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A trail where corporate India needs to focus

The Ministry of Corporate Affairs ("MCA"), in its attempt to improve transparency of financial reporting has amended the Companies (Accounts) Rules, 2014. So, what was this notification, and why did it stir up so much concern? The notification requires companies which maintain their books of account using an accounting software to have a feature of recording audit trail of each and every transaction and to have an edit log of every change made in books of account along with the date when the changes were made and ensuring the audit trail cannot be disabled. The difficulty of implementation of this five-line notification can be gauged from the fact that the original applicability of this notification, which was 1 April 2021, has been postponed twice, first to 1 April 2022 and then to 1 April 2023. Whilst this seems to have been drafted from a very simplistic perspective and expectation, the ramifications percolate through many aspects, which may require immediate consideration and are covered below.

Before we get to the aspects, let us understand what is an audit trail? An audit trail has not been defined but can be colloquially understood to be a chronological sequence of the history of a particular transaction, tracking who created/changed a record, what record, what time etc. Audit trails amongst others may help in investigating frauds, system breaches etc., and hence are extremely essential tools of monitoring and surveillance for organizations.

What has changed? – Do organizations currently maintain audit trails?

Maintaining audit trails is an integral part of any complex IT system like SAP, Oracle, etc. It exists even today, and organizations use it because it is mission critical for certain applications. For e.g., a bill of material application or a payroll application may have detailed audit trails due to the criticality of the applications. Sometimes, certain regulators may require an audit trail to be maintained e.g., the Good Manufacturing Practices (GmP) requirements applicable overseas in the Pharma sector needs [1]audit trail for certain data. The change

1 Source: https://www.fda.gov/media/119267/download

vide this notification is that each and every company, irrespective of size and complexity, would need an audit trail to be maintained. For instance, consider a company that has one building with five lessees where five invoices get generated every month or another company which has a transmission contract in which the amount to be billed for next 20 years is mentioned in the contract. Such companies currently may invest in simple book-keeping software, whose only purpose is to keep an electronic record of transactions. IT systems can differ from, for e.g., a large automobile company which has a complex system of products, vendors, labor contractors, taxes, etc. So, the change is that companies, which earlier had a choice of deciding what type of IT systems to use depending on its needs and also a choice on deciding the type of data which they needed an audit trail for, now have limited choices.

Books of account – what is the breadth of coverage?

Section 2(13) of the Companies Act, 2013 defines books of account. It is a very broad definition which encompasses every record maintained in respect of financial statements. So, inventory records, production records, book to physical adjustments etc., would be part of books of account and would need to be covered and for which audit trail would need to be maintained. Companies do not find it relevant to maintain an audit trail on each and every item of the financial statements and its supporting processes, the reason being that it is expensive to store the trail records. Further, such audit trails need to be monitored, else they may not have any value. If mission critical aspects of a business are looked at in the same lens as non-mission critical, the costs of monitoring would go up significantly and the effectiveness could reduce.

What does an accounting software cover?

The term accounting software means software used for maintenance of books of account. With the definition of books of account being so broad, each and every software used will get covered. The notification seems to assume that every aspect of the business is run on one software, which is far from true. Companies use multiple software within the entire business chain which have interfaces with the main accounting system and the robustness of these software varies depending on business needs, costs, etc. For instance, the company may feel that its Fixed Asset Register needs to be maintained on MS Excel Spreadsheets considering its size of operations/nature of business. Requiring every software used in business to have features as is expected by the notification would mean significant effort to make these systems ready, only to comply with the requirements of the notification.

Software of companies operating as part of international chains

There would be many companies which operate as part of international chains. For e.g., a company in the business of hotels run by an international chain generally uses robust software created for room revenues, food, and beverage etc., which are tested centrally. Local companies which own the hotels may not be permitted to make any changes to these software and the extent of data visibility at the backend in terms of trails etc., may be visible only centrally at the Parent level of these operating international chains. It may be extremely difficult for local companies to get access to such data.

Ability of companies to invest in such software systems and cost of maintaining audit trail

All businesses are not set up with the best-in-class IT systems. It is only when an organization matures that it finds the ability to invest in good IT systems. Also, the cost of these IT systems does not involve only one time cost. They also include expensive upgrades, IT hardware, security systems, among others. For e.g., expecting a startup or a company deep in losses to continue to invest in IT systems may not be a fair expectation since such companies are thin on financial resources. Also, the audit trail and its storage would have a cost associated to it, which means larger the items and fields for which trails are to be maintained more would be the cost of storage.

