Accounting and Auditing Update

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Foreword

Compulsorily Convertible Debentures (CCDs) are an important source of finance and are used by the companies for raising funds. CCDs are debentures with an underlying characteristic of compulsory conversion into equity after a certain period of time, or on happening of a specified event. Ind AS 32, *Financial Instruments: Presentation* establishes the principles for classifying CCDs, from the perspective of the issuer, into financial liabilities and equity instruments. Ind AS 32 requires an entity to assess the substance of a contractual arrangement rather than its legal form while determining such classification. Therefore, the topic of classification of CCDs requires a detailed evaluation as it is possible for an instrument that qualifies as equity for legal or regulatory purposes, classifies as a financial liability under Ind AS. Also, the International Accounting Standards Board (IASB) has undertaken a project on Financial Instruments with the Characteristics of Equity. The IASB aims to address challenges identified in IAS 32, *Financial Instruments: Presentation,* by establishing clearer principles for classifying financial instruments as either financial liabilities or equity, improving the clarity and consistency of the classification requirements for the more complex financial instruments that create a challenge in practice and enhancing the presentation and disclosures about financial liabilities and equity.

Considering that Ind AS are largely aligned with the IFRS, the topic of classification of financial instruments with the characteristics of equity would be of relevance in the Indian context as well. This edition of the Accounting and Auditing Update (AAU) contains an article on this topic which highlights key principles from a recent Expert Advisory Committee (EAC) opinion 'Accounting treatment of CCDs' by the Institute of Chartered Accountants of India (ICAI) relating to guidance on accounting for CCDs.

Our second article focusses on considerations involved with an audit of group's financial statements - ISA 600 *Special Considerations—Audits of Group Financial Statements (Including the work of component auditors).* This standard deals with special considerations that apply to an audit of group financial statements (a group audit), including when component auditors are involved. The International Auditing and Assurance Standards Board (IAASB) has revised the extant ISA 600 to strengthen the auditor's approach to planning and performance of a group audit and clarify the interaction of ISA 600 to the other ISAs. The revised standard is effective for audits of group financial statements for periods beginning on or after 15 December 2023.

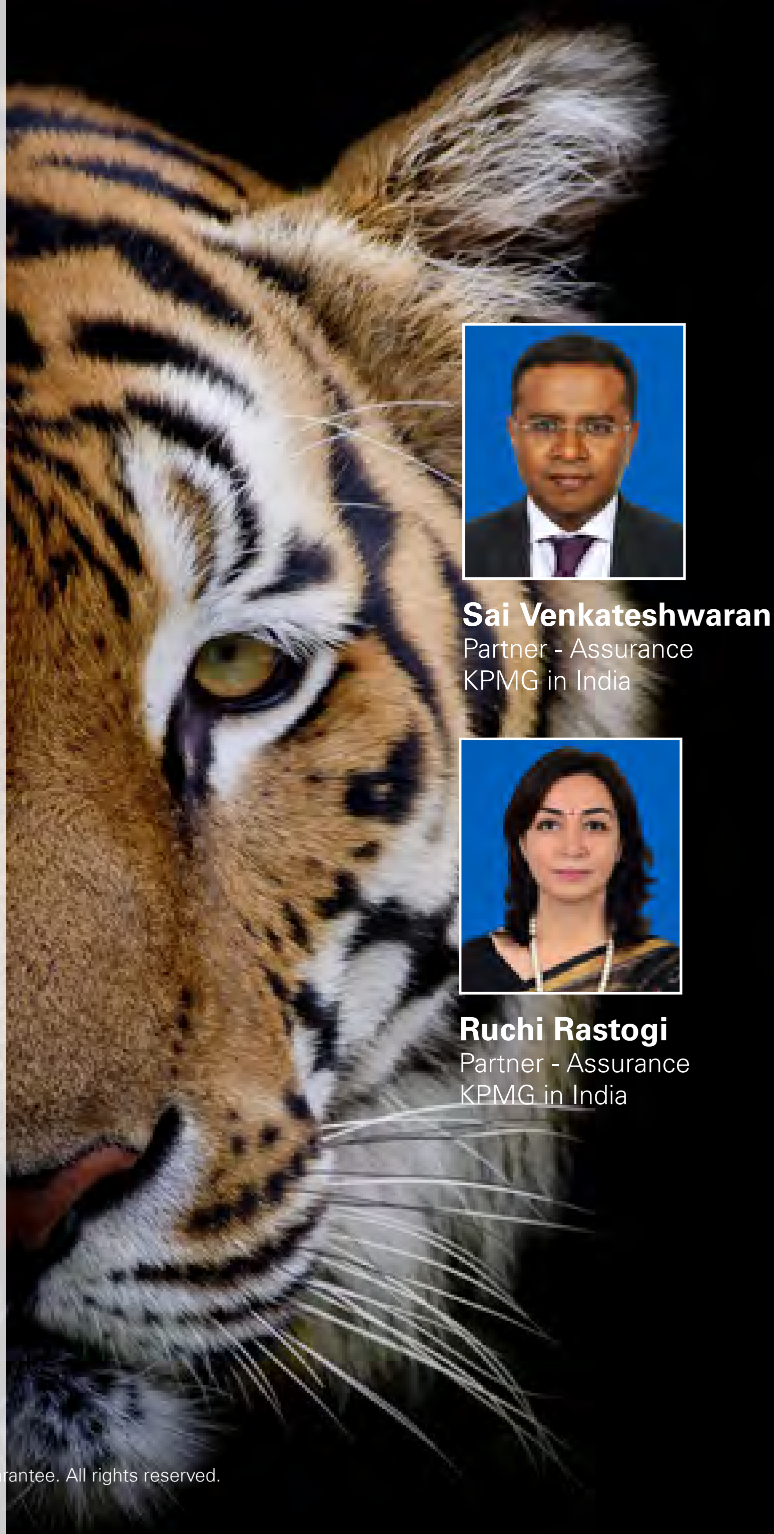
A group audit poses various challenges for an auditor specifically when group auditors are required to work with other component auditor(s). The revised standard provides a new risk-based approach to planning and conducting group audits. It will help drive greater focus by the group engagement team on their responsibility to identify and assess the risks of material misstatement of the group financial statements and to design and perform further audit procedures to respond to those risks, in order to obtain sufficient appropriate audit evidence in respect of the group audit as a whole. This is a fundamental responsibility of the group auditor and the standard places an increased emphasis on it.

Further, the revised standard continues to contemplate the involvement of component auditors by emphasising that they are part of the group engagement team. ISA 600 (Revised) strengthens the framework for a component auditor's responsibilities with respect to the work to be performed at the direction of the group engagement team, including communication with the group engagement team. ISA 600 also sets out matters that a group engagement team is required to communicate to those charged with governance of the group.

Currently, in India, auditing guidance is governed by the Standards on Auditing (SAs) issued by the ICAI and SA 600, *Using the Work of Another Auditor* is applicable for situation of a group with various components. Additionally, in case of listed companies, the Securities and Exchange Board of India (SEBI) through its circular dated 29 March 2019 has prescribed the procedure and formats for limited review report and audit report of the listed entity and its components to be followed by the statutory auditors of such entities.

As is the case each month, we also cover a regular round-up of some recent regulatory updates 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.



