Accounting and Auditing Update

Issue no. 63/2021

October 2021

home.kpmg/in

Foreword

Merger of companies through Special Purpose Acquisition Company (SPAC) route is emerging as a lucrative model for raising capital and going public globally in the Indian start-up eco-system. Though the route provides several opportunities for Indian unicorns to directly access global capital markets, the Indian tax and regulatory framework is not fully prepared to facilitate a smooth SPAC transaction. Additionally, undertaking such transactions is expected to pose innumerable tax challenges including issues related to taxability in case of outbound merger of an Indian company with a foreign company, impact on tax losses of an Indian target and other related issues subsequent to a SPAC transaction. Continuing our discussion, in this edition of Accounting and Auditing Update (AAU), we will discuss the Indian tax and regulatory landscape in the SPAC arena along with highlighting key tax hurdles associated with SPAC transactions.

Equity funding is the most common method of raising funds by a start-up. Other modes of raising funds include debt, investment by angel investors, government investment funds and grants, etc. One of the common ways in which investors invest in such businesses is Compulsorily Convertible Preference Shares (CCPS). Generally, these instruments allow the investors to convert at a future date based on an agreed ratio, the conversion option that could be variable on the basis of the business performance. When the conversion options are linked to future business performances, they may allow investors to get higher number of shares in the event the performance is not in line with projections. There could be other additional features e.g., down round protection and written put options (buy-back). Accounting of such instruments is complex and requires judgement. Therefore, in our article, we will discuss key matters for accounting of CCPS under Ind AS as liability or equity while considering features like anti-dilution or buy-back rights.

Recently, the Reserve Bank of India (RBI) has issued a revised regulatory framework for Non-Banking Financial Companies (NBFCs) i.e., a Scale-Based Regulation (SBR). The SBR framework bifurcates all the NBFCs into four layers based on their size, activity, and perceived riskiness namely - NBFC - Base Layer, NBFC - Middle Layer, NBFC - Upper Layer and NBFC - Top Layer. Additionally, the Securities and Exchange Board of India (SEBI) has issued revised formats for filing of financial information by entities with listed non-convertible securities. Our regulatory updates article covers these and other important regulatory developments in India and internationally.

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

Sai Venkateshwaran
Partner - Assurance
KPMG in India

Ruchi Rastogi
Partner - Assurance
KPMG in India

Chapter 1

SPAC: India tax and regulatory conundrum

This article aims to:

Discuss the Indian tax and regulatory landscape along with the challenges in a SPAC transaction.

Introduction

In our previous editions, we touched upon SPAC[1] as a lucrative model for raising capital and going public globally, accounting nuances of a SPAC transaction and financial reporting complexities involved in SPAC transactions. Continuing our discussion, in this edition, we will be discussing the Indian tax and regulatory landscape in the SPAC arena.

Inspired by the remarkable success enjoyed by SPAC transactions in the US, SPAC is also emerging as an interesting concept in the India start-up eco-system. While SPAC as a capital pooling vehicle provides tremendous opportunities for Indian unicorns to directly access global capital markets, the Indian tax and regulatory framework is not fully prepared to facilitate a smooth SPAC transaction.

Regulatory hurdles in a SPAC transaction

- **Absence of a formal SPAC regime:** Indian capital markets and corporate law currently do not have an identified regime for formation and listing of SPACs. Further, Indian companies are not permitted to directly list on overseas stock exchanges. While the government showed an intent to address this issue through an amendment of Section 23 of the Companies Act, 2013 which permitted public companies to list a class of securities on permitted stock exchanges in permissible foreign jurisdictions, corresponding enabling provisions are yet to be notified under the Securities and Exchange Board of India (SEBI), Foreign Exchange Management Act (FEMA) and income-tax laws.

  As a step forward in this direction, a Consultation Paper was released by the International Financial Services Centers Authority (IFSCA) to establish a framework for listing of SPAC on IFSC at GIFT City, Gujarat. The key features of the consultation paper are as follows:

  - **Eligibility of SPAC to raise capital in an IPO[2]:** The primary objective of the issuer shall be to effect a merger or amalgamation or acquisition of shares or assets of a company having business operations and the issuer does not have any operating business.
  - **Minimum offer size:** Offer size shall not be less than USD50 million and the sponsor shall hold at least 20 per cent of the post issue paid-up capital.
  - **Minimum application size:** The minimum application size in an IPO of SPAC shall be USD250,000.
  - **Minimum subscription:** At least 75 per cent of the offer size.
  - **Sponsor restriction:** Sponsor shall not transfer any of his specified securities prior to the completion of a business acquisition.
- **Round tripping concerns under the Exchange Control Regulations:** Feasibility of cross border SPAC transactions is significantly impacted owing to lack of clarity of the FEMA regulations on cross border mergers and ability of Indian resident shareholders to hold shares of foreign holding companies which in turn hold shares in the target company. Currently, such structures are viewed adversely by the authorities and approval is granted only on a case specific basis. However, recently the government released draft Foreign Exchange Management (Non-debt Instruments - Overseas Investment) Rules, 2021 and draft Foreign Exchange Management (Overseas Investment) Regulations, 2021 which seem to ease norms around round tripping. As per the draft regulations, only those round-trip structures will be prohibited which is designed for the purpose of tax evasion or tax avoidance.