The reason for this notification and its background is not available in the public domain. So, there may definitely be some genuine concerns which regulators may have faced during their regulatory inspections which have driven these changes. But the issues highlighted above indicate that implementing this notification in its current form would result in significant hardships for corporates. Hence, this notification would require significant clarity regarding possible situations and expectation of regulators for foreseeable situations. At a broad level, MCA may consider clarifying some of the following aspects listed below:

- Summary of the expectations with respect to audit trails, especially with respect to assessing their effectiveness in achieving the desired goals.
- Interplay with the internal controls with reference to financial statements e.g., considering certain regulations like Sarbanes Oxley in the US, which provide generic requirements on audit trail.
- Practical expedients for certain non-complex entities which are small in size, having transactions within the group.
- The aspects/fields of accounting software which should have an audit trail.
- The guidance may include a summary of the expectations with respect to audit trails especially with respect to assessing their effectiveness in achieving the goals as required by MCA.
- The statutory auditors are required to specifically report on audit trail. Specific reporting considerations of the auditors may be clarified.

What are the next steps for companies and auditors:

- Take an inventory of software in use by the company during the year.
- Identify the processes which are relevant from a financial statement perspective.
- Identify critical elements in each of the processes for which IT logs changes/ trail may be required.
- Discuss the data requirement with the software vendors and the possibility and cost of generating and maintaining data.
- Discuss the approach for compliance with the MCA requirements with the Board/Audit Committee and the auditors.
- Identify areas/processes/elements in the processes for which trail is not possible/not feasible etc.
- Assess reporting implications, both in the financial statements and in the auditor’s report.

02

Key performance indicators – communicating the measures that matter

In the offer documents, along with audited financial numbers, issuer companies disclose various key performance metrics/ indicators which are not covered in the financial statements e.g., sales per square foot/meter by entities in the retail sector, refinery utilization. These Key Performance Indicators (KPIs) are disclosed in numerical measures indicating different aspects of issuer company's operational performance. Presently, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ('ICDR Regulations') provides a detailed framework for disclosure of information in the offer document, including financial information and information relating to [2]basis for issue price. SEBI noted that issue price/ price band is decided primarily basis certain factors, including trends in KPIs over the past years. However, no framework has been provided in the ICDR Regulations for disclosure of KPIs. Accordingly, ICDR Regulations were amended on 21 November 2022 to provide certain disclosures relating to KPIs in the offer document under the basis for issue price section of an offer document.

This article summarizes the key amendments to ICDR Regulations and the glide path that may be followed by companies for moving toward good practices of improving their communication with stakeholders.

Need for disclosure of KPIs

Traditional financial parameters/ ratios currently required to be disclosed in basis for the issue price section of an offer document represents typical evaluation criteria for companies that take profits into consideration. Even for such companies, KPIs would additionally aid the investors in taking better and more informed decision for investment in the said company. Further, the traditional parameters do not exactly correlate with the companies who are yet to turn profitable or who are seeking to scale up their business in the coming years. New age technology/ startup companies opt for scale over profits in their growth phase and thus, generally break even over a long business cycle. Contrary to established businesses, scale is often considered being the means for profit rather than profit being the primary objective of such companies in the initial years of their operations.

Thus, appropriate disclosures on all parameters that are relevant for assessing the issuer's performance (for both profitable and loss-making companies) are required for helping investors to take informed decision. SEBI felt a need to disclose KPIs, be it profit or loss making, in their offer documents.

2 Para 9(K) under Part A of Schedule VI of ICDR Regulations

Accordingly, ICDR Regulations were amended to provide a framework for disclosure of KPIs under the basis for issue price section of an offer document. The ICDR Regulations do not prescribe a list of KPIs that should be included. The identification and computation of KPIs have been left to the judgement of the issuer company. The ICDR Regulations also provide that the basis for issue price section of an offer document should contain prescribed matters e.g. cross reference of KPIs disclosed in other sections of the offer document to be provided on the basis for issue price section of the offer document.

ICDR Regulations further provide that the issuer company should continue to disclose KPIs disclosed under the basis for issue price section on a periodic basis at least once in a year (or any lesser period as determined by the issuer company). The duration of such disclosure should at least be later of:

- One year after the listing date or period specified by SEBI; or
- Till the utilization of the issue proceeds as per the disclosure made in the objects of the issue section of the prospectus.

Adequate look-back period

SEBI observed that while there is an in-principle agreement for prescribing a look back period, there were divergent views regarding what would constitute an adequate duration for look back. KPIs disclosed at previous rounds of fund-raising before the IPO may no longer be relevant considering the rapidly changing business environment. Also, KPIs provided to different pre-IPO investors may have been different, based on their specific internal fund requirements and therefore it should be at the discretion of the issuer to decide as to which KPI is material or relevant at the time of IPO.