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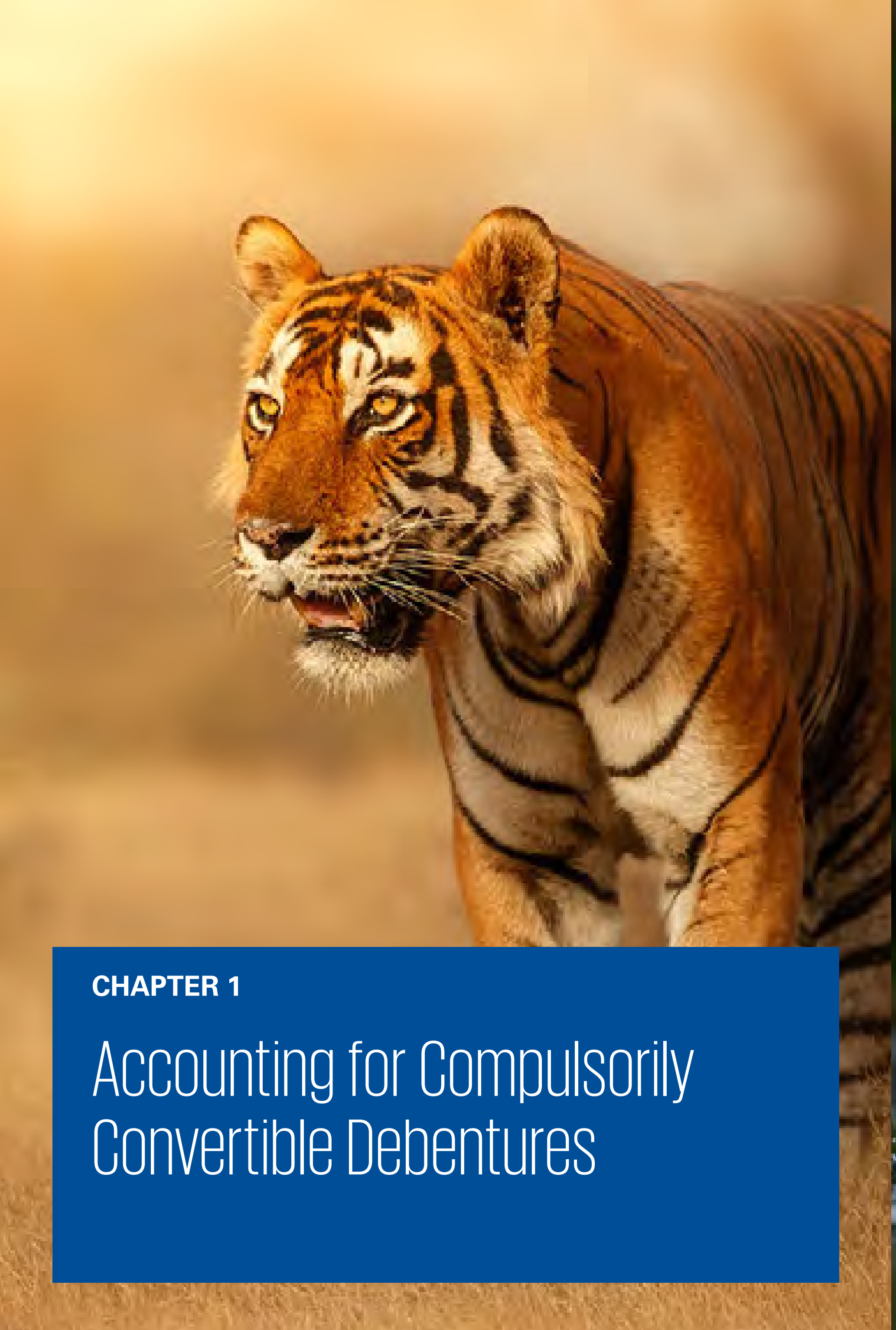
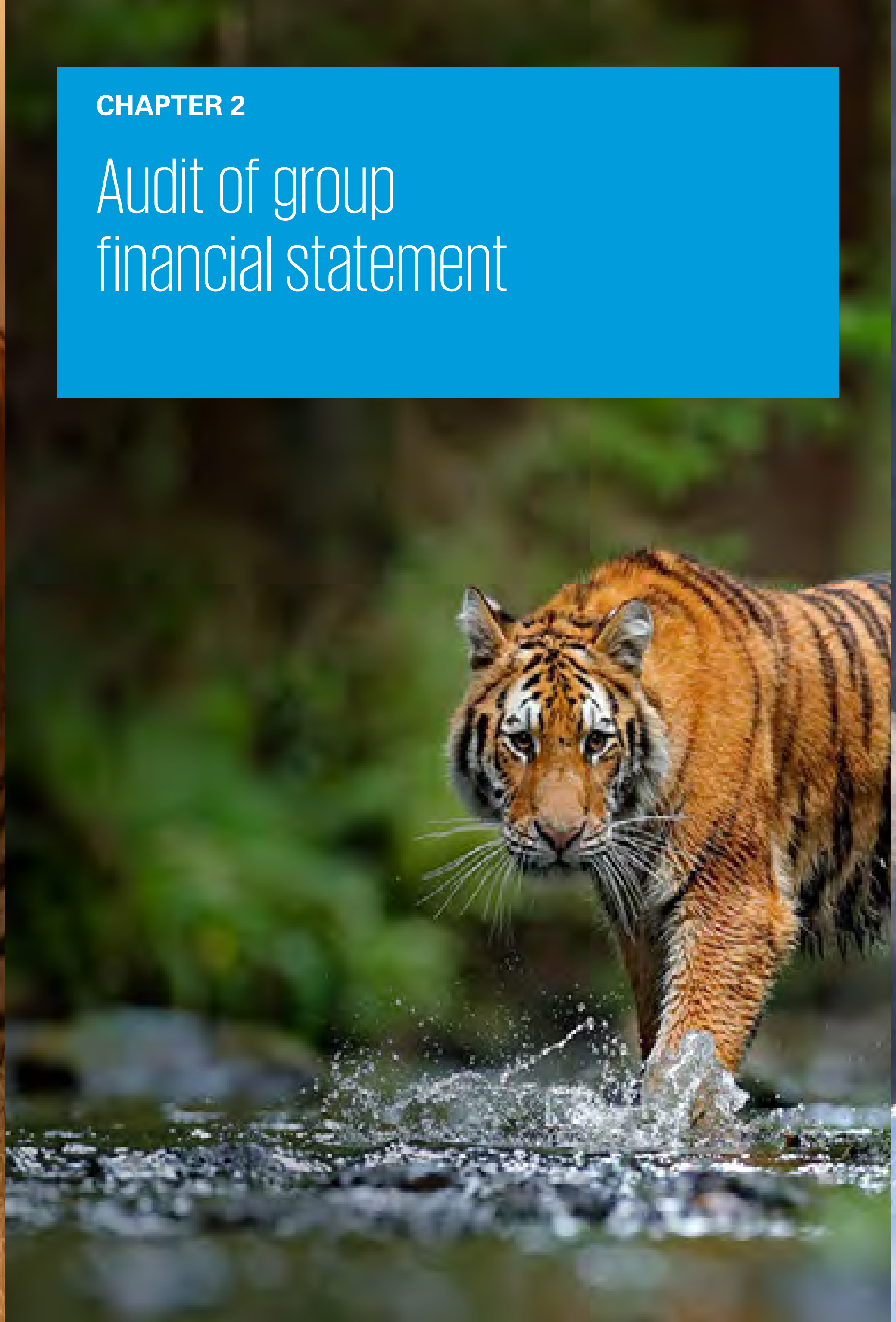


CHAPTER 1

Accounting for Compulsorily Convertible Debentures



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Accounting for Compulsorily Convertible Debentures

This article aims to:

Provide guidance on accounting for Compulsorily Convertible Debentures under Ind AS 32, *Financial Instruments: Presentation* and covers a recent EAC opinion issued on the same topic.

