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cutting through complexity

Voices on Reporting

27 August 2014

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Welcome

Voices on Reporting

- Series of knowledge sharing calls
- Covering current and emerging reporting issues
- Scheduled towards the end of each month
- Look out for our Accounting and Auditing Update and First Notes publications

Your speakers

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Topics for today

1. **Financial Instruments (2014) – An overview**

2. Related party transactions – the Companies Act, 2013

Journey of the Financial Instruments (FI) project

- Project to replace IAS 39, *Financial Instruments: Recognition and Measurement,* launched in 2008
- Implementation of the project was planned in three phases
- The IASB released various versions of IFRS 9, *Financial Instruments,* in piecemeal as under:
  - IFRS 9 (2009) – classification and measurement: financial assets
  - IFRS 9 (2010) – classification and measurement: financial liabilities
  - IFRS 9 (2013) – general hedge accounting.

IFRS 9 (2014) – the complete standard, replaces the earlier versions of IFRS 9

- It includes:
  - Amendments to classification and measurement requirements in the previous versions of IFRS 9
  - A new impairment model.
- It retains from IAS 39:
  - The scope of the standard and the recognition and de-recognition requirements with minor amendments.
- It amends IFRS 7, *Financial Instruments: Disclosures,* and introduces new or amended disclosures.

Classification and measurement of Financial Assets (FAs)

Overview

- One classification approach for all types of FAs, including those that contain embedded derivative features
- FAs' classification is based on two criteria:

Objective of the business model in which assets are managed	Contractual cash flow characteristics
▪ To hold financial assets in order to collect contractual cash flows ▪ To sell financial assets ▪ To both collect contractual cash flows and sell financial assets.	▪ Identify whether contractual cash flows represent Solely Payments of Principal and Interest (SPPI).

- IFRS 9 (2014) has three primary measurement categories for financial assets. These are:
  - Amortised cost
  - Fair Value through Other Comprehensive Income (FVOCI)
  - Fair Value Through Profit or Loss (FVTPL).

Overview (cont.)

- The key characteristics of each of the measurement categories are summarised below:

Amortised cost	FVOCI	FVTPL
▪ Cash flows represent SPPI ▪ FAs are held in a business model whose objective is to hold them in order to collect contractual cash flows.	▪ Cash flows represent SPPI ▪ FAs are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.	▪ Assets are irrevocably designated as at FVTPL to reduce accounting mismatches.

Differences from the current practice

- Although measurement categories are similar to the ones under IAS 39, the basis of classification is significantly different.

Classification and measurement of Financial Liabilities (FLs)

Overview

- Two classification categories:
  - Amortised cost
  - Fair Value Through Profit or Loss (FVTPL).
- Gain or loss on a financial liability designated as FVTPL, attributable to changes in credit risk, is presented in Other Comprehensive Income (OCI).

Differences from the current practice

- IFRS 9 (2014) retains substantially all requirements from IAS 39 on classification and measurement of financial liabilities
- Gain or loss on a financial liability designated as FVTPL, attributable to changes in credit risk, is presented in OCI.

New impairment model

Overview

- The new impairment model moves away from the 'incurred loss' model to 'expected credit loss' model
- Dual measurement approach is followed requiring recognition of either:

12-month expected credit loss

(if the credit risk of a FA has not increased significantly since its initial recognition)

⇄

Lifetime expected credit loss

(if the credit risk of a FA has increased significantly since its initial recognition)

- Simplified approach will be available for certain trade and lease receivables, and for contract assets.

Differences from the current practice

- Impairment allowance will cover both incurred credit losses and (some) expected future credit losses
- Impairment trigger is no longer required before impairment allowance is recognised
- The model is applicable to debt instruments measured at amortised cost or at FVOCI, certain guarantees, loan commitments, and lease and trade receivables, but not to equity investments.

Hedge accounting

Overview

- A more principles-based approach that aligns hedge accounting more closely with risk management
- Additional exposures may qualify as hedged items, for example, components of non-financial items, net positions, layer components, etc.
- New requirements to achieve, continue, and discontinue hedge accounting, for example, elimination of bright lines to assess hedge effectiveness.