However, leaving it to the discretion of the issuer company to decide the relevant and material KPIs that may be susceptible to subjective decision. Disclosure of all the KPIs previously disclosed to pre-IPO investors would aid the prospective investors with the same insight that the pre-IPO investors had, before investing in the IPO. It would bring greater alignment and transparency between the information available pre-and-post IPO.

Accordingly, the ICDR Regulations now require that basis for issue price section of offer document should include disclosure of all the KPIs pertaining to that have been disclosed to the investors at any point of time during the three years preceding to the date of filing of the draft red herring prospectus/ red herring prospectus. The issuer company, in consultation with the lead merchant banker, may make disclosure of any other relevant and material KPIs as it deems appropriate, that have a bearing for arriving at the basis for issue price.

Enhanced monitoring and governance

ICDR Regulations were amended to prescribe additional responsibilities on the issuer company and the lead merchant bankers for all KPIs disclosed in the offer document such as ensuring that:

- Terms used in KPIs have been defined consistently and precisely in the definitions and abbreviations section of the offer document using simple English terms/phrases to enable an easy understanding of the contents. Technical terms, if any, used in explaining the KPIs shall be further clarified in simple terms.
- KPIs disclosed in the offer document have been approved by the Audit Committee.
- KPIs disclosed in the offer document should be comprehensive and explanation should be provided on how these KPIs have been used by the management historically to analyze, track, or monitor the operational and/or financial performance of the issuer company.
- Comparison of KPIs over time should be explained based on additions or dispositions to the business, if any. e.g., in case the issuer company has undertaken a material acquisition or disposition of assets / business for the periods that are covered by the KPIs, the KPIs should reflect and explain the same.
- For each KPI being disclosed in the offer document, the details thereof should be provided for a period which will be co-terminus, with the period for which the restated financial information is disclosed in the offer document.

Audit Committee of the issuer company is required to provide a confirmation that verified and audited details for all the KPIs that have been disclosed to the earlier investors at any point of time during the three years period prior to the date of filing of the draft red herring prospectus/ red herring prospectus have been disclosed under basis for the issue price section of the offer document. Such confirmation should be disclosed under the basis of issue price section in the offer document.

Further, the issuer company and the lead merchant banker should obtain a recommendation from a committee of independent directors that the price band is justified based on quantitative factors/KPIs disclosed in the basis for issue price section vis-à-vis the weighted average cost of acquisition of primary issuance/ secondary transaction(s) disclosed in such section. Such recommendation is required to be disclosed in the price band advertisement.

Independent assurance of KPIs

While discussing with expert bodies including the Institute of Chartered Accountants of India and Institute of Cost Accountants of India, SEBI noted that members of some of the expert bodies can certify KPIs for financials (disclosed in accordance with applicable accounting framework), financial measures which are not defined under accounting framework, as well as the non-financial measures which are quantitative information that are obtained from the accounting records and are subjected to same controls as those financial measures.

Accordingly, ICDR Regulations were amended to provide that KPIs disclosed in the offer document should be certified by the statutory auditor(s) or chartered accountants or firm of charted accountants or by cost accountants holding a valid certificate issued by the Peer Review Board of the respective expert body. The certificate issued with respect to KPIs should be included in the list of material documents for inspection.

Also, the ongoing KPIs post listing (as discussed in the paragraph - Need for disclosure of KPIs) would continue to be certified by a member of an expert body in the same manner.

Glide path to effective communication of KPIs

An issuer company may consider the following common aspects while disclosing KPIs in an offer document. These considerations provide companies with a sound basis for moving towards good practice, as they seek to improve their communication with stakeholders.

Link to strategy

Linking KPIs with the strategies and objectives, as a measure that depicts business performance, enables readers to assess the company and its potential to succeed. KPIs presented in isolation cannot fulfill the desired objective and will fail to provide the reader with the level of understanding they need.

Source, assumptions and limitations

Identify the sources of the data used in calculating KPIs and any limitations on that data. Consider the robustness of IT/systems, processes, and controls. Any assumptions made in measuring performance should be explained so that readers can reach an informed view of judgements made by management.

Definition/ calculation

Given the rapidly increasing usage of industry-specific terminology, clear definitions of KPIs add greatly to the reader's understanding of exactly what is being measured and allow comparisons. With companies applying their own indicators, an explanation of the components of a metric and how it is calculated is vital.

Reconciliation to GAAP

Where the amounts measured are financial but are not commonly known measures in the context of financial statements, it is good practice to explain any differences. A reconciliation should therefore be provided between accounting measures and non-GAAP measures.

Purpose

It is important for management to explain - what makes a performance indicator "key"? The starting point for choosing which performance indicators are key to a particular company could be those that the Board of Directors uses to manage the business and use as inputs to make key decisions.