Overview

Compulsorily Convertible Debentures (CCDs) are an important source of finance and are used by the companies for raising funds. Simply put, CCDs, as the name suggests, are debentures with an underlying characteristic of compulsory conversion into equity after a certain period of time, or on happening of a specified event. CCDs are different from simple debt instruments, as they include a convertibility feature which acts as an incentive for the investors over and above the interest income. Thus, unlike equity, CCDs ensure a fixed return to the investors along with a potential upside on conversion.

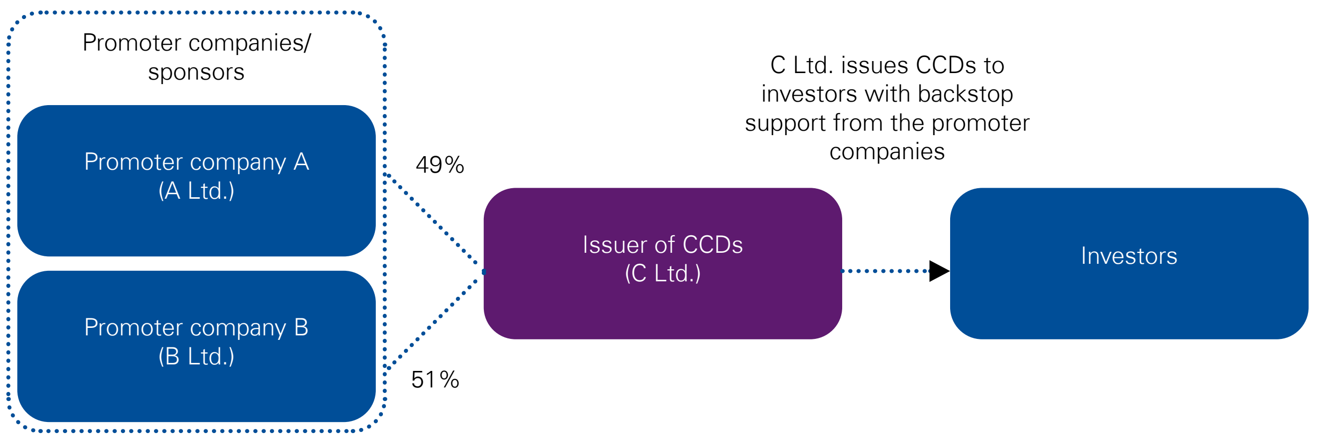
Under the Indian Accounting Standards (Ind AS), Ind AS 32, *Financial Instruments: Presentation* establishes the principles for classifying CCDs, from the perspective of the issuer, into financial liabilities and equity instruments. As per Ind AS 32, while determining such classification, an entity would first need to assess the substance of a contractual arrangement rather than its legal form. Therefore, it is possible for an instrument that qualifies as equity for legal or regulatory purposes, classifies as a financial liability under Ind AS. Accordingly, the Institute of Chartered Accountants of India (ICAI) has from time to time provided clarifications on accounting for CCDs.

Recently, the Expert Advisory Committee (EAC)[1] of ICAI issued guidance on accounting for CCDs through its opinion on 'Accounting treatment of Compulsorily Convertible Debentures (CCDs) by the issuer under Ind AS 32, *Financial Instruments: Presentation*'. In this article, we aim to discuss the main principles enunciated in this opinion.

1. EAC opinion on 'Accounting treatment of Compulsorily Convertible Debentures (CCDs) by the issuer under Ind AS 32, Financial Instruments: Presentation' issued in ICAI journal in January 2022.

Facts of the case

Figure 1: Facts of the case



(Source: EAC opinion on 'Accounting treatment of Compulsorily Convertible Debentures (CCDs) by the issuer under Ind AS 32, *Financial Instruments: Presentation*' issued in ICAI journal in January 2022.)

C Ltd. (the Company), being jointly promoted by A Ltd. and B Ltd. (promoter companies/sponsors) issued CCDs to its investors with backstop support from the promoter companies. The Company has an obligation to make periodic interest payments to the investors during the tenure of the CCDs. The terms of the arrangement provide that the CCDs would not be convertible in the hands of investors, instead the CCDs would be bought back by the promoters of C Ltd.. The Company would be required to convert the CCDs into equity shares ranking *pari-passu* with existing shares at the time of conversion, in the same proportion of shareholding/backstop support of the promoters. The conversion would be made considering the share price prevailing at that time. The Company accounted for the CCDs as compound financial instruments by bifurcating the total proceeds of the CCDs into equity and liability/debt components.

Considering these facts, the EAC opined on (a) the accounting treatment of the CCDs issued by the Company (b) disclosures of CCDs issued in the Company's financial statements, and (c) where EAC opinion is contrary to the accounting treatment of the company, the corrective actions required to be taken by the Company.

Overview of the EAC opinion

Whether the CCDs issued by C Ltd. are ‘compound financial instruments’

As per Ind AS 32, a financial instrument or its components, is classified on initial recognition as a financial asset, financial liability, or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial asset, financial liability, or an equity instrument. In this regard, Ind AS 32 provides the definitions of financial asset, financial liability, and equity, which can be evaluated for the components of the CCD.

The CCD in the current case has two components:

a. Component 1: Obligation of C Ltd. to make periodic interest payments to the investors during the tenure of the CCDs

