC noted, that Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets* does not apply to financial instruments that are within the scope of Ind AS 109. Therefore, financial guarantee contracts governed by Ind AS 109 cannot be classified as contingent liabilities, and instead should comply with the relevant presentation and disclosure requirement of Ind AS 107, *Financial Instruments: Disclosures* and related disclosures of Division II of Schedule III to the Companies Act, 2013 for financial liabilities.

Consider this

While EAC has provided an opinion on accounting for financial guarantee contracts issued by a parent on behalf of its subsidiary, in the parent's separate financial statement, entities would need to reassess the accounting for such contracts while preparing their consolidated financial statements.

(Source: EAC opinion on 'Accounting treatment in the Company's standalone financial statements for the Corporate Guarantee (Deed of Guarantee) issued by the Company being Parent Company to banks/suppliers/service providers on behalf of its Step-down subsidiary company' issued in ICAI journal in February 2022.)





CHAPTER 3

ISSB introduces the proposals on global baselines standards for sustainability disclosures

This article aims to:

Provide an overview of the proposals introduced by the International Sustainability Standards Board (ISSB) on general requirements for disclosure of sustainability-related financial information and climate-related disclosures.

Overview

In recent years, momentum has grown from primary users of general purpose financial reporting for more consistent, complete, comparable and verifiable sustainability-related financial information to enable them to assess an entity's enterprise value. Further, investors and other stakeholders have joined the discussion over lack of harmonised standards for non-financial reporting. Increasing global focus towards climate change, inclusion of social and governance parameters and COVID-19 pandemic crisis have contributed in accelerating this momentum.

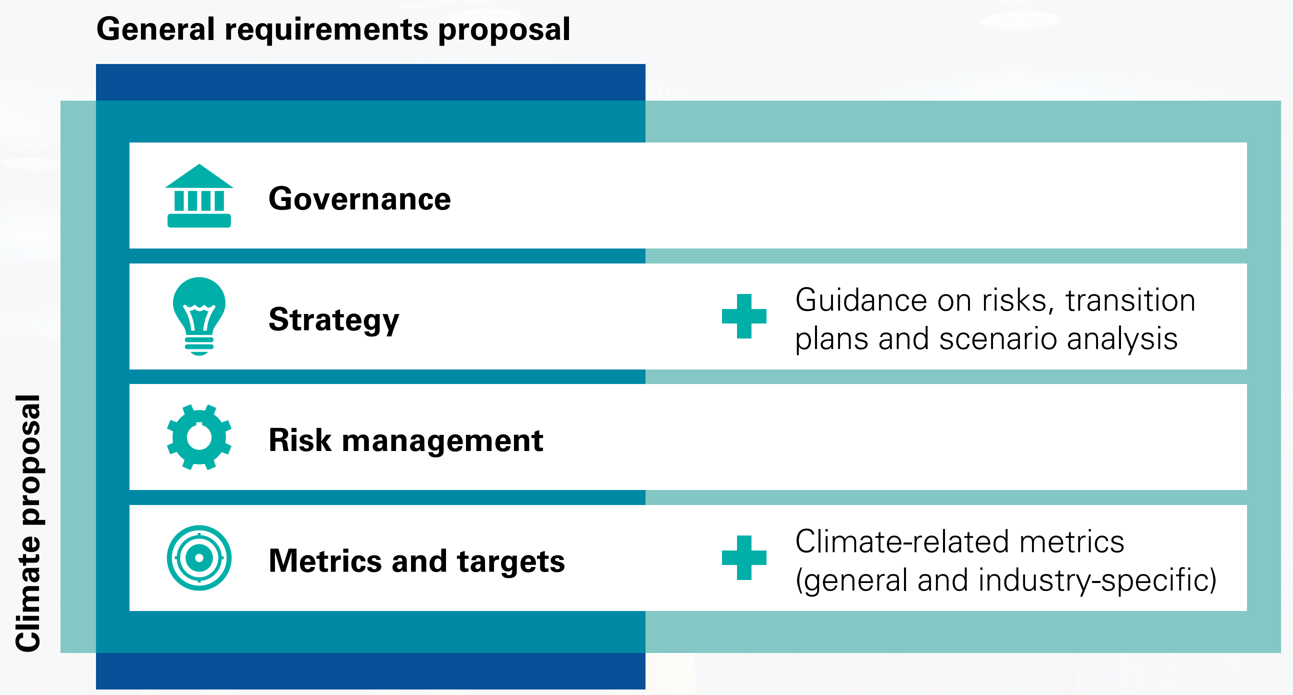
In this regard, in November 2021, the IFRS Foundation announced the creation of the ISSB. ISSB has been formed with an objective to build on the work of investor-focused reporting initiatives to become the global standard setters for sustainability disclosures for the financial markets. As a stepping stone, in November 2021, the IFRS Foundation created the Technical Readiness Working Group (TRWG) which published two protypes namely – the general requirements for disclosure of sustainability-related financial information prototype (general requirements prototype) and the climate-related disclosures prototype for consideration of the ISSB. The prototypes evolved from the work published in December 2020 by a group of five standard-setters and frameworks[1] providers focussed on corporate sustainability and integrated reporting.

Building on these prototypes released by the TRWG, the ISSB, on 31 March 2022 has released the Exposure Draft (ED) of its first two proposed standards. The comment period of both EDs ends on 29 July 2022.

- IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* (ED on IFRS S1)
- IFRS S2 *Climate-related Disclosures* (ED on IFRS S2)

The proposals in the two EDs are structured to be applied together and alongside future topic-or industry-specific standards. They propose reporting across four content areas – governance, strategy, risk management, and metrics and targets – which are consistent with the TCFD framework.