---

1. Special Purpose Acquisition Company
2. Initial Public Offer

- **Concerns around applicability of Press Note 3:** Press Note 3 of 2020 dated 17 April 2020 was introduced by the government to monitor cases of fresh investment by India's neighbouring countries. The amendment mandates a specific government approval where the transaction results in direct/indirect acquisition of beneficial ownership in an Indian company by residents of neighbouring countries which share a land border with India. An unintended consequence of the amendment hinders SPAC transactions as SPAC transactions generally require swap of India target company shares by existing shareholders against fresh shares issuance in the SPAC vehicle. Such swap of shares tends to get covered by the wide sweeping language of Press Note 3. Accordingly, evaluating the profile of the investors of the Indian target company acts as a major checkpoint prior to executing a SPAC transaction.

  In the ensuing paragraphs, we will discuss the tax challenges in a SPAC transaction under Indian tax laws.

Tax hurdles in a SPAC transaction

- **Externalisation is taxable:** SPAC transactions are generally implemented either through merger of identified target companies with SPAC or through swap of shareholding of target company against shares of SPAC. Owing to the regulatory hurdles associated with cross border mergers as discussed above, SPAC transactions with respect to Indian targets are largely achieved through the swap structure.

  Such share swaps attract capital gains tax for both resident and non-resident shareholders of the Indian target. Capital gains on the swap are computed basis the difference between the fair market value of the SPAC shares received and the cost of acquisition of shares of the Indian target company.

  Capital gains tax rates may range from 10 to 40 per cent plus applicable surcharge and cess depending upon the category of the taxpayer viz individuals or company, residential status of shareholders, period of holding of shares, etc. However, in some cases the non-residents may be able to avail benefit of exemption available under the tax treaties where the investors are residents of tax favorable jurisdictions. Availability of such benefit is again dependent upon satisfaction of substance and beneficial ownership tests.

- **Overseas foreign mergers and outbound mergers are taxable:** The Indian tax law provides tax exemptions to amalgamating companies and their shareholders where the amalgamated company is an Indian company. However, the same benefit is not extended in case of outbound merger where the amalgamated company is a foreign company. Additionally, there is lack of clarity on whether shareholders of a foreign holding company of an Indian target will be eligible for tax exemptions where such foreign holding company merges with a SPAC.

- **Impact on tax losses of an Indian target**: The Indian tax law restricts the ability of an unlisted company to carry forward its tax losses where its beneficial shareholding changes by more than 49 per cent. The Indian judiciary has divided views on whether one needs to test the registered shareholding or the ultimate beneficial shareholding for the applicability of provisions which restrict the carry forward of losses owing to change in shareholding. This acts as major dampener towards the viability of SPAC transactions considering most of the Indian targets have significant amount of brought forward losses owing to the cash burn in the initial years of their formation.

- **Swap of ESOPs are taxable:** Many of the new age Indian start-ups offer lucrative stock option plan to attract and retain talent. A SPAC transaction would typically involve such employees to swap their ESOPs[3] in the Indian target company/foreign holding company against shares of the SPAC. Swap of such ESOPs does not enjoy any tax exemption under the Indian tax laws and thus, exposes the employees to unwarranted tax liability in the absence of an actual liquidity event.

- **Post SPAC transaction:** Indian tax laws levy tax on transfer of shares of an overseas holding company where such holding company derives more than 50 per cent value from Indian assets. Accordingly, all subsequent transactions involving transfer of SPAC shares are subject to the indirect transfer taxes as SPAC would derive almost all its value from India. However, the law makers provide for a specific exemption to small shareholders holding less than five per cent of the voting power or share capital in the overseas holding company.

Way forward

While one awaits significant changes to the Indian tax and regulatory framework, SPAC-led transactions are set to dominate headlines in the coming future. Expect several unicorns and emerging companies to dominate merger transactions with SPACs.

3. Employee Stock Option Plans

Chapter 2

Accounting of financial instruments under Ind AS

This article aims to:

Discuss key matters for accounting of compulsorily convertible preference shares as liability or equity with anti-dilution or buy-back rights as triggering events.

Introduction

India Inc. is witnessing a significant growth in the number of start-ups over the last few years. From e-commerce to electric vehicles, the Indian start-ups are the torch bearer for innovation and entrepreneurial spirit of India. Private-equity funding is the most common method of raising funds by a start-up. Other modes of raising funds include debt, investment by angel investors, government investment funds and grants, etc. Raising capital, acquiring customers, compliance with the regulatory requirements and corporate governance related matters are some of the potential issues being faced by the start-ups.

Investors invest in businesses using variety of instruments and one of the common ways to invest is Compulsorily Convertible Preference Shares (CCPS). Generally, these instruments allow the investors to convert at a future date based on an agreed ratio, the conversion option to be variable depending on the business performance. In certain cases, the conversion options are linked to future business performances, thereby allowing investors to get higher number of shares in the event the performance is not in line with projections, thereby protecting investors from loss in valuations.