Differences from the current practice

- New fair value option model for managing credit risk
- Alternative fair value option model for certain own-use contracts
- Time value of purchased options, forward element of forward contracts, and foreign currency basis spreads may be deferred or amortised
- Additional disclosure requirements regarding an entity's risk management and hedging activities.

Key sectors that may be impacted

Banking, insurance, and leasing companies

- IFRS 9 (2014) may have a significant impact on the classification and measurement of:
  - Financial assets held by banks, e.g. those held to meet various liquidity needs
  - Financial assets held by insurance companies to fund their insurance liabilities, or to match the duration of their longer-term insurance liabilities
- Far reaching implications are expected due to the new impairment model
- For leasing companies, the impact of the new impairment model will likely depend on the type of leases and the impairment approach elected.

Other corporates

- Limited impact on corporates is expected owing to new classification and measurement requirements, although investment portfolios are expected to be affected
- Corporates will likely see a limited impact for trade receivables due to the new impairment model.

All sectors are likely to get impacted by the new disclosure requirements.

Effective date

- IFRS 9 (2014) is applicable from annual periods beginning on or after 1 January 2018
- The standard applies retrospectively, with some exceptions
- Early application is permitted
- No convergence with U.S. GAAP.

Possible next steps for companies

- Re-look at the entire range of financial instruments that a company may be holding including re-assessment of all agreements
- Determine the business model as a first step
- Compute the impact on profitability and key metrics, including communication with stakeholders on the key impact areas
- Build capacity and align systems to achieve ‘business as usual’.

Topics for today

1 Financial Instruments (2014) – An overview

2 **Related party transactions – the Companies Act, 2013**

Key changes in the framework for related party transactions

Upto 31 March 2014, the reporting framework of related parties was primarily driven by AS 18 which mandated only 'disclosure' of certain related party transactions.

The universe of related parties and transactions covered under the Companies Act, 2013/the SEBI clause 49 expanded; clarifications on the definition of related party was issued by the MCA.

Approval process has been made more stringent: audit committee approval, board approval, and shareholders' approval are required in certain cases. Upto 31 March 2014, the only requirement under the erstwhile Equity Listing Agreement was for the audit committee to 'review' related party transactions.

Requirements for 'ordinary course of business' and arm's length pricing have come into place for all related party transactions. Earlier, requirement for arm's length pricing was prescribed under the Income Tax Act, 1961 for international transactions and specified domestic transactions.

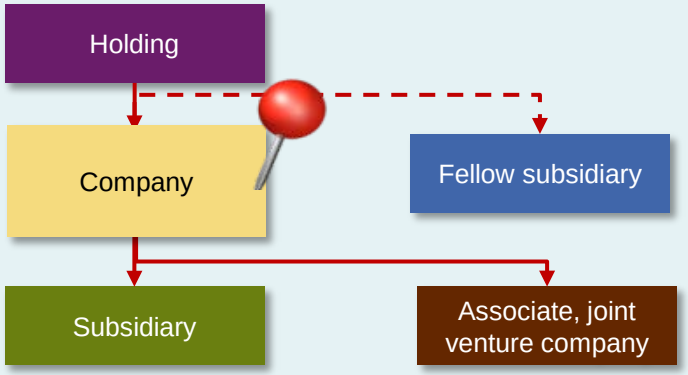
Increased reporting requirements for related party transactions to the Board, and on quarterly basis to the SEBI.

Draft notification providing relief to private companies from the requirements of Section 188 has been issued. Accordingly, Boards' and shareholders' approvals may not be required.

Shift from requiring the Central Government's approval to an emphasis on the shareholders' approval