The diagram below demonstrates the relationship between the proposals. Climate-related content is indicated in green box while General requirements are in blue box.



(Source: Sustainability reporting-New on the Horizon by KPMG International Standards Group; April 2022)

In this article, we aim to provide an overview of the proposals introduced by the ISSB in its ED on IFRS S1 and IFRS S2.

1. The Climate Disclosure Standards Board (CDSB); the International Accounting Standards Board (IASB); the Task Force on Climate-related Financial Disclosures (TCFD); the Value Reporting Foundation, which represents: the Sustainability Accounting Standards Board (SASB); the International Integrated Reporting Council (IIRC); and the World Economic Forum and its Measuring Stakeholder Capitalism Initiative. The International Organisation of Securities Commissions (IOSCO) and the International Public Sector Accounting Standards Board participated as official observers.

IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*

ED on IFRS S1 is based on the general requirements prototype. This ED sets out the proposed overall requirements for disclosing sustainability-related financial information It is intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs. Some of the key elements on the ED are as following:

- It is designed to require information that would complement the information contained in an entity's financial statements, regardless of which GAAP the entity has used when preparing those financial statements.
- It lays down proposals for general requirements that apply to the disclosure of sustainability-related financial information and would form the basis on which complementary standards that set out more specific disclosure requirements will be developed.
- It sets out proposed general requirements that must be applied for an entity to be able to state compliance with IFRS Sustainability Disclosure Standards.
- It identifies the core content of a complete set of sustainability-related financial disclosures and sets out the qualitative characteristics of useful sustainability-related financial information.

Key aspects of the ED on IFRS S1 are as below:

Sustainability-related financial information

Entities should disclose a complete set of sustainability-related financial information. Sustainability-related financial information is defined as 'information that gives insight into sustainability-related risks and opportunities that affect enterprise value, providing a sufficient basis for users of general purpose financial reporting to assess the resources and relationships on which an entity's business model and strategy for sustaining and developing that model depend.' The definition is broad based to reflect that the information relevant to assessing enterprise value will change over time. The information should take into account of the interconnectedness of risks as well as interactions between the entity's resources and relationships. This includes the way in which sustainability related risks and opportunities link and overlap and by doing so influence and amplify each other. Sustainability-related financial information is required only to the extent that it is material to an assessment of enterprise value.

Enterprise value

Enterprise value is defined as 'the total value of an entity' and is 'the sum of the value of the entity's equity (market capitalisation) and the value of the entity's net debt.' ED on IFRS S1 suggests that an enterprise value reflects users' assessments of future cash flows, including the value they attribute to those cash flows, reflecting the cost of capital. Enterprise value, therefore, reflects current market expectations about future cash flows.

The ED states that the information required to be provided by an entity must be sufficient to enable an assessment of enterprise value as at the reporting date taking into consideration information about sustainability-related risks and opportunities over the short, medium and long term. Sustainability-related financial information must, therefore, explain decisions and strategies made as at the reporting date that could reasonably be expected to affect future outcomes.

Core content

The ED proposes disclosure of sustainability-related financial information centered on the following four primary topics, aligned with those in the TCFD recommendations:

Governance

The governance processes, controls, and procedures used to monitor sustainability-related risks and opportunities

Strategy

The approach for addressing sustainability-related risks and opportunities that may affect an entity's business model and strategy over short, medium and long term

Risk management

The processes an entity uses to identify, assess, and manage sustainability-related risks

Metrics and targets

Information to assess, manage and monitor entity's performance w.r.t sustainability-related risks and opportunities over time

General features

This section sets out proposed requirements relating to the reporting entity, connected information, fair presentation, materiality, comparative information, frequency of reporting, location of information, sources of estimation and outcome uncertainty, errors and statement of compliance. These sections of the proposal were adapted from IAS 1, *Presentation of Financial Statements and IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors*. These are as follows:

- **Reporting entity:** An entity is required to disclose sustainability-related financial information for the same reporting entity for which it prepares its general purpose financial statements. For example, a parent that prepares consolidated financial statements would define the reporting entity as itself and its subsidiaries. This is proposed so that users of general purpose financial reporting can assess the enterprise value of the defined parent and subsidiaries.
- **Connected information:** Sustainability- related risks and opportunities are related. An entity is required to provide disclosures that show the relationships between sustainability-related risks and opportunities, on the one hand, and financial position and financial performance, on the other. An entity should highlight or explain connections between:
  - Separate sustainability-related risks and opportunities,
  - The pieces of information disclosed including between:
    1. Information to respond to separate disclosure requirements about the same risk or opportunity that affects more than one core content,
    2. Disclosures about different risks and opportunities, both within and across core content and
    3. Sustainability-related financial disclosures and information in the financial statements.
- **Fair presentation:** The ED requires that 'a complete set of financial disclosures shall present fairly the sustainability-related risks and opportunities to which an entity is exposed.' Fair presentation requires an entity 'to disclose information that is relevant, representationally faithful comparable, verifiable, timely and understandable' and 'to provide additional disclosures when compliance with the specific requirements in IFRS Sustainability Disclosure Standards is insufficient' for the needs of users of general purpose financial reporting. An entity should consider all relevant facts and circumstances when deciding how to aggregate information in sustainability related financial disclosures, but the understandability of disclosures shall not be reduced 'by obscuring material information with immaterial information or by aggregating material items that are dissimilar'.