Sometimes investor agreements contain a clause which protects the investor from the investee company raising capital from others at a valuation lower than the base at which the present investor invested into the company. This is referred to as the 'Down Round Protection'. This feature essentially helps ensure that if the company raises further capital at a valuation lower than its earlier investment level, the company will issue additional shares to compensate investor's value diminution. Essentially, it protects the investor from a downside risk in the event the business raises further capital at lower valuation, thereby diluting the investor's equity holding in the company.

This clause also protects an investor for adjustments arising from issuance of bonus shares/share splits, etc. Additionally, another feature of the CCPS could be that it includes a written put option (buy-back) that provides the investor with the right to sell CCPS at a specified date (or on occurrence of certain events) at a specified price (or at a variable price to be determined in future) to a given party. These are included in investment agreements to provide the investor with an option to sell his/her holding back to the company or the promoter, and thereby exiting from the company. These are generally triggered in the event the company is unsuccessful in doing an IPO within a specific period of time or any other event agreed at the time of the investment e.g., a strategic sale. These put options can be exercised on the company or the promoter depending on how the agreement between the investor and the company has been agreed upon.

Accounting and presentation of financial instruments - Equity or liability

Guidance under Ind AS

Ind AS 32, *Financial Instruments: Presentation* establishes principles for the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities, and equity instruments. In accordance with Ind AS 32, an instrument is an equity instrument if both the given conditions are met:

a. The instrument includes no contractual obligation:

   i. To deliver cash or another financial asset to another entity, or

   ii. To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the issuer.

b. If the instrument will, or may, be settled in the issuer's own equity instruments, it is:

   i. A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments, or

   ii. A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options, or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options, or warrants pro rata to all its existing owners of the same class of its own non-derivative equity instruments.

An issued share option that gives the holder the right to buy a fixed number of the entity's shares for a fixed amount of cash or for a fixed stated principal amount of a bond is an equity instrument (fixed-for-fixed criterion).

Also, changes in the fair value of an instrument because of changes in market interest rates that do not affect the amount of cash or other financial assets to be received or paid, or the number of equity instruments to be received or delivered, do not impact classification as an equity instrument.

Accounting under Ind AS is determined not only by considering the legal form of the instrument but by also considering the underlying substance of the transaction. Accordingly, the company needs to evaluate the entire contract of the CCPS and all its features to determine if the instrument needs to be classified as a financial liability or equity.

Equity classification

Investments generally which are made through plain vanilla CCPS (i.e., do not contain any adjustment clauses that do not violate the fixed-for-fixed criterion) are classified as equity instruments since they represent residual interest in the entity. It is important to note that any specific features can cause the entire instrument to be classified outside of equity.

Liability classification

Investments made through instruments which contain an unconditional obligation to deliver cash or another financial asset would result in the instrument being classified as a financial liability. If the CCPS contain rights to convert into variable number of equity shares the same would represent a financial liability in accordance with the guidance given in Ind AS.

Down round protection

Down round protection clauses that only protect an investor from bonus/share splits would typically not require any separate accounting. However, other clauses that protect an investor against future fair value losses due to fresh equity issuances in future, would need to be evaluated.

A question arises about whether a feature that requires adjustment to an otherwise fixed conversion ratio when additional equity instruments are issued at a price below the initial conversion price - i.e., a 'down-round feature' that violates the fixed-for-fixed requirement - creates an obligation for the issuer to issue a variable number of own equity instruments. In our view, the classification of the instrument depends on whether the decision not to issue additional equity instruments that may trigger the down-round feature is in the entity's control - i.e. there is neither any contractual nor statutory obligation that may require the entity to issue additional equity instruments that might trigger the down-round feature.

If the entity has control over issuing additional equity instruments and the CCPS contain no other feature that would be inconsistent with equity classification, then we believe that the entity should choose an accounting policy, to be applied consistently, to:

- Classify the CCPS entirely as equity because the entity has no contractual obligation to deliver a variable number of own equity instruments, or
- Recognise separately the equity host and an embedded derivative for the conversion option including the down-round feature measured at fair value through profit and loss because it does not meet the fixed-for-fixed requirement.

If an entity does not have control over issuing additional equity instruments due to specific laws or regulations, then such factors would require detailed evaluation[1].

Put options/buy back

Put options or buy back requirements could trigger when for instance, an IPO does not take place within the specified time, and the company cannot ensure that the IPO will actually occur. In such a scenario, since the exit mechanism by way of an IPO is a contingency i.e., an uncertain future event which is beyond the control of both the company and the investor in the CCPS, the CCPS would be potentially redeemable in cash. In this situation, the CCPS would contain a liability, regardless of the likelihood of cash settlement.

There could be a number of scenarios where buy back and put options could trigger and therefore, careful evaluation will be required to classify CCPS as equity or liability.