Changes in KPIs

Comparability over time is a key principle of good corporate reporting. When changes are made to the KPIs, either in terms of the KPIs used or how they are calculated - these changes need to be explained.

How we look at it

On the back of heightened IPO activity followed by lackluster performance and subdued IPO activity over the last 18 months, the above amendments seem to be an effort to bolster investor confidence and bring more transparency to IPO pricing process through increased disclosures by reducing the information asymmetry between the issuer and the investor. Indian capital markets are taking a lead in the level of disclosure issuer companies are required to make in relation to KPIs.

Companies should carefully evaluate and determine what would be categorized as KPI for them, the relevant industry benchmarks, the appropriateness of KPIs (especially modifying GAAP recognition and measurement principles to produce non-GAAP measures) that best depicts business performance and impacts the basis of issue price.

The committee of independent directors would need to recommend that the price band is justified based on quantitative factors / KPIs. This puts an onerous responsibility on independent directors since providing such recommendation would generally involve exercise of significant judgement by such directors.

It is imperative to build a firm foundation by considering existing and prospective industry practices, processes, and controls, and defining a governance framework for ongoing communication with current and prospective investors.

03

How analytics can help in better insights, improved governance and enhance decision making

By 2030, the world will enter the 6G era – an intelligently autonomous, sensory, massively distributed but highly networked world that blends our physical, digital, and human systems. Data will be created on an unimaginable scale, changing how we collaborate, convene, create, and contextualize.

We always knew how important transformation was to an organization's enduring success. For decades, this process of organizations changing their operations to improve performance and drive sustainable growth was episodic. Every few years, shifts in market sentiment or stakeholder demands would push leaders to make incremental changes to adapt, or to reimagine their organization from the ground up.

However, over the last few years, there has been a shift in the nature and speed of transformation. According to 82% of board members and CEOs in the EY 2021 Global Board Risk Survey, market disruptions have become more frequent and impactful. To keep pace, companies have begun to transform more frequently. The need to transform – and to do so continuously in the face of disruption – is now critical for organizations to survive.

This article summarizes how analytics can help in better insights, improved governance and enhance decision making.

Deeper business insights

We are entering a new era of data centricity, with over half of senior executives now identifying data and analytics as their top investment priority. This shift is enabled by a sophisticated new tech stack of cloud, Artificial Intelligence ('AI') and the Internet of Things - the top technology priorities for transformation leaders. The most successful technology transformations put human - committed leadership and empowered employees - at its center.

The use of data has been of critical importance to companies for many years. The current trend in data analytics is also opening new possibilities and opportunities, thanks to increasing technical sophistication and steadily lower barriers to entry. Companies can establish a competitive advantage over peers by monetizing financial and non-financial data from a wide range of sources. They can also present their contribution to society based on data, or address changes in market conditions earlier and more proactively, as well as derive value-added decisions from them using driver-based management models.

Supercharged by emerging technologies, the world is entering an entirely new generation of data and analytics. Not tomorrow, right now 53% of senior executives have identified data and analytics as their top investment priority in the next two years based on a survey conducted by EY Global. This is an increase of 50% since 2020. These next generation analytics would just appear out of the ether. They will be built on a flexible, agile, and fast-evolving combination of technology, ecosystems, and talent.

Data is emerging as the strategic currency of the digital age. It will be generated based on the success of how humans work together across an enterprise, including functions, data and analytics teams and technology, to drive a cultural shift. In fact, using advanced data analytics is no longer a purely voluntary decision. External stakeholders, such as investment funds, analyst firms, consumers, employees and, of course, activists, are using freely accessible external data to analyze companies across various dimensions. This harbors the risk that companies which do not intensively use data analytics can be overrun by external analytics results. This could lead to unwanted public attention with regard to their business activities and change the way customers perceive them. It could also result in better forecasts of its actual market potential by third parties, etc.

Evolved finance function to improve governance

To focus on long-term growth, CFOs need to use forward-looking measures in tandem with backward-looking KPIs like return on invested capital.

Companies today operate in an extremely dynamic environment. The time available to respond to any changes is becoming shorter and shorter. The role of the CFO has taken on a new importance in helping companies navigate through change processes. On the one hand, CFOs are responsible for external reporting and, in many cases, for the preparation, interpretation and management of (financial) information. Accordingly, the finance function's documentation tasks are being replaced by a strong focus on added value.