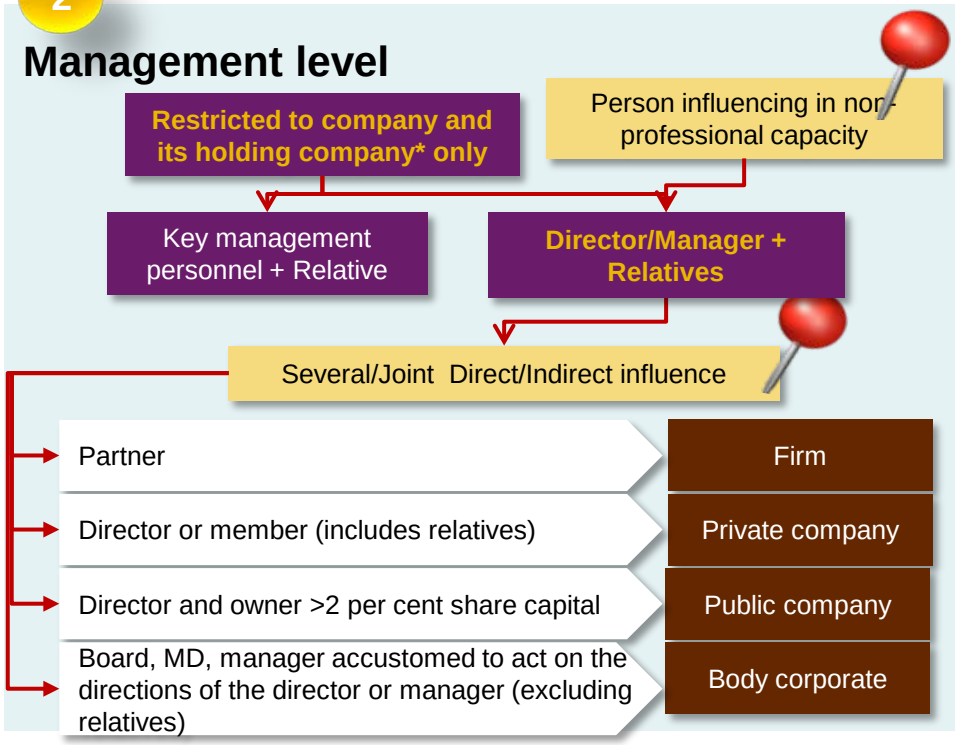
Universe of related parties

1 Company level

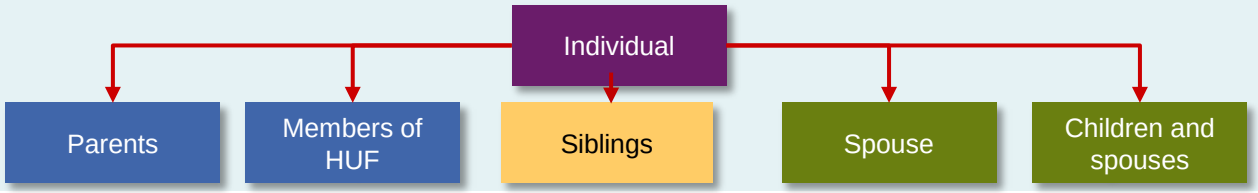


SEBI's definition enhanced to cover additional parties (e.g. person/entity having control, joint control, or significant influence on the company and fellow joint ventures/ associates, etc.)