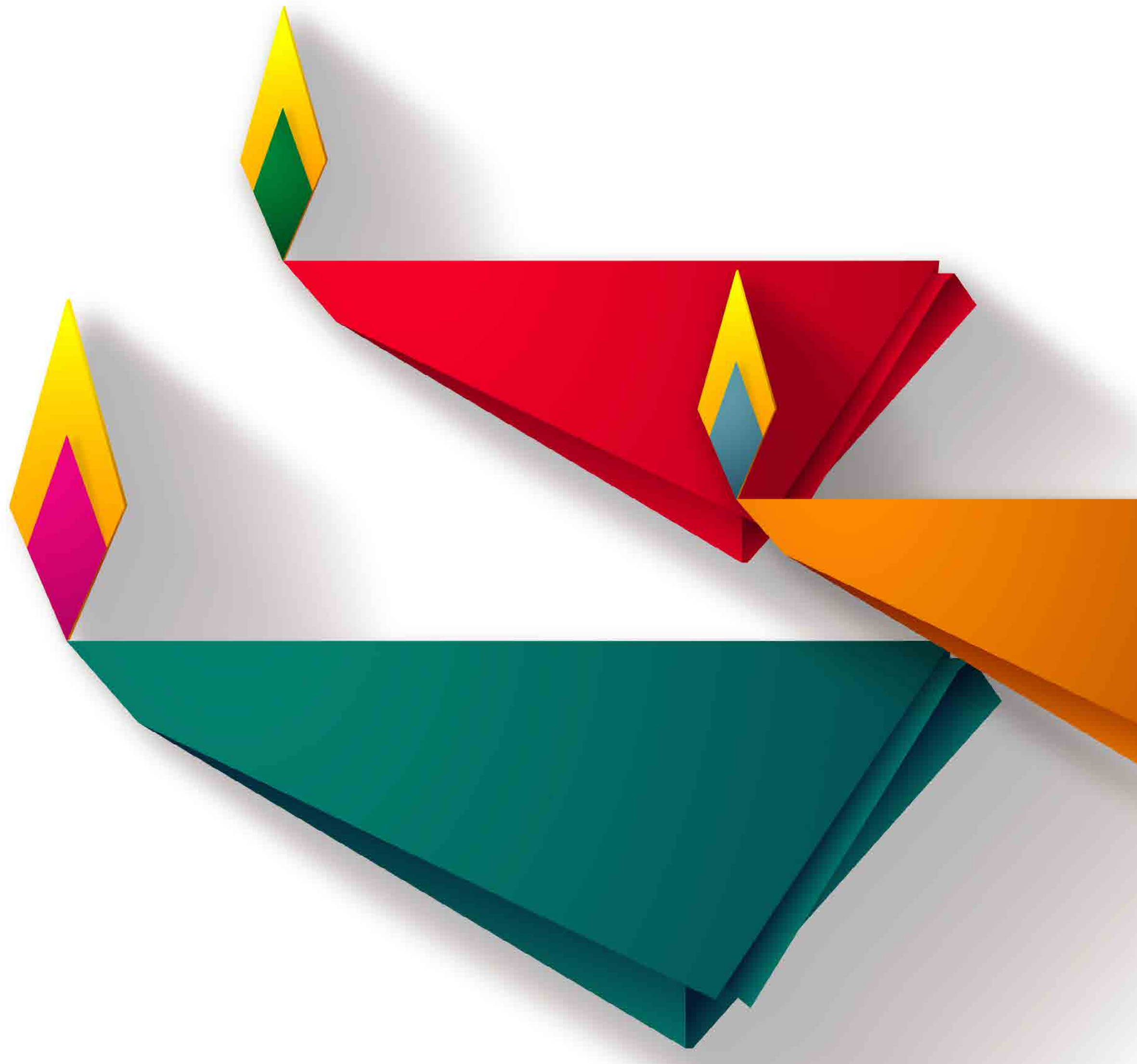
Conversion of financial liability to equity

In certain cases, an entity may amend the contractual terms of an instrument such that the classification of the instrument changes from a financial liability to equity.

This change would require detailed evaluation of the amended terms and conditions and may potentially have a large impact on the statement of profit and loss.

Conclusion

Accounting for CCPS particularly from a classification perspective can be quite complex when features like buy back or down round protection are attached to such instruments. The measurement of such instruments depends on their classification. Many start-up companies attract private equity/venture capital funding and therefore, it is important to understand the impact of accounting for such instruments under Ind AS. Companies should carefully assess facts and circumstances of each contract to evaluate appropriate classification and measurement.



1. Guidance taken from Insights into IFRS, 18th edition, 2021/22, Para reference 7.3.770

Chapter 3

Regulatory updates

SEBI issued amendments to the ICDR Regulations

Background

Currently, if an issuer has issued SR equity shares to its promoters/founders, the said issuer shall be allowed to do an Initial Public Offer (IPO) of only ordinary shares for listing on the main board subject to compliance with the provisions of Chapter II of the Securities and Exchange Board of India (SEBI) (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations) and other specified conditions which, *inter alia*, includes the following:

a. The SR shareholder should not be part of the promoter group whose collective net worth is more than **INR500 crore**.

b. The SR equity shares have been held for a period of **at least six months** prior to the filing of the red herring prospectus.

New development

SEBI through a notification dated 26 October 2021 has issued certain amendments to the ICDR Regulations. The amendments have modified the above mentioned conditions as follows:

a. The net worth of the SR shareholder **as determined by a Registered Valuer**, should not be more than **INR1,000 crore**.