  It is also proposed that an entity is required to disclose the industry or industries specified for the disclosures that it has provided. Entities should consider the SASB Standards as a means both of identifying sustainability-related risks and opportunities and to develop disclosures in the absence of specific requirements in IFRS Sustainability Disclosure Standards.
- **Materiality and comparatives:** The proposals require that a complete depiction of sustainability-related financial information include material information about all significant sustainability-related risks and opportunities. This definition of materiality was developed based on the definitions of 'material' and 'materiality' in the Conceptual Framework and IAS 1. The ED is supplemented with Illustrative Guidance. It illustrates how to think about materiality matters, but is not considered to be mandatory in applying the proposals. The proposals, if approved would ensure that all entities applying the proposed requirements will use the same definition of material information. Also, an entity would be required to reassess its materiality judgements at each reporting date to take into account of changed circumstances and assumptions.

  An entity should disclose comparative information in respect of the previous period for all metrics disclosed in the current period. When such information would be relevant to an understanding of the current period's sustainability-related financial disclosures, the entity should also disclose comparative information for narrative and descriptive sustainability related financial disclosures.
- **Frequency of reporting and location of information:** The proposal lays down that sustainability-related financial disclosures be disclosed as part of a reporting entity's general purpose financial reporting. A consequence is that an entity would be required to report its sustainability-related financial disclosures at the same time it publishes its related financial statements. This requirement would be a change for entities that disclose sustainability-related financial information separately from and later than their financial statements.
- **Sources of estimation and outcome uncertainty:** Entities are required to disclose information about any material changes in estimates or material errors. An entity should identify metrics that have significant estimation uncertainty and disclose the sources, nature and factors affecting the uncertainties. Also, when sustainability-related financial disclosures include financial data and assumptions, they should be consistent with the corresponding financial data and assumptions in the entity's financial statements, to the extent possible. The ED proposes that all changes in estimate and corrections of errors in previously reported metrics and targets would be corrected by restating any comparative information presented.

- **Statement of compliance:** An entity whose sustainability-related financial disclosures comply with all the relevant requirements of IFRS Sustainability Disclosure Standards, should include an explicit and unqualified statement of compliance. The ED proposes issuing disclosure-only standards and if an entity meets these disclosure requirements, it can assert compliance with IFRS Sustainability Disclosure Standard.

IFRS S2 *Climate-related Disclosures*

Exposure Draft *Climate-related Disclosures* (ED to IFRS S2) has been developed in response to the demand for globally consistent climate-related disclosures that meet the needs of users of general purpose financial reporting. Information about the climate related matters that are relevant to assessments of enterprise value over the short, medium and long term is increasingly important for decisions made by investors and other stakeholders. This ED builds on the prototype developed by the TRWG and the proposals in ED to IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information.*

The ED requires an entity to disclose information about its exposure to significant climate-related risks and opportunities, enabling users of an entity's general purpose financial reporting:

(a) to assess the effects of climate-related risks and opportunities on the entity's enterprise value

(b) to understand how the entity's use of resources, and corresponding inputs, activities, outputs and outcomes support the entity's response to and strategy for managing its significant climate-related risks and opportunities; and

(c) to evaluate the entity's ability to adapt its planning, business model and operations to significant climate-related risks and opportunities.

The proposals of this ED replicate the core content requirements of the general requirements proposal ED which are structured around governance, risk management, strategy and associated metrics and targets. These are discussed in detail below:

Governance

An entity is required to disclose information that enables users of general purpose financial reporting to understand the governance processes, controls and procedures used to monitor and manage climate related risks and opportunities. To achieve this objective, the ED proposes that an entity be required to disclose information about the governance body or bodies (which can include a board, committee or equivalent body charged with governance) with oversight of climate-related risks and opportunities, and a description of management's role regarding climate-related risks and opportunities. The ED expects detailed disclosures and includes requirements such as how the governance body's responsibilities for climate-related risks and opportunities are reflected in the entity's terms of reference, board mandates and other related policies, etc.

Strategy and resilience

The objective of climate-related financial disclosures on strategy is to enable users to understand an entity's strategy for addressing significant climate-related risks and opportunities that could reasonably be expected to affect the entity's business model, strategy and cash flows, its access to finance and its cost of capital, over the short, medium or long term. In preparing such disclosures, an entity should refer to the industry disclosure requirements, consider the applicability of cross-industry metric categories and the industry-based metrics associated with disclosure topics.

While providing disclosures on its strategy, it should provide information about decision-making, including transition plans, information about current and anticipated changes to its business model, information regarding climate-related targets of these plans and qualitative and quantitative information about the progress of such plans disclosed in prior periods.

The ED proposes that an entity be required to also disclose the effects of significant climate-related risks and opportunities on its financial position, financial performance and cash flows for the reporting period, and the anticipated effects over the short, medium and long term - including how climate-related risks and opportunities are included in the entity's financial planning. The requirements also seek to address potential measurement challenges by requiring disclosure of quantitative information unless an entity is unable to provide the information quantitatively, in which case it shall be provided qualitatively.

An entity shall also disclose information that enables users of general purpose financial reporting to understand the resilience of the entity's strategy (including its business model) to climate-related changes, developments or uncertainties—taking into consideration an entity's identified significant climate-related risks and opportunities and related uncertainties. An entity be required to use climate-related scenario analysis to assess its climate resilience unless it is unable to do so. If an entity is unable to use climate-related scenario analysis, it shall use an alternative method or technique to assess its climate resilience.