Advanced data analytics is regarded as the new gold. In the past, it was difficult to identify and quantify the specific added value and actual results of effective data management. However, as the costs and accessibility of AI, cloud services and other analytical instruments are steadily declining, and there is greater clarity about key analytical areas, the targeted use of data analytics is increasingly becoming a focal point for many companies. Today, no company can afford to ignore the potential advantages of data analytics for business decision-making processes, for example, regarding an improved profit margin or stronger customer loyalty. The prime objective of data analytics is to obtain more detailed information and draw conclusions to flow into ongoing operations in a timely and targeted manner. Clear responsibilities and governance structures in the various functions and business segments are key to successfully unlocking the value potential of data.

While converting data into insights is a technical task, the translation of insights into added value requires a sound understanding of the business and financial impact. The finance function has always been responsible for translating financials into business activity, and already works in a cross-functional manner by monetizing each of the company's actions, options, and activities. Ultimately, it is in the unique position of being able to collect data from every area of the company as well as to process and present this data for management decisions. CFOs today are expected, from an internal management perspective, to provide real-time insights from data of all types, also increasing beyond the scope of purely financial insights. To this end, the finance function requires access to structured financial data, as well as other structured company data and unstructured market data. Only by doing this can the finance function use analytics to map complex value relationships, influence their impact on financial ratios, simulate potential scenarios, and reliably predict relevant market developments.

A key objective of the finance function will therefore be to align quality assertions in the financial statements with the data available on the market. In contrast to external analysis, the CFO must always be in a position to gain deeper insight, access better information and make more accurate forecasts than external parties. The establishment of a management and analytics model is necessary to allow for prompt reporting on key value drivers.

Creating new opportunities

Advanced data analytics is often perceived as an opportunity to address business challenges with the aid of new technology. It can also be used in the finance function to create the following added value for the company:

Enhancing customer lifetime value

Customer lifetime value (CLV) is a key management ratio to measure the contribution margin that customers or customer groups realize during the entire course of their "lifetime." A significant factor that affects CLV is the customer's trust in a brand or company. The traditional parameters for calculating CLV (customer loyalty, product mix, product margin, age, purchasing power) are no longer relevant. Only a few years ago, customer loyalty primarily depended on direct product experiences and marketing. Now customers can use analytics solutions to gather information on every conceivable aspect of a product and promptly change their assessment.

One example of such an analytics solution is Codecheck, a free service that provides information on harmful ingredients in foodstuffs and cosmetics. The app scans the barcode of products and instantly provides a rating regarding the origin, the ingredients used and how healthy or unhealthy they are. Codecheck receives the required information for these assessments from institutions, such as the EU Commission or the California Department of Public Health. This guides purchasing decisions without companies influencing the process. Consequently, a control measure based on CLV must not only include the financial ratios, but especially also include external analytics on product, brand, and consumer ratings under the customer loyalty parameter.

Reducing cost of capital

A company's cost of capital also highlights the significance of analytics for the finance function. While the cost of capital mainly depended on a company's creditworthiness and economic perspectives in the past, the increasing importance of sustainability and other social factors are causing the spotlight to shift to "green funding." Institutional investors all over the world over are intensely pressuring companies to operate ethically and sustainably. Analytics allow investors to gain extensive insights into a company's environment, social and governance (ESG) footprint using data freely available on the market. Companies that fail to perform adequate data analysis in this context may be unpleasantly surprised by external findings about their company and suddenly face a drop in investor interest and the rising cost of capital.

Moreover, ESG scorecards and ratings are gaining increasing weight in the context of available capital. This is already affecting access to and the cost of capital to a large extent.

Management of reputation risks

Classic reputation risks often arise as a result of global-scale scandals, which prompt customers to reassess a company. But advanced data analytics increase the possibility that even smaller scandals can be aggregated to a larger overall picture. Or analytics can allow external parties to question or refute assertions in companies' sustainability reports. This may not stir up scandals with significant public impact, but a reputation risk may creep in.

Glide path for implementation

The use of advanced data analytics as part of the finance function is based on the following three critical success factors:

- Firstly, a clear strategic direction must be developed for the use of advanced data analytics. Together with an integrated change management initiative, necessary change processes can then be implemented. A clear, future-oriented target state is necessary and must combine the strategic and technological components of a company-wide uniform data utilization system. This can be closely monitored by management with strong leadership support.
- Secondly, companies will need a flexible culture and work methodology with interdisciplinary teaming. The ideal team will have a broad range of core competencies, from data scientists, programmers, and business analysts through on-call experts. These skillsets will be able to address specific questions and drive the project forward with new approaches, value-creating innovations, and data-based decisions. The right team composition thus forms the link between the strategy and the operational challenges of the company as a whole, including IT and the finance function.
- The third success factor is the right infrastructure and architecture for analytics tools and methods. Strategically valuable information can be extracted from a pool of structured and unstructured internal and external data using statistical models, algorithms and cloud-based tools and solutions. Using specific mathematical methods and toolsets enable companies to model future scenarios and automate decision-making aids. Machine learning, AI, data, and process mining as well as sentinel and semantic analysis make it possible to integrate internal data with enriched external data. This combination can produce reliable new findings that can be used to derive KPIs and create company-wide added value.