While determining the individual net worth of the SR shareholder, his/her investment/shareholding in other listed companies should be considered but not that of his/her shareholding in the issuer company.

b. The SR equity shares have been issued prior to the filing of draft red herring prospectus and held for a period of at least **three months** prior to the filing of the red herring prospectus.

Effective date: The amendments are effective from the date of their publication in the official gazette i.e. 26 October 2021.

(Source: SEBI notification no. SEBI/LAD-NRO/GN/2021/52 dated 26 October 2021)

SEBI issued revised formats for entities with listed non-convertible securities

Background

On 7 September 2021, the Securities and Exchange Board of India (SEBI) amended the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations). The amendments, *inter alia*, requires entities with listed non-convertible securities to disclose audited/unaudited financial results with limited review report on a quarterly basis (earlier required on a half-yearly basis) within 45 days of end of quarter, other than last quarter. Such entities are also required to disclose statement of assets and liabilities and statement of cash flows on a half-yearly basis.

New development

Formats for filing financial information

SEBI through its circular dated 5 October 2021 has prescribed revised formats for filing of financial information by entities with listed non-convertible securities as below:

- Standalone financial results required to be filed with the stock exchanges on a quarterly basis
- Standalone and consolidated financial results required to be filed with the stock exchanges on an annual basis
- Statement of assets and liabilities to be filed with the stock exchanges on a half-yearly basis
- Statement of cash flows to be filed with the stock exchanges on a half-yearly basis
- Format for financial results to be published in newspapers.

SEBI has clarified the following regarding the comparatives to be provided in the financial results:

- **Quarterly financial results:** Where the entity does not have corresponding quarterly financial results for the four quarters ended September 2020, December 2020, March 2021 and June 2021, the column on corresponding figures for such quarters would not be applicable.
- **Half yearly financial results:** Where the entity does not have corresponding statement of assets and liabilities or the corresponding cash flow

statement for the half-year ended September 2020, the column on corresponding figures will not be applicable.

Further, in case of non-submission/delayed submission of such financial results, the listed entity shall disclose detailed reasons for such non-submission/delay to the stock exchanges within one working day of the due date of submission of the financial results. In case the decision to delay the results was taken by the listed entity prior to the due date, the listed entity shall disclose detailed reasons for such delay to the stock exchanges within one working day of such decision.

Formats for limited review report and audit report

SEBI through its circular dated 14 October 2021 has issued revised formats for limited review report/ audit report for issuers of non-convertible securities (other than insurance companies) as follows:

- Annexure I - Limited review report for quarterly standalone financial results for entities other than banks and Non-Banking Financial Companies (NBFCs)
- Annexure II - Limited review report for quarterly standalone financial results for banks and NBFCs
- Annexure III - Audit report for quarterly standalone financial results for entities other than banks and NBFCs
- Annexure IV - Audit report for quarterly standalone financial results for banks and NBFCs
- Annexure V - Audited annual consolidated financial results for entities other than banks and NBFCs
- Annexure VI - Audited annual consolidated financial results for banks and NBFCs.

Insurance companies will be required to disclose limited review/audit reports as per the formats specified by the Insurance Regulatory and Development Authority of India (IRDAI).

(Source: SEBI circular no. SEBI/HO/DDHS/ CIR/2021/0000000637 dated 5 October 2021 and SEBI circular no. SEBI/HO/DDHS/ CIR/2021/0000000638 dated 14 October 2021)

RBI issued revised regulatory framework for NBFCs - Scale-Based Regulation

On 22 October 2021, RBI issued a revised regulatory framework for NBFCs - Scale Based Regulation (SBR). The regulatory framework bifurcates all the NBFCs into four layers based on their size, activity, and perceived riskiness which are as follows:

- **NBFC - Base Layer (NBFC-BL):** The Base Layer shall comprise:
  a. Non-deposit taking NBFCs below the asset size of INR1,000 crore
  b. NBFCs undertaking the following activities:
     i. NBFC-Peer to Peer Lending Platform (NBFC-P2P)
     ii. NBFC-Account Aggregator (NBFC-AA)
     iii. Non-Operative Financial Holding Company (NOFHC) and
     iv. NBFCs not availing public funds and not having any customer interface.
- **NBFC - Middle Layer (NBFC-ML):** The middle layer shall consist of:
  a. All deposit taking NBFCs irrespective of asset size
  b. Non-deposit taking NBFCs with asset size of INR1,000 crore and above
  c. NBFCs undertaking the following activities:
     i. Standalone Primary Dealers
     ii. Infrastructure Debt Fund – NBFCs
     iii. Core Investment Companies (CICs)
     iv. Housing Finance Companies (HFCs)
     v. Infrastructure Finance Companies (NBFC-IFCs).
- **NBFC - Upper Layer (NBFC-UL):** The upper layer shall comprise those NBFCs which are specifically identified by RBI as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology. The top 10 eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.

  The methodology for assessing the NBFC-UL shall be reviewed periodically.
- **NBFC - Top Layer (NBFC-TL):** The Top Layer will ideally remain empty. If RBI is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer, then such NBFCs shall move to the Top Layer from the Upper Layer.