Risk management

An entity would provide disclosures to understand the process, or processes, that an entity uses to identify, assess and manage not only climate-related risks, but also climate-related opportunities. An entity would need to describe climate-related risks for risk management purposes, the extent to which and how the climate-related risk identification, assessment and management process, or processes, are integrated into the entity's overall risk management process and the extent to which and how the climate-related opportunity identification, assessment and management process, or processes, are integrated into the entity's overall management process.

Metrics and targets

The ED proposes incorporating the TCFD's concept of cross-industry metrics and metric categories with the aim of improving the comparability of disclosures across reporting entities regardless of industry. The proposals require an entity to disclose these metrics and metric categories irrespective of its particular industry or sector (subject to materiality). The ED proposes seven cross-industry metric categories that all entities would be required to disclose: greenhouse gas (GHG) emissions on an absolute basis and on an intensity basis; transition risks; physical risks; climate-related opportunities; capital deployment towards climate-related risks and opportunities; internal carbon prices; and the percentage of executive management remuneration that is linked to climate-related considerations. The GHG Protocol be applied to measure GHG emissions.

Further, an entity be required to disclose information about its emission-reduction targets, including the objective of the target (for example, mitigation, adaptation or conformance with sector or science-based initiatives), as well as information about how the entity's targets compare with those prescribed in the latest international agreement on climate change.

Industry based disclosures

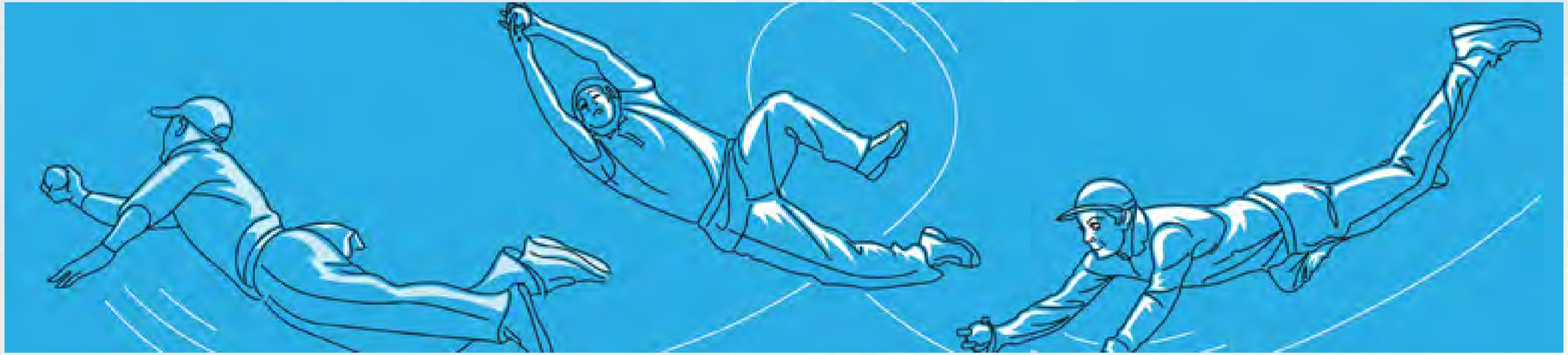
The ED proposes industry-based disclosure requirements in Appendix B that address significant sustainability-related risks and opportunities related to climate change. These requirements have been derived from the SASB Standards.

Next steps

The IFRS Sustainability Disclosure Standards will provide a global baseline of requirements – a building blocks approach. Having a global baseline of ISSB standards will enhance global comparability. Although the proposals do not specify an effective date, the ISSB has stated that it aims to issue the final standards before the end of 2022. Early application could be useful for entities already providing disclosures about sustainability-related risks and opportunities.

For many entities, these requirements may be new. Therefore, entities should act now and understand their sustainability-related risks and opportunities, establish a board-led governance structure that brings both financial and sustainability report to the boardroom table for making informed commitments and reporting on sustainability matters, create or adjust their internal systems and controls to meet the requirements of the sustainability standards.