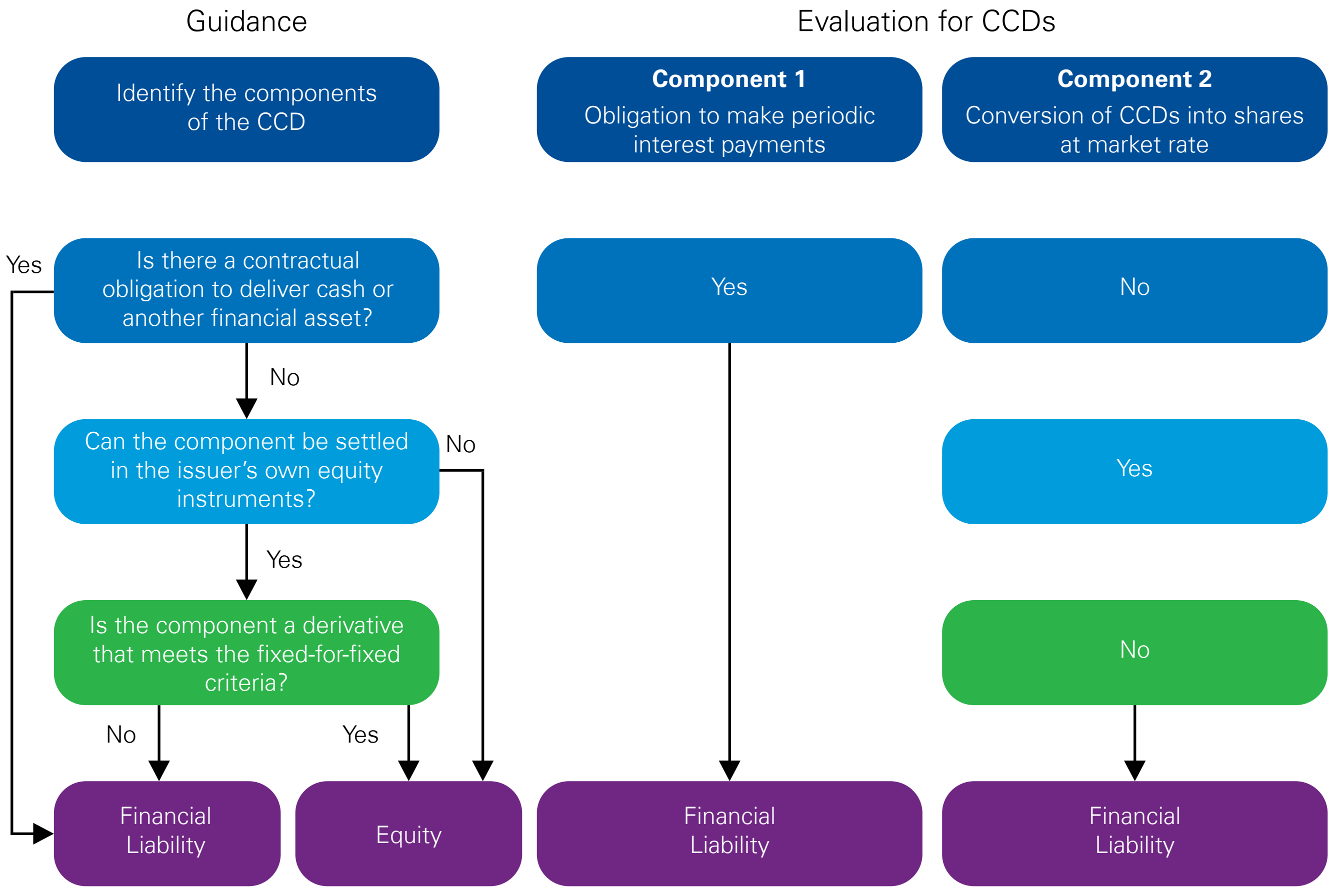
b. Component 2: Converting the CCDs into equity shares at the share price prevailing at the time of conversion

Figure 2 depicts the evaluation of the guidance provided by Ind AS 32 and its applicability to the components of the CCD.

As can be seen in figure 2, each component of the CCD is analysed separately to determine its classification. The analysis, based on guidance in Ind AS 32 indicates that:

- Component 1: Interest payable to investors by the Company meets the criteria for financial liability classification, since there is an obligation to pay cash that the Company cannot avoid.
- Component 2: With regard to the conversion feature of the CCD, there is no contractual obligation to pay cash, since the conversion into own equity shares is compulsory. Therefore, further evaluation of the conversion ratio is required[2]. As per the terms of the CCD, the conversion ratio of the CCDs will be dependent on the share price of the Company at the time of conversion- i.e. there is an obligation to issue a variable number of shares, and the fixed-for-fixed criteria is not met. Therefore, the conversion component within the CCD does not meet the criteria laid down in Ind AS 32 for the purpose of classifying as equity.

Figure 2: Evaluation of Ind AS 32 guidance for components of CCD



(Source: KPMG in India’s analysis, 2022 read with Ind AS 32)

On the basis of the above evaluation, on an overall basis, the CCDs do not meet the criteria for being classified as a compound financial instrument as there is no equity component. Hence, the CCDs should be classified as financial liabilities in entirety.

2. The evaluation will be whether the component is a derivative that will be settled by the issuer with fixed amount of cash/other financial asset for a fixed number of own equity instruments (i.e. the fixed-for-fixed criteria).

Disclosures and presentation for the CCD

Disclosures and presentation for the CCDs that are classified in their entirety as a financial liability should be made as per the applicable requirements of Ind AS 32, Ind AS 107, *Financial Instruments: Disclosures,* Ind AS 113, *Fair Value Measurement* and Schedule III (Division II – applicable to entities preparing their accounts in accordance with Ind AS) to the Companies Act, 2013, that are relevant for financial liabilities.

Accounting for accelerated buy-out option

In the current case, the terms of the CCDs contain an accelerated buy-out option, or the accelerated put option. Upon exercise of these options by the sponsors or investors, the Company would be required to convert the CCDs into equity shares, earlier than the expected tenure.

These options may represent embedded derivatives under Ind AS 109, *Financial Instruments.* It should be determined whether the embedded derivatives are closely related to the host contract as per the requirements of Ind AS 109. As per Ind AS 109, for convertible notes with embedded derivative liabilities, the embedded derivative liability is determined first, and the residual value is assigned to the debt host liability.

Correcting accounting errors

In the current case, the Company has accounted for the CCDs as compound financial instruments. However, based on the evaluation done by the EAC, the CCDs should be classified as a financial liability in their entirety. This tantamounts to an error in the classification of the CCDs.

As per Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* material prior period errors should be corrected retrospectively by restating the comparative amounts for prior period(s) presented in which the error occurred. If the error occurred before the earliest period presented, the opening balance of assets, liabilities and equity/retained earnings for the earliest period presented should be adjusted. Therefore, the Company should correct the accounting treatment of the CCDs as a prior period error retrospectively in the first set of financial statements approved for issue after the discovery of the error.

Consider this

While CCDs which are convertible into a fixed number of shares at the end of their term are in the nature of compound financial instruments, yet such transaction structures are usually unique in every case. Ind AS 32 requires an entity to assess the substance of a contractual arrangement rather than its legal form. Therefore, it is possible for an instrument that qualifies as equity for regulatory purposes, to be classified as a financial liability under Ind AS.

Future developments

The International Accounting Standards Board (IASB) has undertaken a project on Financial Instruments with the Characteristics of Equity. Through this project, the IASB aims to address challenges identified in IAS 32, *Financial Instruments: Presentation,* by establishing clearer principles for classifying financial instruments as either financial liabilities or equity, improving the clarity and consistency of the classification requirements for the more complex financial instruments that create a challenge in practice and enhancing the presentation and disclosures about financial liabilities and equity. Clarifications vide an exposure draft is expected in the following six areas:

- Classification of financial instruments that will or may be settled in the issuer's own equity instruments - e.g. the application of the fixed-for-fixed condition to particular derivatives on own equity and the classification of mandatorily convertible financial instruments
- Accounting for obligations to redeem own equity instruments - e.g. accounting for written put options on non-controlling interests
- Accounting for financial instruments that contain contingent settlement provisions - e.g. financial instruments with a non-viability clause
- The effect of laws and regulations on the classification of financial instruments
- Reclassification between financial liability and equity instruments - e.g. when circumstances change or contractual terms are modified, and
- Classification of particular financial instruments that contain obligations that arise only on liquidation of the entity - e.g. perpetual financial instruments.