2 Management level

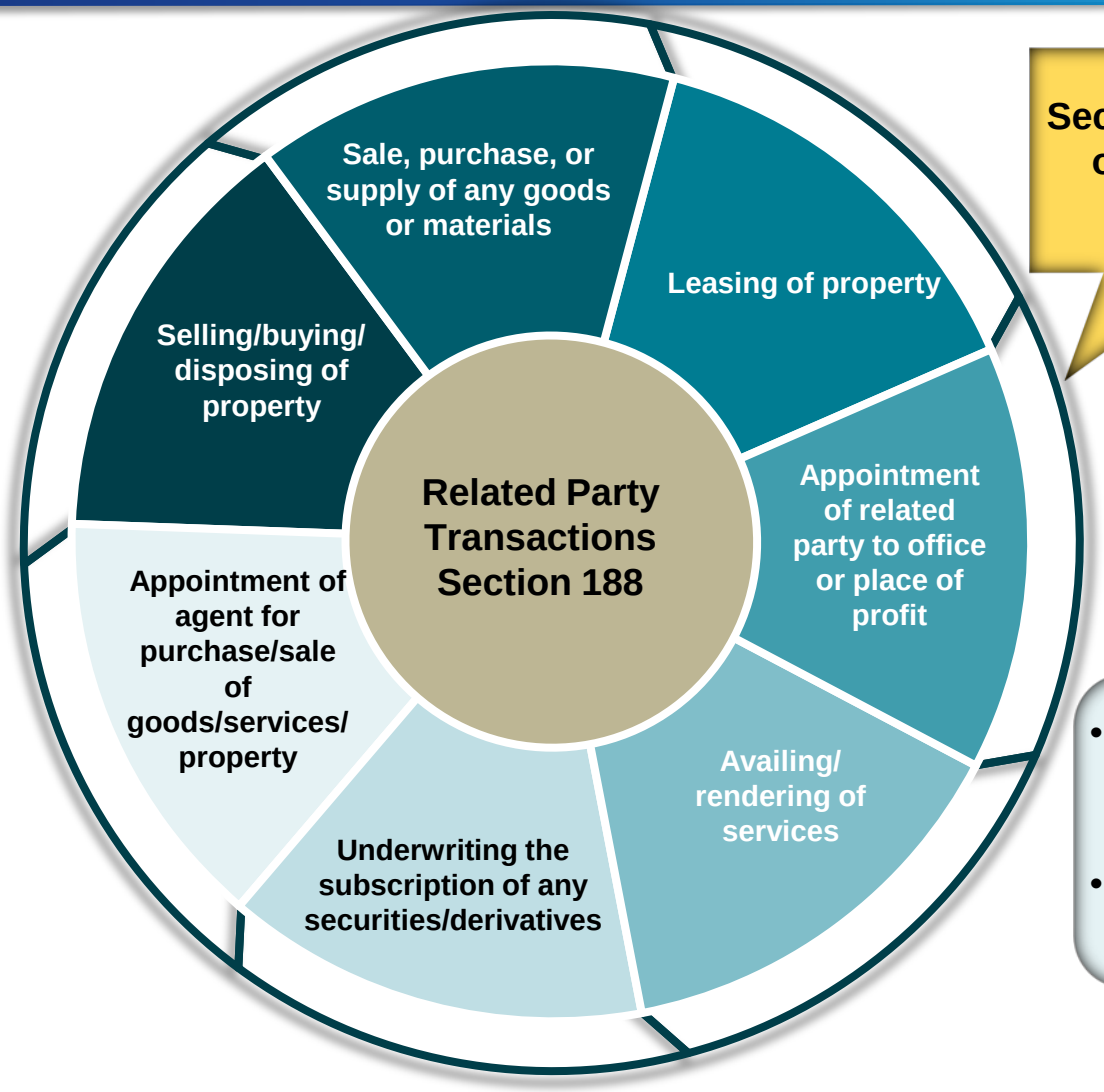


3 Relatives



*Independent directors of holding company are excluded

Universe of related party transactions



Section 188 is a subset of all related party transactions

- Section 177 covers <u>all transactions</u> with related parties, whether covered under Section 188 or not
- Clause 49 also covers transactions even if no price is charged

Related party transactions - Approval process under the Companies Act, 2013

For certain specific transactions and arrangements (given in the following table), section 188 of the 2013 Act requires approval by the Board and/or shareholders through special resolution if such transactions are not at arm's length or not in the ordinary course of business.

Prescribed transaction categories	Existing requirements	Amended Rules
Sale, purchase or supply of any goods or material (directly or through an agent)	Exceeding 25 per cent of annual turnover	Exceeding 10 per cent of turnover or INR1 billion, whichever is lower*
Selling or otherwise disposing of, or buying property of any kind (directly or through an agent)	Exceeding 10 per cent of net worth	Exceeding 10 per cent of net worth or INR1 billion, whichever is lower*
Leasing of property of any kind	Exceeding 10 per cent of net worth or 10 per cent of turnover	Exceeding 10 per cent of net worth or 10 per cent of turnover or INR1 billion, whichever is lower*
Availing or rendering of any service (directly or through an agent)	Exceeding10 per cent of net worth	Exceeding 10 per cent of turnover or INR500 million, whichever is lower*
Appointment to any office or place of profit in the company, subsidiary company or associate company	Remuneration exceeding INR0.25 million per month	No change
Underwriting the subscription of any securities or derivatives of the company	Remuneration exceeding one per cent of net worth	No change

*Applies to transaction or transactions to be entered into either individually or taken together with the previous transactions during a financial year.