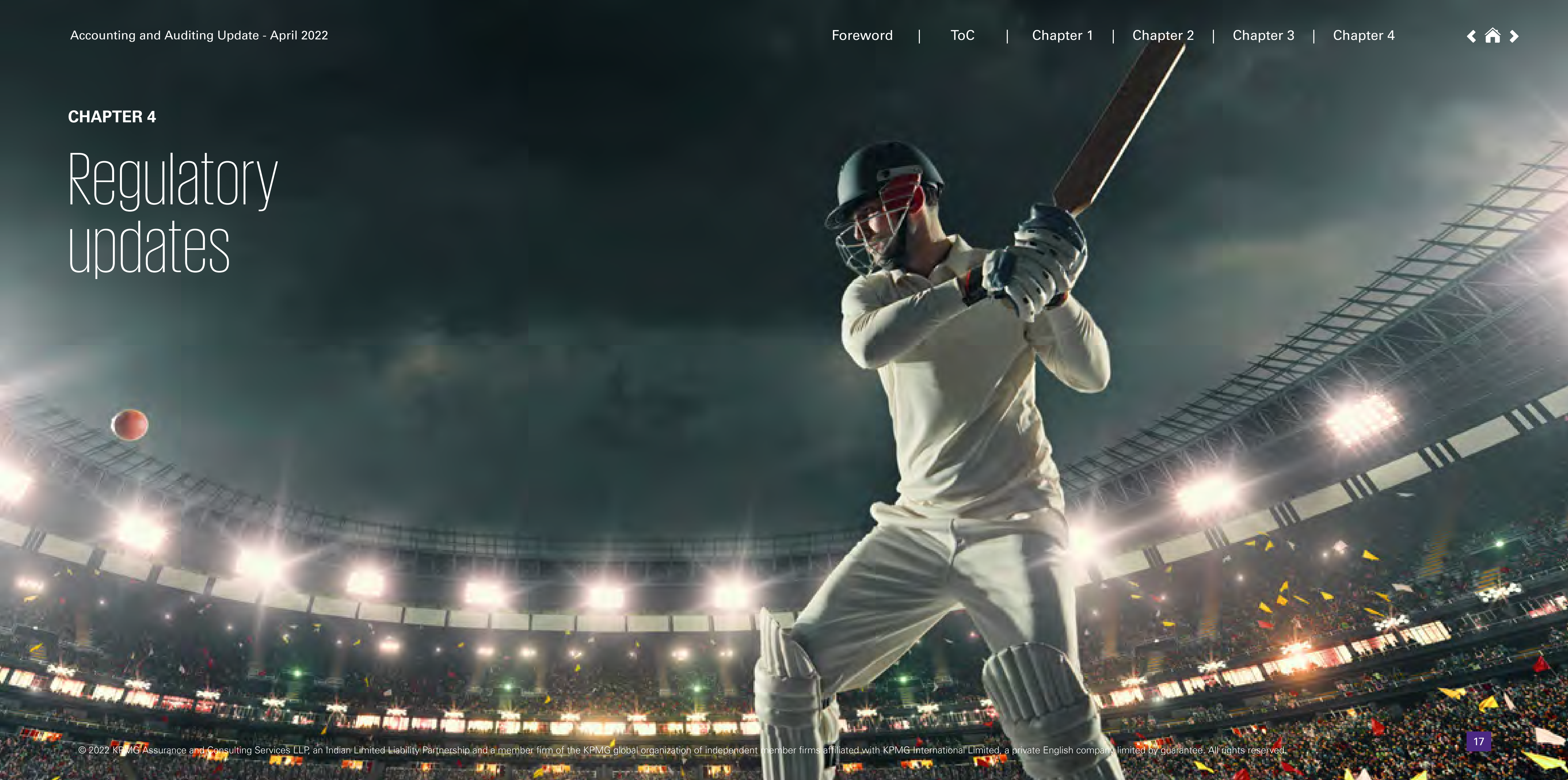
As sustainability reporting evolves, independent assurance by auditors on non-financial information is also evolving. The IAASB[2], SEC[3] and other regulators are making significant steps in supporting this area and further developments are expected in this area.



2. IAASB – International Auditing and Assurance Standards Board
3. SEC – U.S. Securities and Exchange Commission

CHAPTER 4

Regulatory updates



Amendments issued to Indian Accounting Standards

The Ministry of Corporate Affairs (MCA) vide notification dated 23 March 2022 issued the Companies (Indian Accounting Standards) Amendment Rules, 2022. These rules notify certain amendments to Indian Accounting Standards (Ind AS). These amendments are effective from 1 April 2022.

Most of these amendments have been made to keep the Ind AS converged with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) except for an amendment to Ind AS 16, *Property, Plant and Equipment.*

An overview of the amendments are given below:

Ind AS	Amendments notified
Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*	As per Ind AS 37, a contract is 'onerous' when the unavoidable costs of meeting the contractual obligations (i.e. the lower of the costs of fulfilling the contract and the costs of terminating it) outweigh the economic benefits. Ind AS 37 did not define what are the costs of fulfilling a contract. The amendments have clarified the types of costs a company can include as the 'costs of fulfilling a contract' while assessing whether a contract is onerous as under: (a) The incremental costs of fulfilling that contract—for example, direct labour and materials; and (b) An allocation of other costs that relate directly to fulfilling contracts— for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others. ***Transition:*** The amendments apply for annual reporting periods beginning on or after 1 April 2022 to contracts existing at the date when the amendments are first applied. At the date of initial application, the cumulative effect of initially applying the amendments is recognised as an opening balance adjustment to retained earnings or other component of equity, as appropriate. The comparatives are not required to be restated.
Ind AS 103, *Business Combinations*	The amendments have given reference of *Conceptual Framework for Financial Reporting under Ind AS* for definition of assets and liabilities without changing the accounting requirements for business combinations. This amendment is applicable to business combinations for which acquisition date is on or after 1 April 2022.
Ind AS 16, Property, *Plant and Equipment (PPE)*	Amendments to Ind AS 16 have clarified the accounting treatment for sale proceeds of items produced by PPE while preparing it for its intended use. These amendments have clarified that excess of net sale proceeds of items produced over the cost of testing, if any, would not be recognised in the statement of profit or loss, but deducted from the directly attributable costs considered as part of cost of an item of PPE. (Note: This is a carve out from IAS 16, *Property, Plant and Equipment*, which requires proceeds from selling items before the related item of PPE is available for use to be recognised in the statement of profit and loss.) The amendments are effective for annual reporting periods beginning on or after 1 April 2022

Annual improvements to Ind AS (2021)	
Ind AS 101, *First-time Adoption of Indian Accounting Standards*	As per the amendment, if a subsidiary adopts Ind AS later than its parent and applies Ind AS 101.D16(a), then a subsidiary may elect to measure cumulative translation differences for all foreign operations at amounts included in the consolidated financial statements of the parent, based on the parent's date of transition to Ind AS. A similar election is available to an associate or joint venture that uses the exemption in paragraph D16(a).
Ind AS 109, *Financial Instruments*	This amendment clarifies that for the purpose of performing the '10 per cent test' for derecognition of financial liabilities – in determining those fees paid net of fees received, a borrower includes only fees paid or received between the borrower and the lender, including the fees paid or received by either the borrower or lender on the other's behalf. This amendment would be applicable to financial liabilities that are modified or exchanged on or after 1 April 2022.
Ind AS 41, *Agriculture*	The amendment removes the requirement to exclude cash flows for taxation when measuring fair value, thereby aligning the fair value measurement requirements in Ind AS 41 with those in Ind AS 113, *Fair Value Measurement*. This amendment would be applicable to fair value measurements on or after 1 April 2022.