How we look at it

Now more than ever, CFOs have the means of contributing to the success of their companies in a sustainable manner thanks to solid data analysis. In this way, the finance function's key focus will shift from a unit primarily providing internal transparency and transactional services to that of a business partner providing added value.

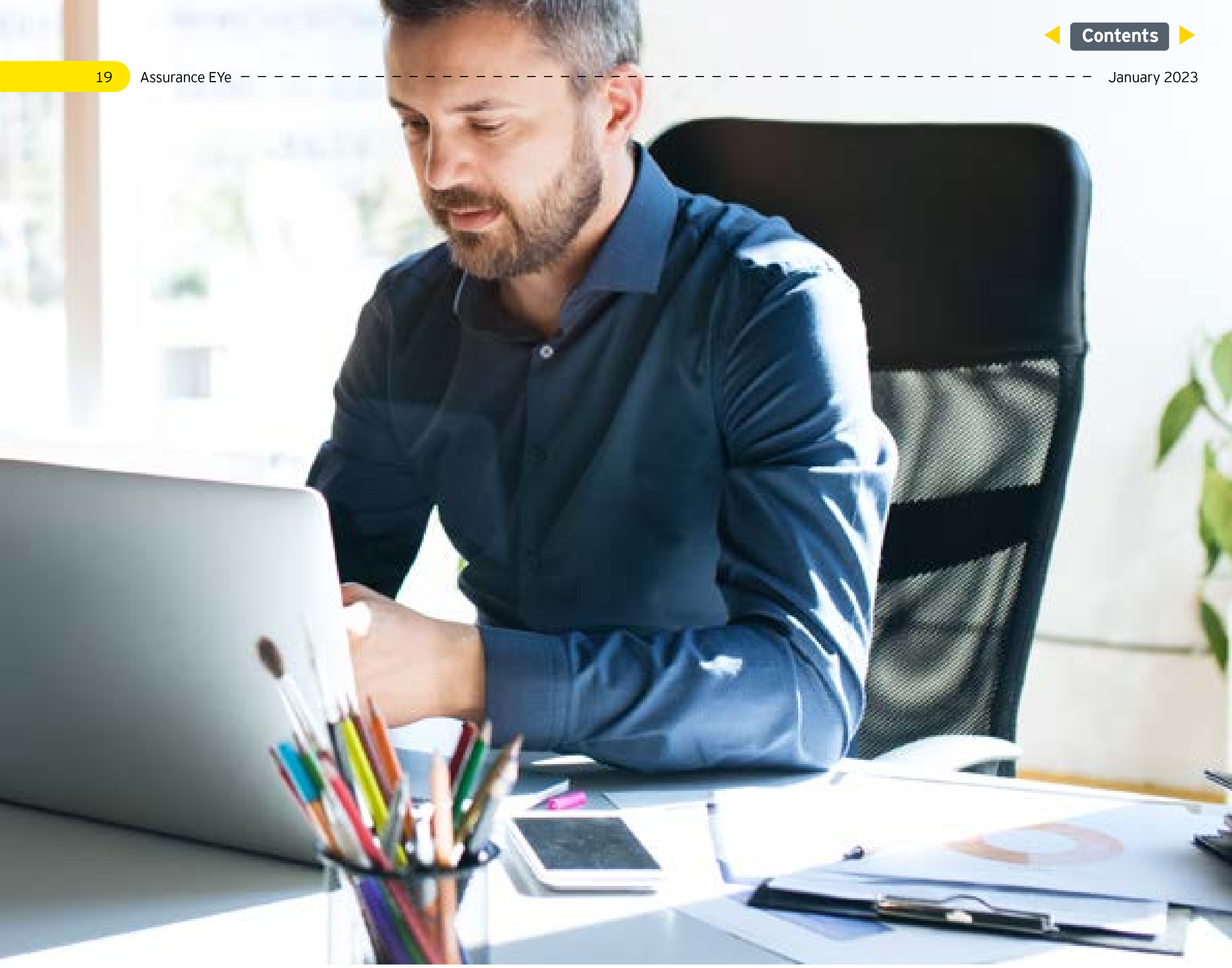
Business partnering will be decisive for companies using advanced data analytics, allowing them to strengthen their market position, by making advanced data analytics an integral part of their DNA. Largely basing their decisions, forecasts and communication on data analytics means they can become the kind of company that stakeholders expect them to be. Not only does the company benefit internally from better and fact-based decisions, but it is regarded as a reliable partner on the market by consumers, investors, employees, and other stakeholders.