Since the Ind AS are largely aligned with the IFRS, it is expected that these updates would be adopted in Ind AS as well. Accordingly, companies that have issued compound financial instruments should watch this space for further information.

CHAPTER 2

Audit of group financial statements

This article aims to:

Summarise key changes and considerations involved with an audit of group's financial statements.

Introduction

ISA 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the work of component auditors)* is an extension and revised version of ISA 600. The standard applies to an audit of group's financial statements (a group audit) and brings out special considerations that apply to a group audit, including in those circumstances when component auditors are involved.

ISA 600 (Revised) includes new and revised requirements and application material that aligns the standard with recently revised standards such as ISQM 1, *Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements;* ISA 220 (Revised), *Quality Management For An Audit Of Financial Statements* and ISA 315 (Revised 2019), *Identifying And Assessing The Risks Of Material Misstatement.* A group audit poses various challenges for an auditor specifically when group auditors are required to work with other component auditor(s).

The revised standard provides a new 'risk-based approach' to planning and conducting group audits. This approach will help drive greater focus by the group engagement team on their responsibility to identify and assess the risks of material misstatement of the group financial statements and to design and perform further audit procedures to respond to those risks, in order to obtain sufficient appropriate audit evidence in respect of the group audit as a whole. This is a fundamental responsibility of the group auditor and the standard places an increased emphasis on it.

The revised standard defines 'group' and 'component' and clarifies the applicability of the standard to wide range of group structures that exist e.g. shared service centers, entities with branches and divisions and non-controlled entities, including equity accounted investees and investments carried at cost.

The revised standard is effective for audits of group financial statements for periods beginning on or after 15 December 2023.

What's new

Some of the new requirements of ISA 600 are as follows:

- **Communication between group and the component auditor:** ISA 600 in its revised form reinforces the need for robust communication during the audit. The standard has been strengthened and clarified on the need for two-way communications between the group auditor and component auditors. These communications would include communication of relevant ethical requirements, determination of competence and capabilities of the component auditor, and determination of the appropriate nature, timing and extent of involvement by the group auditor in the work of the component auditor.

  The standard highlights group auditor's expectation that communications will take place at appropriate times throughout the group auditor.

- **Communication with group management and Those Charged with Governance (TCWG)**: The standard also places emphasis on the communications with group management and TCWG of the group. The revised standard specifies matters that a group engagement team is required to communicate to TCWG such as fraud or suspected fraud involving component management of the group and also ensure that information from component auditors relevant to the group has been communicated.

- **Revised definition of an engagement team:** ISA 600 (Revised) incorporates the revised requirements of other standards such as ISA 220 (Revised). ISA 220 (Revised) has issued the revised definition of an engagement team. As per the revised definition, an engagement team shall include all partners and staff performing the audit engagement, and any other individuals who perform audit procedures on the engagement, excluding an auditor's external expert and internal auditors who provide direct assistance on an engagement. Considering the revised definition, under ISA 600 (Revised), engagement team includes group auditor and component auditor and thus, the component auditor is required to perform the audit in compliance with all other ISAs, as relevant.
- **Enhanced role and responsibility of group engagement partner:** The changes brought by ISA 600 (Revised) and ISA 220 (Revised) together aim to clarify and enhance the role and responsibility of the (group) engagement partner, in particular, in respect of their responsibility to pro-actively manage and achieve audit quality at the engagement level (complementing ISQM 1 and ISQM 2).

  ISA 600 (Revised) emphasises the importance of professional skepticism. A group audit is required to direct, supervise, and review the work of engagement team members, including component auditors. This will help inform the group auditor about whether the engagement team has appropriately exercised professional skepticism.

  Also to evaluate whether sufficient appropriate audit evidence has been obtained (including by component auditors) to provide a basis for forming an opinion on the group financial statements.
- **Involvement of the component auditor:** The revised standard provides a framework for planning and performing a group audit engagement. The framework emphasises special considerations for establishing the overall group audit strategy and group audit plan and requires the group auditor to determine the nature, timing and extent of involvement of component auditors. It provides a robust framework for a component auditor's responsibilities with respect to the work to be performed on a component at the direction of the group engagement team, including communication with the group engagement team. It also highlights that component auditors can be, and often are, involved in all phases of the group audit including in risk assessment procedures.

  Establishing clear and sufficiently detailed instructions for the component auditors is fundamental for the planning and performance of the group audit as it will be the basis for the direction of the component auditors by the group engagement team throughout the audit engagement. As mentioned earlier, the standard emphasises the importance of two-way communication between group and component auditors throughout the audit.

Key considerations for management

The section below highlights some of the key considerations from management's perspective:

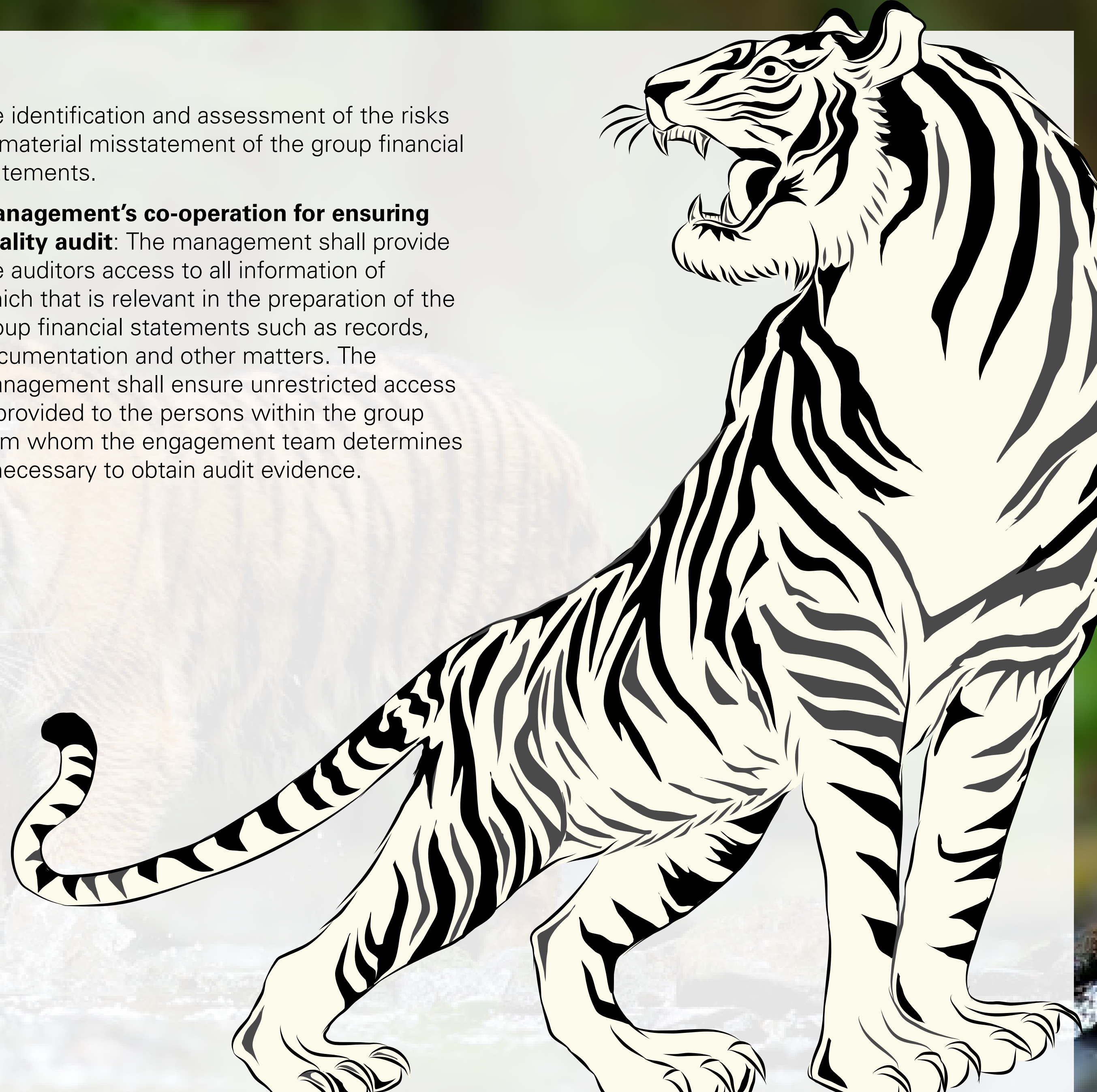
a. **Background and understanding of the business and the organisation:** The management is expected to provide complete information to the auditor regarding the organisation structure, business model, nature of operations including the locations at which the group has its operations or activities and extent to which the group's business model integrates the use of Information Technology (IT). The management should incorporate internal controls and communicate ethical and behavioral standards across the group (e.g., group-wide programmes, such as codes of conduct and fraud prevention programmes). The auditor should be informed regarding such internal controls, the extent of commonality of internal controls across the group. In case of shared service centers or service organisations are being used by the management, the same shall be informed to the group auditor to enable the auditor to plan the nature, timing and extent of the audit procedures to be performed.