(Source: MCA notification no G.S.R. 255 (E) dated 23 March 2022)

Extension of timelines by MCA

Manner of maintaining books of account in electronic mode

As per the proviso to rule 3 of the Companies (Accounts) Rules, 2014, every company which uses accounting software for maintaining its books of account, should use only such accounting software which has a feature of recording audit trail of each and every transaction, creates an edit log of each change made in the books of account along with the date when such changes were made and ensures that the audit trail cannot be disabled. This rule was applicable from 1 April 2022.

The MCA vide circular dated 31 March 2022 has deferred the applicability of this clause. Accordingly, it would now be applicable from 1 April 2023.

(Source: MCA notification dated 31 March 2022)

Time period for filing of CSR return

On 11 February 2022, MCA had amended rule 12 of the Companies (Accounts) Rules, 2014, thereby inserting a new sub-rule (1B) which required every company covered under section 135(1) of the Companies Act, 2013 (2013 Act) to furnish a report on Corporate Social Responsibility (CSR) in Form CSR-2 to the Registrar of Companies (RoC) for the preceding financial year (2020-2021) and onwards as an addendum to Form AOC-4 or AOC-4 XBRL or AOC-4 NBFC (Ind AS), as the case may be. Form CSR-2 for the preceding financial year (FY2020- 2021) would be filed separately on or before 31 March 2022, after filing Form AOC-4 or AOC-4 XBRL or AOC-4 NBFC (Ind AS), as the case may be.

The MCA, vide notification dated 31 March 2022 has extended the due date for filing Form CSR-2 for FY2020-2021 to 31 May 2022.

(Source: MCA notification dated 31 March 2022)

The Company Law Committee report

In 2019, the Company Law Committee (CLC) was constituted by the Ministry of Corporate Affairs (MCA) to make recommendations to the Government on changes aimed at facilitating and promoting greater ease of doing business in India.

The CLC has submitted its latest Report (2022) to the Government on 21 March 2022 which has made recommendations on issues expected to facilitate smooth conduct of business, given the COVID-19 pandemic. The report recommends various changes to the 2013 Act to recognise new concepts, expedite corporate processes, improve compliance requirements, and remove ambiguities from existing provisions.

Some of the key recommendations of the CLC regarding the 2013 Act are as follows:

- Allowing certain companies to revert to the financial year followed in India
- Facilitating certain companies to communicate with their members in only electronic form
- Recognising issuance and holding of fractional shares, restricted stock units and stock appreciation rights
- Easing the requirement of raising capital in distressed companies
- Replacing the requirement of furnishing affidavits with the filing of self certification/ declaration
- Clarifying the inclusion of ‘free reserves’ while determining the limit for buying back of a company’s equity shares
- Allowing companies to hold general meetings in virtual, physical or hybrid modes
- Creating an electronic platform for maintenance of statutory registers by companies
- Strengthening the National Financial Reporting Authority
- Reviewing and strengthening the audit framework and introducing mechanisms to ensure the independence of auditors
- Standardising the manner for auditors to provide qualifications
- Recognising and providing an enabling framework for the constitution of Risk Management Committees
- Clarifying the tenure of independent directors
- Revising provisions relating to the disqualification and vacation of the office of directors
- Clarifying the procedure for the resignation of key managerial personnel
- Strengthening the provisions relating to mergers and amalgamations
- Modernising enforcement and adjudication activities through electronic mode.

(Source: MCA issued Report of the Company Law Committee dated 21 March 2022)

SEBI issues clarification on omnibus approval of audit committee on material related party transactions

Background

- As per Regulation 23(3)(e) of the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations), an omnibus approval granted by the audit committee shall be valid for a period not exceeding one year and shall require fresh approvals after expiry of one year.
- Regulation 23(4) of the Listing Regulations requires shareholder's approval for material Related Party Transactions (RPTs). Further, as per the 2013 Act the time gap between two Annual General Meetings (AGMs) cannot be more than 15 months.
- SEBI received various requests to clarify the period of validity of the omnibus approval where the transactions are material and shareholders' approval is also required.

Clarification

Accordingly, in order to enable listed entities to align their processes to conduct AGMs and obtain omnibus shareholders' approval for material RPTs, SEBI provided the below clarifications:

- The shareholders' approval of omnibus RPTs obtained in an AGM then it would be valid upto the date of the next AGM for a period not exceeding 15 months
- In case of omnibus approvals for material RPTs, obtained from shareholders in general meetings other than AGMs then such omnibus approval would be valid for one year.