Some of the key regulatory changes under SBR for all layers of NBFCs are as follows:

- **Net owned fund:** Regulatory minimum Net Owned Fund (NOF) for NBFC-ICC, NBFC-MFI and NBFC-Factors shall be increased to INR10 crore. The following glide path is provided for the existing NBFCs to achieve the NOF of INR10 crore:

NBFCs	Current NOF (INR)	NOF by 31 March 2025	NOF by 31 March 2027
NBFC-ICC	INR2 crore	INR5 crore	INR10 crore
NBFC-MFI	INR5 crore	INR7 crore	INR10 crore
NBFC-Factors	INR5 crore	INR7 crore	INR10 crore

However, for NBFC-P2P, NBFC-AA, and NBFCs with no public funds and no customer interface, the NOF shall continue to be INR2 crore. It is clarified that there is no change in the existing regulatory minimum NOF for NBFCs - IDF, IFC, MGCs, HFC, and SPD.

- **NPA classification:** The extant NPA classification norm stands changed to the overdue period of more than 90 days for all categories of NBFCs. A glide path is provided to NBFCs in Base Layer to adhere to the 90 days NPA norm as under:

NPA norms	Timeline
>150 days overdue	By 31 March 2024
>120 days overdue	By 31 March 2025
>90 days	By 31 March 2026

  The glide path will not be applicable to NBFCs which are already required to follow the 90-day NPA norm.

- **Experience of the board:** At least one of the directors shall have relevant experience of having worked in a bank/NBFC.
- **Ceiling on IPO funding:** A ceiling of INR1 crore per borrower for financing subscription to an Initial Public Offer (IPO) has been imposed. However, NBFCs can fix more conservative limits.

Transition plan

Once a NBFC is identified for inclusion as NBFC-UL, the NBFC shall be advised about its classification by the Department of Regulation, RBI placed under regulation applicable to the Upper Layer. For this purpose, the following timelines shall be adhered to:

a. **Within three months of being advised by RBI regarding its inclusion in NBFC-UL:** A board approved policy for adoption of the enhanced regulatory framework and an implementation plan for adhering to the new set of regulations should be put in place.

b. **Within 24 months from the date of advice regarding classification as a NBFC-UL:** The board should ensure that the stipulations prescribed for the NBFC-UL are adhered to. During the period of transition, calibrated increment to business may be allowed through supervisory engagement.

The road map as approved by the Board towards implementation of the enhanced regulatory requirement shall be submitted to RBI and shall be subject to supervisory review.

Effective date: These guidelines shall be effective from 1 October 2022. The instructions relating to ceiling on IPO funding shall come into effect from 1 April 2022.

(Source: RBI notification no. RBI/2021-22/112 dated 22 October 2021)

RBI issued master directions

RBI through notifications dated 24 September 2021 has issued following two master directions:

- **RBI (Transfer of Loan Exposures) Directions, 2021:** The directions provide a comprehensive, self-contained set of regulatory guidelines governing transfer of loan exposures.

Some of the key provisions of the directions are:

- **Applicability:** The provisions of these directions shall apply to the following entities subject to specified conditions:
  a. Scheduled commercial banks
  b. Regional Rural Banks (RRBs)
  c. Primary (urban) co-operative banks/state co-operative banks/district central co-operative banks
  d. All India Financial Institutions
  e. Small finance banks and
  f. All NBFCs including Housing Finance Companies (HFCs).
- **Compliance with Accounting Standards:** NBFCs which are required to comply with the Indian Accounting Standards (Ind AS) shall continue to be guided by the standards and the advisories issued by the Institute of Chartered Accountants of India in case of any inconsistencies between these directions and the standards.
- **General conditions applicable for all loan transfers:** Following are matters to be considered:
  a. The lenders must put in place a comprehensive board approved policy for transfer and acquisition of loan exposures under these guidelines. Those guidelines must, *inter alia*, lay down the minimum quantitative and qualitative standards relating to due diligence, valuation, risk management and periodic board level oversight. It should also ensure independence of functioning and reporting responsibilities of the units and personnel involved in transfer/acquisition of loans from that of personnel involved in originating the loans.
  b. Loan transfers should result in transfer of economic interest without being accompanied by any change in the underlying terms and conditions of the loan contract usually.
  c. A transferor cannot re-acquire a loan exposure, either fully or partially, that had been transferred by the entity previously, except as a part of a resolution plan under the RBI (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016.
  d. Transfer as well as acquisition of exposures by overseas branches of Indian banks shall be required to be in compliance with the requirements prescribed in this circular without derogation of any other statutory or regulatory provisions including those prescribed under the Foreign Exchange Management Act, 1999.

e. In respect of exposures that do not meet the requirements of these directions, transferee(s) shall maintain capital charge equal to the actual exposure acquired. In such cases, the transferor shall continue to recognise the transferred loan in its entirety, as if it was not transferred at all in the first place, and the consideration received shall be recognised as an advance.

- **Transfer of stressed loans:** All loans classified as Non-Performing Asset (NPA) above a threshold amount decided by the board/board committee shall be reviewed by the board/board committee at periodic intervals.

  The lender acquiring stressed loans should make provisions for such loans as per the asset classification status in its books upon acquisition. If the net present value of the cash flows estimated while acquiring the loan is less than the consideration paid for acquiring the loan, provisions shall be maintained to the extent of the difference.