b. **Communication of significant matters:** The management shall communicate significant matters that support the preparation of the group financial statements and related financial reporting responsibilities in the information system and other components of the group's system of internal control. The group auditor would also request the component auditor to communicate matters relevant to the group auditor's conclusion with regard to the group audit including significant deficiencies in internal control. Communications between regulatory authorities and entities or business units, including non-compliance or suspected non-compliance with laws or regulations that are relevant to the group audit should be communicated to the group auditor. The management should also discuss events or conditions identified by group management or component management that may cast significant doubt on the group's ability to continue as a going concern.

c. **Identification of related party relationships and transactions:** It is the primary responsibility of the group management to identify related party relationships and transactions and the same shall be communicated to the auditor. The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. In a group audit, there may be a higher risk of material misstatement of the group financial statements, including due to fraud, associated with related party relationships. Therefore, understanding the process for identifying related party relationships and related party transactions for reporting in accordance with the applicable financial reporting framework is imperative for a group auditor's understanding of the consolidation process and is an important consideration when component auditors are involved.

d. **Preparation of financial information/ statements:** The management shall be responsible for the preparation of the group financial statements. The management shall ensure whether uniform accounting policies are used to prepare the financial information of the components for the group financial statements and, if not, how differences in the accounting policies are identified and adjusted (when required by the applicable financial reporting framework). In order to achieve uniformity and comparability of financial information, the group management may issue instructions (e.g., communicate financial reporting policies) to the entities or business units that include details about financial reporting processes or may have policies that are common across the group. The group management should also incorporate a process for ensuring complete, accurate and timely financial reporting by the entities or business units in the group for the consolidation. Obtaining an understanding of group management's instructions is also important for the group auditor as it may affect the identification and assessment of the risks of material misstatement of the group financial statements.

e. **Management's co-operation for ensuring quality audit**: The management shall provide the auditors access to all information of which that is relevant in the preparation of the group financial statements such as records, documentation and other matters. The management shall ensure unrestricted access is provided to the persons within the group from whom the engagement team determines it necessary to obtain audit evidence.



Current scenario in India

In India, audit is conducted in accordance with Standards on Auditing (SAs) issued by the Institute of Chartered Accountants of India (ICAI). Currently, in a situation of a group with various components SA 600, *Using the Work of Another Auditor,* issued by ICAI permits the principal auditor to place reliance on the audit procedures performed by the component auditors in order to provide an opinion on the Consolidated Financial Statements (CFS) based on the audit report provided by the component auditors and comply by the principles and Guidance Note on Audit of Consolidated Financial Statements. Considering the auditing practices and conditions presently prevailing in India, ICAI would need to consider the requirements of the ISA 600 (Revised) and accordingly, decide whether it would be applicable in India.

Additionally, in case of listed companies, the Securities and Exchange Board of India (SEBI) through its circular dated 29 March 2019 has prescribed the procedure and formats for limited review report and audit report of the listed entity and its components to be followed by the statutory auditors of such entities. The circular reiterates that the audit and limited review of the respective components that are being consolidated with the parent company would continue to be undertaken by the respective auditors of such components. The parent company management is responsible to ensure that there is co-ordination between principal and component auditor to comply with the requirements of SA 600.

Further, the circular provides detailed procedures for the principal auditor or group auditor to consider while performing the audit/review of the components of the listed entity. The circular requires the principal auditor to communicate the requirement to the component auditor on a timely basis. It also provides the formats for limited review reports and audit reports to be submitted by the statutory auditors. These formats require principal auditor to assess that the audit/review of the components has been performed by the component auditor and ensuring that the principal auditor has performed the procedures as per the SEBI circular while relying on the work of the component auditor. The SEBI vide circular no. CIR/CFD/CMD1/80/2019 dated, 19 July 2019 has issued revised formats for limited review/audit report of the listed entities and those entities whose accounts are to be consolidated with the listed entity.

The bottom line

The new and revised requirements strengthen the group auditor's responsibilities relating to professional skepticism, planning, and performing a group audit and documentation. The introduction of the new risk-based approach would require a group auditor to determine an appropriate approach to planning and performing audit procedures to respond to the assessed risks of material misstatement of the group financial statements. Also, it reinforces the need for clear and regular communication between group and component auditors throughout the audit. The standard sets out explicit requirements for communication on specific matters between the group auditor and the component auditors.

CHAPTER 3

Regulatory updates

SEBI issues a consultation paper to extend the applicability of insider trading norms to the units of mutual funds

The Securities and Exchange Board of India (SEBI) (Prohibition of Insider Trading) Regulations, 2015 (PIT Regulations) are applicable to entities in case of dealing in securities that are listed or proposed to be listed. It casts disclosure requirements on certain specified individuals that are in possession of Unpublished Price Sensitive Information (UPSI).

The PIT Regulations are not applicable to the units of mutual funds. In the past, SEBI observed that there could be situations of misuse of sensitive non-public information pertaining to a scheme of mutual funds. Therefore, SEBI has issued a consultation paper on 8 July 2022 relating to applicability of PIT Regulations to mutual funds.