In a world shaped by constant change, it is critical that CFOs collaborate on the corporate strategy and help communicate it to stakeholders on the basis of well-balanced information. Data analytics can contribute decisively toward achieving this objective and will be a, if not the, cornerstone for valuable contribution by CFOs.

In the dynamic world, advanced data analytics in their finance function is imperative. Data usage contains opportunities and risks for an enterprise, creating a need for corporate data strategy. CFOs can leverage data to gain benefits for their company on an internal as well as external front.

04

Accounting solutions



This section provides practical application issues with reference to ESOP trust, discontinued operations, and disclosure of commercially sensitive information.

Accounting for employee share ownership plan (ESOP) trust in the separate and consolidated financial statements

Fact pattern

Entities frequently establish employee share ownership plan trusts, which are generally legally constituted trusts, for their employees, whereby the employees are able to buy shares in the entity on favorable terms, or to receive them free. The ESOP trust may hold shares issued by the entity or bought in the open market.

One of the reasons for using a trust is that the employer (or sponsoring) entity may be prohibited under local legislation from holding shares itself.

If existing shares are used, they are often purchased by the ESOP trust financed by a loan from the employer (or sponsoring) entity. The ESOP trust can repay the loan out of the proceeds of the exercise of options by employees, with any shortfalls paid by the employer.

Issue

How is an ESOP trust accounted for in the separate financial statements and in the consolidated financial statements of the employer (or sponsoring) entity?

Point of view - consolidated financial statements

The question of whether the sponsoring entity consolidates the ESOP trust depends on whether the trust is 'controlled' by the sponsoring entity. This requires an assessment of the control criteria under IND AS 110 *Consolidated Financial Statements* to determine if the ESOP trust should be consolidated.

If the trust is treated as an extension of the employer (or sponsoring) entity (see below), its assets and liabilities will already be included in the financial statements of the employer entity that are used for preparing the consolidated financial statements of the group. If the trust is not accounted for as an extension of the employer (or sponsoring) entity, the parent will need to assess whether the trust, as a separate vehicle, needs to be consolidated according to IND AS 110.

Point of view - separate financial statements

If the ESOP trust is treated as a separate entity, the separate financial statements of the employer/sponsoring entity must show transactions and balances with the trust, rather than the transactions, assets and liabilities of the trust.

If the ESOP trust is treated as a direct extension of the employer/sponsoring entity, the transactions, assets and liabilities of the trust are included in the separate financial statements, as if they were those of the employer/sponsoring entity itself.

The following points outline the accounting treatment in the consolidated financial statements where the parent treats the trust as an extension of its own activities, or where the trust is consolidated as a group entity and in the separate financial statements of the employing/sponsoring entity where it treats the trust as an extension of its own activities;

- Until such time as the entity's own shares held by the ESOP trust vest unconditionally in employees:
  - any consideration paid for the shares is deducted in arriving at shareholders' equity in accordance with IND AS 32 *Financial Instruments: Presentation*.
  - the shares are treated as if they were treasury shares when calculating earnings per share under IND AS 33 *Earnings per Share*.
- Assets and liabilities (including borrowings) of the ESOP trust are consolidated as assets and liabilities in the consolidated financial statements of the sponsoring entity if the sponsoring entity 'controls' the trust in accordance with IND AS 110 and included in the separate financial statements of the sponsoring entity if the trust is treated as an extension of that entity.
- Consideration paid or received for the purchase or sale of the entity's own shares in an ESOP trust may be shown as separate amounts in the statement of changes in equity.
- No gain or loss is recognized in the Statement of Profit and Loss on the purchase, sale, issue, or cancellation of the entity's own shares.
- Finance costs and any administration expenses are charged as they accrue and not as funding payments are made to the ESOP trust.
- Any dividend income arising on own shares is excluded in arriving at profit before tax and deducted from the aggregate of dividends paid and proposed. Entity may disclose the deduction if material.

Classification of equity accounted investment as discontinued operations

Fact pattern

Entity A holds a 25% investment in the equity of Entity B. This investment in Entity B is accounted for by Entity A using the equity method as applied under IND AS 28 *Investments in Associates*. This investment also meets the requirements for classification as a non-current asset held for sale under IND AS 105 *Non-current Assets Held for Sale and Discontinued Operations*.

Issue

Could an equity accounted investment in an associate (as defined in IND AS 28 *Investments in Associates*) or an equity accounted investment in a joint venture (as defined in IND AS 111 *Joint Arrangements*) which has been classified as held for sale also meet the requirements to be classified as a discontinued operation?