  NBFCs preparing financial statements as per Ind AS shall continue to make provisions as required as per Ind AS. However, they shall concurrently assess the provisioning required as per the methodology explained above and provisions so required shall be included in the computation of the prudential floor prescribed under the RBI circular dated 13 March 2020[1].

- **Disclosures and reporting:** Lenders should make specified disclosures in their financial statements, under 'Notes to Accounts', relating to the total amount of loans not in default/stressed loans transferred and acquired to/from other entities, on a quarterly basis starting from the quarter ending on 31 December 2021. Those, *inter alia*, include:

  a. *In respect of loans not in default that are transferred or acquired:* Disclose aspects such as weighted average maturity, weighted average holding period, retention of beneficial economic interest, coverage of tangible security coverage, and rating-wise distribution of rated loans. Also, all instances where the transferor has agreed to replace loans transferred to transferee(s) or pay damages arising out of any representation or warranty should be disclosed.

  b. *In case of stressed loans transferred or acquired:* Appropriate disclosures with regard to the quantum of excess provisions reversed to the profit and loss account on account of sale of stressed loans should be provided by the transferor.

(Source: RBI notification no. RBI/DOR/2021-22/86 dated 24 September 2021)

- **RBI (Securitisation of Standard Assets) Directions, 2021:** These directions will be applicable to securitisation transactions undertaken subsequent to the issue of these directions.

  Some of the key features of the directions are as follows:

  - **Applicability:** The provisions of the directions are applicable to the following entities:

    a. Scheduled commercial banks (excluding RRBs)

    b. All India Term Financial Institutions (AIFIs)

    c. Small finance banks (as permitted under Operating Guidelines for Small Finance Banks dated 6 October 2016 and as amended from time to time) and

    d. All NBFCs including HFCs.

  - **Assets eligible for securitisation:** Lenders, including overseas branches of Indian banks, shall not undertake securitisation activities or assume securitisation exposures as given below:

    a. Re-securitisation exposures

    b. Structures in which short term instruments such as commercial paper, which are periodically rolled over, are issued against long term assets held by a Special Purpose Entity (SPE)

    c. Synthetic securitisation and

    d. Securitisation with the following assets as underlying:

      i. Revolving credit facilities as underlying

      ii. Restructured loans and advances which are in the specified period

      iii. Exposures to other lending institutions

      iv. Refinance exposures of AIFIs and

      v. Loans with bullet payments of both principal and interest as underlying.

  - **Minimum Retention Requirement (MRR):** The originators[2] should adhere to the prescribed MRR while securitising loans leading to issuance of securitisation notes as below:

    a. *For underlying loans with original maturity of 24 months or less:* The MRR shall be five per cent of the book value of the loans being securitised.

    b. *For underlying loans with original maturity of more than 24 months as well as loans with bullet repayments:* The MRR shall be 10 per cent of the book value of the loans being securitised.

    c. *In case of residential mortgage-backed securities:* The MRR shall be five per cent of the book value of the loans being securitised, irrespective of the original maturity.

1. Paragraph 2 of the Annex to the circular no. DOR (NBFC). CC.PD.No.109/22.10.106/2019-20 dated 13 March 2020.
2. Originator refers to a lender that transfers from its balance sheet a single asset or a pool of assets to an SPE as a part of a securitisation transaction and would include other entities of the consolidated group to which the lender belongs.

- **Limit on total retained exposures by originators:** The total exposure of an originator to the securitisation exposures belonging to a particular securitisation structure or scheme should not exceed 20 per cent of the total securitisation exposures created by such structure or scheme.
- **Issuance and listing:** The minimum ticket size for issuance of securitisation notes shall be INR1 crore.
- **Accounting provisions:** NBFCs which are required to comply with Ind AS shall continue to be guided by the standards and the ICAI advisories with respect to accounting for securitisation exposures and transactions. In case of other lenders, any loss, profit or premium realised at the time of the sale should be accounted accordingly and reflected in the profit and loss account for the accounting period during which the sale is completed.
- **Due diligence requirements:** Lenders who are investors in securitisation exposures can invest in securitised notes only if the originator has explicitly disclosed to the purchasing lenders that it has adhered to the MRR and MHP requirements and will adhere to MRR on an ongoing basis, as applicable and advised in this direction. Lenders need to monitor performance information on the exposures underlying their securitisation positions on an ongoing basis and in a timely manner, and take appropriate action, if any, required.
- **Capital requirements for securitisation exposures:** Lenders must maintain capital against all securitisation exposure amounts, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in asset-backed or mortgage-backed securities, retention of a subordinated tranche, and extension of a liquidity facility or credit enhancement.
- **Disclosures:** The notes to annual accounts of the originators should indicate the outstanding amount of securitised assets as per books of the SPEs and total amount of exposures retained by the originator as on the date of balance sheet to comply with the MRR. These figures should be based on the information duly certified by the SPE's auditors obtained by the originator from the SPE.

The originator(s) should disclose to investors the weighted average holding period of the assets securitised and the level of their MRR in the securitisation.