Some of the key proposals provided by the consultation paper are:

- **Securities and Trading definition:** To amend the definition of 'securities' to include mutual fund units also. The Trading definition to include 'redeeming' and 'switching'. Consequential amendments to be made to other definitions in the PIT Regulations e.g. UPSI, generally available information, connected person, designated person, systematic transactions.
- **Legitimate purposes:** Board of directors of an Asset Management Company (AMC) should make a policy for determination of legitimate purposes with the approval of the Trustees. The term 'legitimate purpose' shall include sharing of UPSI in the ordinary course of business by an insider with trustees, registrars and share transfer agents, custodians, valuation agencies, fund accountants, association of mutual funds of India, credit rating agencies, legal advisors, auditors or other advisors or consultants, provided that such sharing has not been carried out to evade or circumvent the prohibitions of these regulations.
- **New chapter:** Separate chapter titling 'Restrictions on communications in relation to, and trading by insiders in the units of mutual funds' to be inserted.
- **Reporting of transactions in mutual fund units by designated persons:** AMCs to disclose the details of holdings in the units of the mutual fund schemes held by the designated persons of AMC/trustees, their immediate relatives and any other person for whom such person takes trading decisions on an independent platform and on the date as specified by SEBI and to require disclosures on quarterly basis thereafter. Also, SEBI proposes to make reporting mandatory of all the trading of mutual fund units executed by the designated persons of AMC/trustees, their immediate relatives and by any other person for whom such person takes trading decisions. The reporting will be made to the compliance officer of AMC within seven calendar days from the date of transaction and to specify that all such transactions above value of INR10 lakh are to be disclosed by the AMC on an independent platform as decided by SEBI within 48 hours of receipt of the same.
- **Code of conduct:** To prescribe minimum standard of code of conduct for designated persons as Schedule B1 which will be in line with provisions of existing Schedule B of PIT Regulations. For every other person who is required to handle UPSI relating to a mutual fund scheme or its units in the course of business operations, it is proposed to make existing Schedule C of PIT Regulations applicable.
- **Closure period:** The compliance officer of the AMC shall determine the closure period during which a designated person or class of designated persons can reasonably be expected to have possession of UPSI, their immediate relatives and any other person for whom such person takes trading decisions cannot transact in units of the mutual fund. During such time, no request in transactions in the units of the mutual funds by the designated persons or those persons specified above shall be processed by AMC.
- **Pre-clearance of mutual fund transactions:** In case when the closure period is not applicable, pre-clearance by the compliance officer would be required, for trading in the mutual fund units by designated persons, their immediate relatives and any other person for whom such person takes trading decisions including for initiation of systematic transactions.

The consultation paper is open for public comments by 29 July 2022 on the proposal to cover dealings in units of mutual funds under PIT Regulations.

(Source: SEBI consultation paper on applicability of SEBI PIT Regulations to MF units dated 8 July 2022)

Guidelines on provisioning for investments in security receipts issued by RBI

The Reserve Bank of India (RBI) issued the Master Direction – RBI (Transfer of Loan Exposures) Directions, 2021 (MD-TLE) dated 24 September 2021. These are applicable to:

- all commercial banks (including small finance banks, local area banks and regional rural banks),
- primary (urban) co-operative banks/state co-operative banks/district central cooperative banks,
- all-India financial institutions,
- non-banking financial companies (including housing finance companies) on transfer of loans and exposures.

As per Clause 77 of the MD-TLE, investments by lenders in Security Receipts (SRs)/Pass Through Certificates (PTCs)/other securities issued by Asset Reconstruction Companies (ARCs) shall be valued periodically by reckoning the Net Asset Value (NAV) declared by the ARC based on the recovery ratings received for such instruments. This clause is applicable with two conditions, they are as follows:

- When transferors invest in the SRs/PTCs issued by ARCs in respect of the stressed loans transferred by them to the ARC, the transferors shall carry the investment in their books on an ongoing basis, until its transfer or realisation, at lower of the redemption value of SRs arrived based on the NAV as above, and the NBV of the transferred stressed loan at the time of transfer.
- When the investment by a transferor in SRs backed by stressed loans transferred by it, is more than 10 per cent of all SRs backed by its transferred loans and issued under that securitisation, the valuation of such SRs by the transferor will be additionally subject to a floor of face value of the SRs reduced by the provisioning rate as applicable to the underlying loans, had the loans continued in the books of the transferor.

The RBI has issued a circular on 28 June 2022, to provide a glide path for entities to ensure smooth implementation of clause 77 of the MD-TLE. The circular provides following in respect of the valuation of investments in SRs outstanding on the date of issuance of MD-TLE:

a. The difference between the carrying value of such SRs and the valuation arrived at as on the next financial reporting date after the date of issuance of MD-TLE, in terms of clause 77 of the MD-TLE, may be provided over a five-year period starting with the financial year ending March 31, 2022 - i.e. from FY2021-22 till FY2025-26.

b. Subsequent valuations of investments in such SRs on an ongoing basis shall, however, be strictly in terms of the provisions of MD-TLE.

- Further, as per the circular, all lending institutions shall put in place a board approved plan to ensure that the provisioning made in each of the financial years in compliance of clause 2(a) above is not less than one fifth of the required provisioning on this count.
- The valuation of investments in SRs made after the issuance of MD-TLE shall be strictly in terms of the provisions thereunder.
- All other provisions of the MD-TLE shall continue to be applicable, as hitherto.

(Source: RBI circular No. RBI/2022-23/78 DOR.STR.REC.51/21.04.048/2022-23 dated 28 June 2022)

ICAI issued revised Guidance Note on the Companies (Auditor's Report) Order, 2020 (Revised 2022 Edition)

The Companies Act, 2013 (2013 Act) requires auditors of specified class of companies to include a statement in their reports on specific matters as prescribed in the Companies (Auditors' Report) Order (CARO). In 2020, the Ministry of Corporate Affairs (MCA) issued a revised CARO (CARO 2020) which is applicable to wide range of companies for audits of financial years commencing on or after 1 April 2021. Consequently, the Institute of Chartered Accountants of India (ICAI) has issued a guidance note on CARO 2020 (guidance note) which provides guidance on application of the CARO 2020.

Further, to align the auditor's reporting requirement with the disclosures provided by the companies, on 24 March 2021, the MCA has issued a slew of amendments to Schedule III to the 2013 Act[1]. The amendments are effective from 1 April 2021.

The ICAI on 1 July 2022 has revised the Guidance note on CARO 2020 (Revised Edition 2022). The revised guidance has been issued to include the revised disclosure requirements of Schedule III amended by MCA and include other revised guidance and regulatory updates relating to CARO 2020.

The revised guidance has been issued to include the revised disclosure requirements of Schedule III amended by MCA and include other revised guidance relating to CARO 2020.

Following are some of the key changes:

a. **Applicability:** For companies following IGAAP (both AS and Ind AS entities), total income would now be considered as a criterion for applicability of CARO 2020 instead of total revenue.