(Source: SEBI notification no SEBI/HO/CFD/CMD1/ CIR/P/2022/47 dated 8 April 2022)

SEBI amends certain Regulations

SEBI, vide notification dated 11 April 2022, has issued amendments in the following regulations:

SEBI Listing Regulations (Third Amendment) Regulations, 2022

Regulation 54 of the SEBI Listing Regulations provides that a listed entity which has issued listed non-convertible debt securities should maintain 100 per cent asset cover sufficient to discharge the principal amount at all times for the non-convertible debt securities issued. The recent amendments are as follows:

- Term 'asset cover' has been substituted with the term 'security cover' in Regulation 54 and 56
- Regulation 54 states that a listed entity shall maintain 100 per cent security cover sufficient to discharge both principal **and interest** (Earlier: only principal)
- Maintenance of security cover prescribed for **secured** listed non-convertible debt securities (Earlier: listed non-convertible debt securities).

SEBI (Debenture Trustees) (Amendment) Regulations, 2022

Regulation 15 of SEBI (Debenture Trustee) Regulations, 1993, specifies duties of the debenture trustees, has been amended by substituting the term 'asset cover' with the term 'security cover'.

SEBI (Issue and Listing of Non-Convertible Securities) (Amendment) Regulations, 2022

The following amendments have been made:

- Regulation 23 and 38 of SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 have been amended to state that the issuer and lead manager should ensure that the secured debt securities are secured by 100 per cent security cover or higher security cover as per the terms of the offer document and/or debenture trust deed, sufficient to discharge the principal amount and the interest thereon at all times for the issued debt securities.
- Due Diligence by the debenture trustee shall be followed by furnishing a due diligence certificate to the Board and the stock exchanges in the formats prescribed for secured debt securities (Schedule IV) and unsecured debt securities (Schedule IVA)
- Rationalised references with respect to disclosure of credit ratings have been stated.

(Source: SEBI notification no SEBI/LAD-NRO/GN/2022/77, SEBI/LAD-NRO/GN/2022/78, SEBI/LAD-NRO/GN/2022/79 dated 11 April 2022).

RBI issued clarification with regard to the revised regulatory framework for NBFCs – Scale Based Regulation

Background

In October 2021, the Reserve Bank of India (RBI) had issued the Scale-Based Framework (SBR framework) for Non-Banking Financial Companies (NBFCs), rendering the regulation and supervision of the NBFCs to be a function of their size, activity and perceived riskiness. Various regulatory revisions were prescribed for NBFCs under different layers of the SBR framework (NBFC-Base Layer (BL), NBFC- Middle Layer (ML), NBFC- Upper Layer (UL) and NBFC- Top Layer (TL). However, RBI had mentioned that it would issue clarifications on some of these regulations on subsequent dates.

New development

On 19 April 2022, RBI issued clarifications on the following topics:

A. Capital requirements for NBFCs

NBFC-UL shall maintain, on an on-going basis, Common Equity Tier 1 (CET1) capital of at least 9 per cent of Risk Weighted Assets and provides the formula for the CET 1 ratio. The circular also prescribes the elements of CET I Capital to include head such as paid-up equity share capital issued by the NBFC, share premium resulting from the issue of equity shares, capital reserves representing surplus arising out of sale proceeds of assets, statutory reserves, revaluation reserves, subject to meeting prescribed conditions, etc.

Applicability – These clarifications are applicable to all NBFCs identified as NBFC-UL, except Core Investment Companies (CICs).

B. Disclosures in Financial Statements – Notes to Accounts of NBFCs

NBFCs are required to make disclosures in their financial statements in accordance with existing prudential guidelines, applicable accounting standards, laws, and regulations. RBI has issued certain additional disclosure requirements for NBFCs in line with the SBR framework. Comprehensive disclosures that help in the understanding of financial position and performance of the company have been encouraged. The additional disclosure requirements for NBFCs in accordance with the SBR framework are prescribed as annexure in the RBI circular.

Applicability – The RBI circular is applicable to all NBFCs. The circular specifies the applicability of specific disclosure requirements to specific NBFC layers as per Scale Based Regulation. The disclosure requirements applicable to lower layers of NBFCs will be applicable to NBFCs in higher layers. These guidelines are effective for annual financial statements for year ending 31 March 2023, and onwards.

C. Regulatory restrictions with regard to Loans and Advances

The RBI circular has provided detailed guidelines on regulatory restrictions on lending in respect of NBFCs placed in different layers as per the Scale Based Regulation. These guidelines shall be effective from 1 October 2022.

Guidelines applicable to NBFC – Middle Layer (ML) and NBFC-Upper Layer (UL) regulatory restrictions on loans and advances

1. ***Loans and advances to Directors*** – NBFCs require sanction by the Board of Directors/ Committee of Directors for grant of any loans or advances aggregating INR5 crore and above to:
    - Their directors (including the Chairman/ Managing Director) or relatives of directors
    - Any firm in which any of their directors or their relatives is interested as a partner, manager, employee or guarantor
    - Any company in which any of their directors, or their relatives is interested as a major shareholder, director, manager, employee or guarantor.
2. ***Loans and advances to senior officers of the NBFC*** – All loans and advances sanctioned to senior officers are required to be reported to the Board. A senior officer or a committee comprising of a senior officer shall not sanction any credit to a relative of that senior officer. Such a facility shall be sanctioned by the next higher sanctioning authority under the delegation of powers.
3. ***Loans and advances to real estate sector*** – The borrowers from this sector are required to obtain prior permission from government/ local government/ other statutory authorities for the project. The disbursements shall be made only after the borrower has obtained requisite clearances from the government/other statutory authorities.
4. ***Guidelines for NBFC Base Layer (BL)*** – A Board approved policy shall be in place for grant of loans to directors, senior officers and relatives of directors and to entities where directors or their relatives have major shareholding. The policy should prescribe a threshold beyond which loans to abovementioned persons shall be reported to the Board. A disclosure is required in the annual financial statements stating the aggregate amount of such sanctioned loans and advances.