Related party transactions - Approval process under the Companies Act , 2013

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Companies Act requirements
Applies to all companies (both listed and unlisted)

All transactions require prior audit committee approval

Transactions under section 188 - Not in the ordinary course of business/not at arm's length

Board approval required

Other cases if certain thresholds are met (see previous slide)

Special resolution at general meeting required: voting by members other than interested related party

Transactions under section 188 - Ordinary course of business and at arm's length

No further approval required

Contract voidable at the option of the Board if not ratified within 90 days

Directors interested personally liable for loss caused to company

Related party transactions - Approval process under the Companies Act , 2013

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1. Arm's length transaction is a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

2. Ordinary course of business is not defined under the Act. However, based on the review of the broad set of parameters on which the phrase has been interpreted by the courts, and other sources both in India and globally, the following instances may classify a particular activity as being treated as being in the ordinary course of business

- Transactions that are reasonable in the context of business
- Transactions that are necessary, normal, and incidental to the business
- Transactions that are customary and happen with certain frequency
- Transactions that are part of the standard industry practice, even though the particular entity in question may not have done it
- Transactions that are not part of the pre-dominant business of the party may be considered in the normal course of business if it is related to such pre-dominant business
- Activities that are infrequent but important to the central mission can arguably be 'in the ordinary course of business'.

Related party transactions - Approval process under SEBI requirements

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Clause 49 requirements (incremental)
Listed companies

All transactions (even if no price charged) requires prior audit committee approval

Material transactions (Higher of five per cent of turnover and 20 per cent of net worth)

Special resolution at general meeting required via voting by members other than related parties

Not material transactions

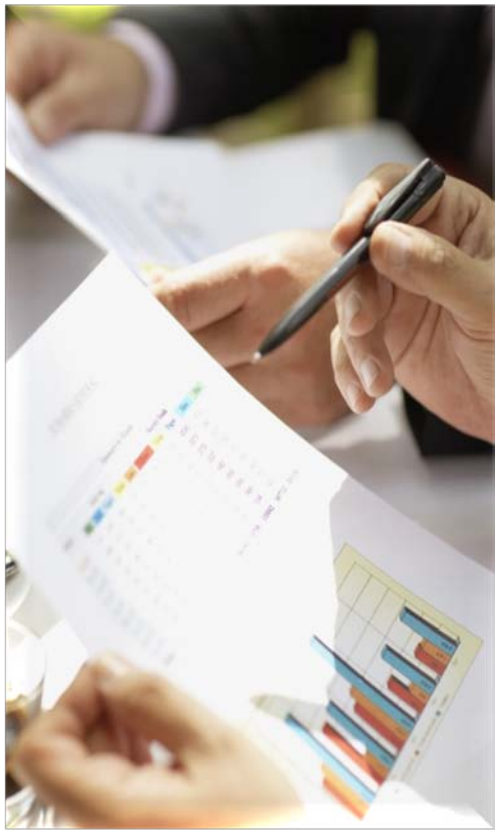
No further approval required

SEBI corporate governance norms

- Scope of the definition of RPT widened and includes person with joint control or significant influence on the company and fellow joint ventures and subsidiaries of entity having influence
- Shareholders to approve all material RPTs (special resolution)
- All existing material related party contracts or arrangements that would continue beyond 31 March 2015 should be approved by shareholders at the first general meeting after 1 October 2014.

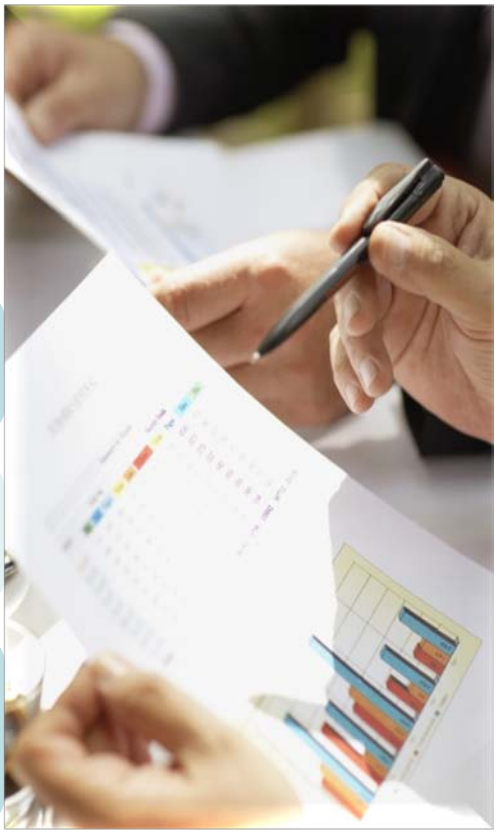
Key practical challenges faced by companies