The originator must also submit the details of the securitisation transactions undertaken, including the details of the securitisation notes issued, to the RBI on a quarterly basis.

(Source: RBI circular no. RBI/DOR/2021-22/85 dated 24 September 2021)

FASB provides practical expedient to private companies that issue equity-classified share-based awards

On 25 October 2021, the Financial Accounting Standards Board (FASB) has issued an Accounting Standards Update (ASU) to improve an area of financial reporting for non-public business entities (private companies) that issue equity-classified share-based awards.

The ASU provides private companies an option to elect a practical expedient to determine the current price input of equity-classified share-based awards issued as compensation using the reasonable application of a reasonable valuation method. The characteristics of a reasonable valuation method are the same as the characteristics used in the regulations of the U.S. Department of the Treasury related to Section 409A of the U.S. Internal Revenue Code (the Treasury Regulations) to describe the reasonable application of a reasonable valuation method for income tax purposes.

The key characteristics prescribed for the reasonable application of a reasonable valuation method are as follows:

a. The date on which the valuation's reasonableness is evaluated is the measurement date.

b. The scope of information to be considered in a reasonable valuation is all information material to the value of the entity.

c. Factors to be considered in a reasonable valuation include value of the tangible and intangible assets of the entity, recent arm's-length transactions involving the sale or transfer of the stock or equity interests of the entity and an entity's consistent use of a valuation method to determine the value of its stock or assets for other purpose.

The practical expedient in this ASU can be elected for equity-classified share-based awards within the scope of FASB Accounting Standards Codification Topic 718, *Stock Compensation*. Its amendments apply to all non-public entities (as defined in the Master Glossary of the Codification) that issue equity-classified share-based awards and elect the practical expedient.

Effective date: The practical expedient is effective prospectively for all qualifying awards granted or modified during fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022. Early application, including application in an interim period, is permitted for financial statements that have not yet been issued or made available for issuance as of 25 October 2021.

(Source: FASB's ASU No. 2021-07 dated 25 October 2021)

FASB issued an ASU on accounting of revenue contracts with customers acquired in a business combination

On 28 October 2021, FASB has issued an ASU that aims to improve the accounting for acquired revenue contracts with customers in a business combination by addressing diversity in practice and inconsistency related to the following:

a. Recognition of an acquired contract liability

b. Payment terms and their effect on subsequent revenue recognised by the acquirer.

The amendments in the ASU require acquiring entities to apply Topic 606, *Revenue from Contracts with Customers* to recognise and measure contract assets and contract liabilities in a business combination. At the acquisition date, an acquirer should account for the related revenue contracts in accordance with Topic 606 as if it had originated the contracts. Generally, this should result in an acquirer recognising and measuring the acquired contract assets and contract liabilities consistent with how they were recognised and measured in the acquiree's financial statements (if the acquiree prepared financial statements in accordance with GAAP).

The amendments improve comparability by specifying for all acquired revenue contracts regardless of their timing of payment:

a. The circumstances in which the acquirer should recognise contract assets and contract liabilities that are acquired in a business combination and

b. How to measure those contract assets and contract liabilities.

As per the ASU, the acquired contract assets and contract liabilities arising from revenue contracts with customers in a business combination should be measured in accordance with Topic 606 at the acquisition date. Therefore, the acquirer should no longer measure the remaining obligations of the acquired revenue contract at fair value but, instead, utilise the transaction price allocated to the remaining performance obligations in accordance with the principles of Topic 606.

Effective date: For public business entities, the amendments in the ASU are effective for fiscal years beginning after 15 December 2022, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after 15 December 2023, including interim periods within those fiscal years. The amendments should be applied prospectively to business combinations occurring on or after the effective date of the amendments. Early adoption of the amendments is permitted, including adoption in an interim period.

(Source: FASB's ASU no. 2021-08 dated 28 October 2021)

KPMG in India's IFRS institute

Visit KPMG in India's IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

First Notes

SEBI amends provisions related to independent directors

8 September 2021

On 29 June 2021, SEBI, in its board meeting approved some of the proposals pertaining to Independent Directors (IDs) mentioned in the consultation paper issued in March 2021. These decisions come into effect though SEBI's notification dated 3 August 2021 which amended the Listing Regulations pertaining to regulatory provisions related to IDs. The amendments mainly pertain to the following areas:

- Eligibility of IDs
- Appointment, reappointment and resignation of IDs
- Committees of the board
- Related party transactions
- Directors and Officers insurance (D&O insurance) for IDs.

These amendments will be applicable to all listed companies (however, requirement to procure D&O insurance for IDs is applicable to top 1,000 listed companies) effective 1 January 2022.

In this issue of First Notes, we aim to provide an overview of the key amendments made by SEBI in the Listing Regulations relating to IDs.

Voices on Reporting (VOR)

On 28 October 2021, KPMG in India issued VOR - Quarterly 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) relevant for stakeholders for the quarter ended 30 September 2021.

To access the publication, please click here.

#KPMG josh

Follow us on:
home.kpmg/in/socialmedia

Previous editions are available to download from:
home.kpmg/in

Feedback/queries can be sent to
aaupdate@kpmg.com

KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000.

Introducing

'Ask a question'

write to us at
aaupdate@kpmg.com