D. Large Exposure Framework for NBFC (UL)

RBI has introduced Larger Exposures Framework (LEF) for NBFC-UL which sets out the prudential guidelines on exposure norms aimed at addressing credit risk concentration in NBFC-UL. These instructions set out to identify large exposures, refine the criteria for grouping of connected counterparties and put in place norms for large exposures. These instructions will be applicable from 1 October 2022.

(Source: RBI circular no RBI/2022-23/26, RBI/2022-23/29, RBI/2022-23/30 and RBI/2022-23/32 dated 19 April 2022)

Compliance function and role of chief compliance officer under the Scale Based Regulation framework

As per the revised regulatory framework for NBFCs (SBR framework) issued by RBI in October 2021, the Non-Banking Financial Companies in the Upper Layer (NBFC-UL) and Middle Layer (NBFC-ML) would be required to have an independent Compliance Function and a Chief Compliance Officer (CCO).

Compliance function has a critical part in the overall corporate governance structure. RBI, on 11 April 2022, issued a circular with the aim of introducing certain principles, standards and procedures for Compliance Function in NBFC-UL and NBFC-ML, keeping in view the principles of proportionality. NBFC (UL) and (ML) shall put in place a Board approved policy and a Compliance Function, including the appointment of a Chief Compliance Officer (CCO), based on the framework provided in the circular, latest by 1 April 2023 and 1 October 2023, respectively.

(Source: RBI circular no RBI/2022-23/24 dated 11 April 2022)

Implementation guide on new reporting requirements under the Companies (Audit and Auditors) Rules, 2014

Background

Section 143(3) of the Companies Act, 2013 ("the Act") provides various matters on which auditors are required to report in their auditor's report. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 specifies such other matters that are to be reported by the auditor.

The Ministry of Corporate Affairs vide notification dated 24 March 2021 issued the Companies (Audit and Auditors) Amendment Rules, 2021 amending Rule 11 by adding new Rule 11 (e)[1] which deals with reporting on lending or receiving funds via pass through entities marked for ultimate beneficiary and new Rule 11 (f)[2] which deals with reporting on the payment/declaration of dividend. The new reporting requirements are applicable for audits of financial year 2021-22 and onwards.

New development

In April 2022, ICAI has issued an Implementation Guide on these new reporting requirements with the aim to provide guidance to auditors to discharge their duties in an efficient and effective manner.

The Implementation Guide contains detailed guidance on various aspects of reporting under Rule 11(e) and 11 (f) like analysis of Rules, management's responsibilities in respect of disclosures in financial statements under Schedule III to the Companies Act, 2013, various audit procedures to be performed, reporting requirements, illustrative formats of confirmation letters, illustrative formats of management representations.

In addition, it discusses various scenarios for better understanding of practical situations faced by auditors while reporting under these rules.

(Source: ICAI issued Implementation Guide on reporting under Rule 11 (e) and Rule 11 (f) of the Companies (Audit and Auditors Rules, 2014 in April 2022)

IAASB has issued revised International Standard on Auditing (ISA) 600

Recently, on 7 April 2022, the International Auditing and Assurance Standards Board (IAASB) released International Standard on Auditing (ISA) 600 (Revised). The revised standard addresses special considerations that apply to group audits, including when component auditors are involved. It includes new and revised requirements that aligns the standard with the recently revised standards such as International Standard on Quality Management 1 and International Standards on Auditing 220 (Revised), *Quality management for an audit of financial statements* and ISA 315, *Identifying and assessing the risks of material misstatement.*

ISA 600 (Revised) has a robust risk-based approach to planning and performing a group audit which focuses the group auditor's attention on identifying and assessing the risks of material misstatement of the group financial statements and designing and performing further audit procedures to respond to those assessed risks. It also recognises that component auditors can be, and often are, involved in all phases of the group audit. The standard furthermore promotes a clear, proactive and scalable approach for group audits that can be applied to today's evolving group audit structures.

Applicability - ISA 600 (Revised) will be effective for audits of group financial statements for periods beginning on or after 15 December 2023.

(Source: IAASB announcement dated 7 April 2022)

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1. Rule 11(e) of the Companies (Audit and Auditors Rules, 2014 in April 2022)

   ""(e) (i) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

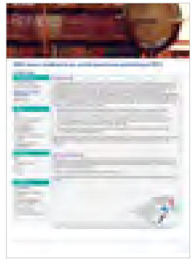
   (ii) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

   (iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement."

2. Rule 11(f) of the Companies (Audit and Auditors) Rules 2014:

   "Whether the dividend declared or paid during the year by the company is in accordance with section 123 of the Companies Act 2013".

First Notes



SEBI issues clarification on certain provisions pertaining to RPTs

29 April 2022

On 9 November 2021, SEBI notified certain amendments to the SEBI Listing Regulations with regard to provisions pertaining to Related Party Transactions (RPTs).

Based on representations received from listed entities and industry bodies, SEBI, on 30 March 2022 and 8 April 2022 issued certain clarifications and guidance in relation to these amendments.

These circulars are applicable from 1 April 2022.

In this issue of first notes, we provided an overview of the clarifications issued by SEBI..

On 28 April 2022, KPMG in India released its VOR - Annual updates publication. The publication provides a summary of key updates from the Securities and Exchange Board of India (SEBI), the Ministry of Corporate Affairs (MCA), the Institute of Chartered Accountants of India (ICAI) and the Reserve Bank of India (RBI) for the year ended 31 March 2022.

To access the publication, please click here.

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