- What will be the impact on existing related party contracts such as those approved under section 297 of the Companies Act, 1956?
- How should a company approach the pre-approval process?
- What constitutes 'ordinary course of business'?
- Can arm's length price be linked to transfer pricing norms?
- How would the approval process work in case of transactions with fellow subsidiaries or joint venture companies?
- Should consolidated or standalone amounts be considered in evaluating transaction materiality?



Key practical challenges faced by companies

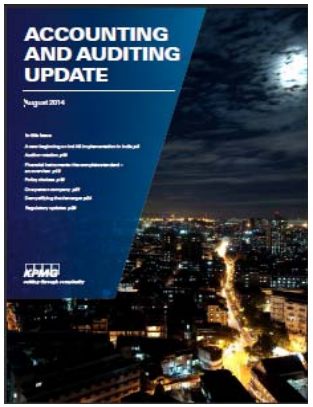
- Should all transactions with a party, or all transactions of a similar nature be grouped in evaluating materiality?
- What would be the period of validity of shareholders' approval for continuing transactions?
- How should the term 'accustomed to act' be interpreted?
- How should the term 'close member of family' under revised clause 49 be interpreted?
- Form AOC-2 requires disclosure of material related party transactions in the Board's report. What do we mean by 'material'?



Q&A

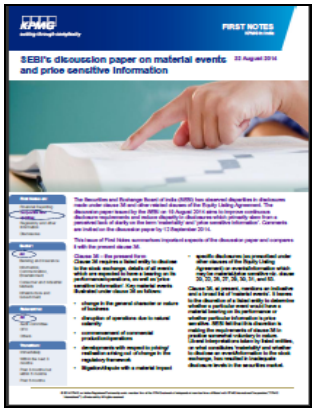
Topics discussed in AAU and First Notes

Accounting and Auditing Update



- A new beginning on Ind AS implementation in India
- Auditor rotation
- Financial instruments: the complete standard – an overview
- Policy choices
- One person company
- Demystifying the demerger
- Regulatory updates

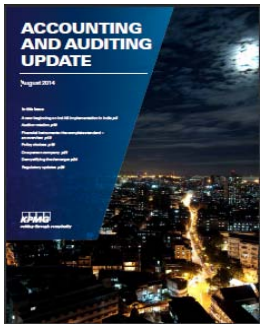
First Notes

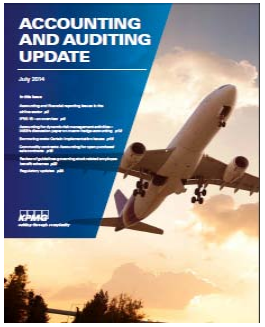


The Securities and Exchange Board of India (SEBI) has observed disparities in disclosures made under clause 36 and other related clauses of the Equity Listing Agreement. The disparity primarily stems from a perceived lack of clarity on the term 'materiality' and 'price sensitive information. The SEBI has issued a discussion paper on 19 August 2014 to improve continuous disclosure requirements and reduce disparity in disclosures. Comments are invited on the discussion paper by 12 September 2014. Our First Notes summaries important aspects of the discussion paper and compares it with the present clause 36.

Others

Missed an issue of the Accounting and Auditing Update?





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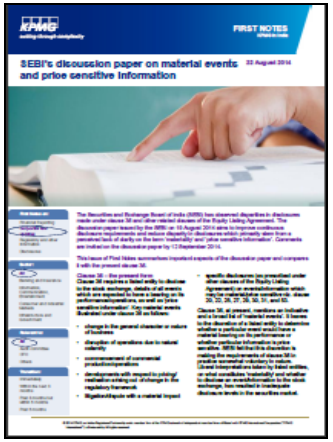
Missed an issue of the First Notes?



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Coming up next

September 2014

Latest issue of:

- **Accounting and Auditing Update**
- **First Notes**
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