   Additionally, for the purpose of verifying the applicability of CARO 2020 to Non-Banking Financial Companies (NBFCs), the revised guidance note has amended the definition of Reserves and Surplus in order to align the same with Schedule III and it now comprises of:

   - Capital Reserve
   - Securities Premium
   - Other Reserves (specify nature and purpose)
   - Retained earnings i.e., balance in statement of profit and loss.

b. **Clause 3(i)(c) – Title deeds held in the name of the company:** The revised guidance note provides that for reporting under this clause, Right of Use (ROU) assets covered under Ind AS 116, *Leases,* should be considered.

c. **Clause 3(iii)(c) - Regularity of repayment of principal and interests for loans granted:** Under this clause, the auditor is required to report in respect of loans and advances in the nature of loans, on stipulation of schedule of repayment of principal and payment of interest and on regularity of their repayments i.e., the principal and interest should normally be received whenever they fall due. The revised guidance note has modified the reporting format and added an additional column for actual date of payment.

d. **Clause 3(iii)(e) - Evergreening of loans/ advance in nature of loans granted:** The revised guidance note has modified the reporting format and added an additional column for gross amount of loans/advances in nature of loan granted during the year to those parties where the overdue amount was settled by renewal or extension or fresh loan.

e. **Clause (ix) - Reporting on repayment and usage of borrowings:** With respect to loans raised by a company against a pledge of securities held in its subsidiaries, associates and joint ventures, then the company would now be required to disclose the carrying amount of the securities pledged in the financial statements (including cross reference to the relevant note in the financial statements).

f. **Clause 3(xvi)(b) - Companies registered with RBI:** CARO 2020 requires an auditor to report on whether a company has conducted any non-banking financial or housing finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India (RBI) as per the RBI Act. The revised guidance note includes reference to the definition of Housing Finance Company' stated in the RBI Circular on 'Review of regulatory framework for Housing Finance Companies (HFCs)' dated 22 October 2020.

g. **Clause (xix) - Reporting on financial position:** As per the existing set of requirements, auditors, based on review of liquidity ratios of the company, were required to report on whether material uncertainty exists as on the date of the audit report. However, now instead of review of liquidity ratios, auditors would need to form an opinion based on the financial ratios disclosed by the company.

(Source: ICAI revised Guidance Note on the Companies (Auditor's Report) Order, 2020 (Revised 2022 Edition, July 2022)

1. Schedule III to the 2013 Act provides general instructions for presentation of financial statements of a company under both AS and Ind AS.

ICAI issues Technical Guide on financial statements of Limited Liability Partnerships

Limited Liability Partnership (Amendment) Act, 2021 has prescribed that the Central Government may, in consultation with the National Financial Reporting Authority (NFRA) prescribe the standards of accounting as recommended by ICAI for a class or classes of Limited Liability Partnerships (LLPs). The Accounting Standards (AS) for LLPs are yet to be notified by the Central Government and, currently for the purpose of preparation and presentation of the financial statements, the LLPs shall apply accounting standards prescribed by the ICAI. The AS issued by ICAI for the non-company entities effective 1 April 2020 would be applicable.

While the accounting standards lay down recognition and measurement principles for the events, transactions and various elements of the financial statements and also prescribes disclosures and presentation aspects for the same, the formats for presentation of financial statements have not been prescribed. In June 2022, ICAI has issued a Technical Guide on 'Financial Statements of Non-Corporate Entities' which prescribes formats for the preparation of the financial statements for all noncorporate entities except LLPs which are corporate form of entities.

Considering above, the Accounting Standards Board (ASB) of the ICAI issued a separate Technical Guide to prescribe formats of the financial statements for the preparation and presentation of the financial statements for LLPs. The technical guide provides the format for the balance sheet, cash flow statement and profit and loss account. The format is largely based on the format provided by Schedule III – Division I (financial statements for a company required to comply with the Companies (Accounting Standards) Rules, 2006) with certain modifications and excludes items which are not relevant for LLPs.

Further, for the purpose of applicability of Accounting Standards, non-company entities are classified into four categories, viz., Level I, Level II, Level III and Level IV. The technical guide also includes the criteria for classifying LLPs under these categories. The criteria for entities to be classified as Level I, II, III and IV have been provided in the technical guide along with the applicability of AS and exemptions/relaxations to such entities.

(Source: ICAI Technical Guide on Financial Statements of Limited Liability Partnerships, June 2022)

Release of educational material on Ind AS 34, *Interim Financial Reporting*

Ind AS 34 prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period.

This standard applies if an entity is required or elects to publish an interim financial report in accordance with Indian Accounting Standards (Ind AS).

Recently, Accounting Standards Board (ASB) of ICAI has formulated an educational material on Ind AS 34. which seeks to provide guidance by way of Frequently Asked Questions (FAQs) to explain the principles enunciated in the standard. The educational material aims to provide guidance to stakeholders on content of an interim financial report, application of the recognition and measurement principles to an interim financial report and various other aspects related to such report. It also covers the major differences in Ind AS 34, from IAS 34, *Interim Financial Reporting* and AS 25, *Interim Financial Reporting*.

(Source: Educational material on Ind AS 34 issued by ICAI on 4 July 2022)

FASB issues an update on fair valuation measurement guidance for equity securities

Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurement* states that when measuring the fair value of an asset or a liability, a reporting entity should consider the characteristics of the asset or liability, including restrictions on the sale of the asset or liability, if a market participant also would take those characteristics into account.

However, some stakeholders noted that Topic 820 contains conflicting guidance on what the unit of account is when measuring the fair value of an equity security which resulted in diversity in practice on whether the effects of a contractual restriction that prohibits the sale of an equity security should be considered in measuring that equity security's fair value. Some stakeholders apply a discount to the price of an equity security subject to a contractual sale restriction, whereas other stakeholders consider the application of a discount to be inappropriate under the principles of Topic 820.

To address the issue, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) that clarifies the principles when measuring the fair value of an equity security subject to a contractual sale restriction and improve current GAAP by reducing diversity in practice, reducing the cost and complexity in measuring fair value, and increasing comparability of financial information across reporting entities that hold those investments.

The ASU clarified that a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. The ASU also clarifies that an entity cannot, as a separate unit of account, recognise and measure a contractual sale restriction. The ASU has also introduced certain new disclosure requirements for equity securities subject to contractual sale restrictions:

1. The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet
2. The nature and remaining duration of the restriction(s)
3. The circumstances that could cause a lapse in the restriction(s).

Effective Date: The amendments in this update are effective for public business entities for fiscal years beginning after 15 December 2023, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after 15 December 2024, and interim periods within those fiscal years.

Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.

(Source: Accounting Standard Update No. 2022-03 dated June 2022 by FASB)

First Notes

MCA issues narrow scope amendments to Indian Accounting Standards

5 May 2022

In view of the recent amendments to IFRS, and in order to keep the Ind AS converged with IFRS1, the Ministry of Corporate Affairs (MCA) issued certain amendments to Ind AS2 vide a notification dated 23 March 2022 (2022 amendments). These amendments have been issued in the areas mentioned below:

- Ind AS 16, Property, Plant and Equipment - Accounting for proceeds before intended use
- Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets - Determining costs to fulfil a contract
- Ind AS 103, Business Combinations - Reference to the Conceptual Framework for Financial Reporting
- Annual improvements to Ind AS (2021)
  - Ind AS 101, First-time adoption of Indian Accounting Standards
  - Ind AS 109, Financial Instruments
  - Ind AS 41, Agriculture

This issue of First Notes provides an overview of the 2022 amendments.

On 21 July 2022, KPMG in India released its 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) for the quarter ended 30 June 2022.

To access the publication, please click here.

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