Point of view

Paragraph 32 and Appendix A of IND AS 105 define a 'discontinued operation' as:

"A component of an entity that either has been disposed of, or is classified as held for sale, and:

(a) represents a separate major line of business or geographical area of operations,

(b) is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) is a subsidiary acquired exclusively with a view to resale." [emphasis added]

Appendix A of Ind AS 105 further defines the term 'component of an entity' as:

"Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity."

Paragraph 31 of Ind AS 105 elaborates on this definition, stating "....... *In other words, a component of an entity will have been a cash-generating unit or a group of cash- generating units while being held for use."*

A discontinued operation may also be a 'disposal group', which Ind AS 105 defines in Appendix A as *"A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction ..."*

On this basis, it is highly unlikely the definition of a discontinued operation would be met by a single non-current asset. Accordingly, while classified as held for sale, the investment in an associate accounted for by Entity A using the equity method is highly unlikely to meet the conditions required to be classified as a discontinued operation as defined in IND AS 105. Only in very rare circumstances would it be expected that such an equity accounted investment, while classified as held for sale, would represent a separate major line of business or geographical area of operations and therefore meet the conditions required for classification as a discontinued operation.

Non-disclosure of commercially sensitive information or information that can be seriously prejudicial for an entity

Fact pattern

Management is concerned that disclosing certain information required by IND AS either in their segment note or within other parts of their financial statements might give new insights to competitors, suppliers, customers and employees that could harm the entity's competitive position.

Issue

Is an entity required to provide all disclosures required under IND AS even when that information is commercially sensitive or that disclosure would be seriously prejudicial to that entity?

Point of view

IND AS does not permit exclusion of required disclosures based on potential competitive harm.

The objective of IND AS 1 *Presentation of Financial Statements* is to establish principles for reporting financial information to help users of financial statements better understand the entity's past performance, better assess the entity's risks and returns, and make informed judgments about the entity. Paragraph 16 of IND AS 1 states:

"....An entity shall not describe financial statements as complying with IND ASs unless they comply with all the requirements of IND ASs."

Paragraph 20 of IND AS 108 *Operating Segments* provides the following core principle of segment reporting:

"An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates."

Reference can also be made to Paragraph BC44 of IFRS 8 *Operating Segments*, which states:

"The Board concluded that a 'competitive harm' exemption would be inappropriate because it would provide a means for broad non-compliance with the IFRS. The Board noted that entities would be unlikely to suffer competitive harm from the required disclosures since most competitors have sources of detailed information about an entity other than its financial statements."

In paragraph 92 of IND AS 37 *Provisions, Contingent Liabilities and Contingent Assets* there is a specific exception to the requirement to make all disclosures, even when potentially commercially sensitive or detrimental to the entity.

"In extremely rare cases, disclosure of some or all of the information required by paragraphs 84 to 89 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed."

Similarly, Ind AS 24 Related Party Disclosures provides the following:

4A Related party disclosure requirements as laid down in this Standard do not apply in circumstances where providing such disclosures would conflict with the reporting entity's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

4B In case a statute or a regulator or a similar competent authority governing an entity prohibits the entity to disclose certain information which is required to be disclosed as per this Standard, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings."

The fact that the MCA has provided specific exceptions, including exception in IND AS 37 it supports the conclusion that disclosure is required unless an exception is provided explicitly.

Considering above guidance, it seems an entity is required to provide all disclosures required under IND AS, even when the entity believes that the information is commercially sensitive or potentially detrimental to the entity, unless there is an explicit exemption or exception.

05

Regulatory updates

SEBI updates

Amendments to issue of capital and disclosure norms

SEBI has amended the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 to inter alia introduce an alternate method of filing draft IPO document. Pursuant to this alternate method, an issuer will have an option to keep the offer document confidential from the public by initially filing the draft offer document with SEBI as per the prescribed conditions.

These amendments are effective from the date of publication in the Official Gazette i.e., 21 November 2022. To access the SEBI notification, click here.

Amendments to SEBI Listing Regulations

SEBI has amended SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 to inter alia:

- Introduce alternate mechanism for appointment and/ or removal of Independent Directors in entities having listed specified securities.
- Incorporate provisions pertaining to schemes of arrangement for entities having listed non-convertible debt securities/non-convertible redeemable preference shares.

These amendments are effective from the date of publication in the Official Gazette on 14 November 2022. To access the SEBI notification, click here.

Further, in relation to the scheme of arrangement by entities having listed non-convertible debt securities/ non-convertible redeemable preference shares, SEBI has:

- Prescribed the operational aspects relating to scheme of arrangement e.g., format of auditor's certificate while submitting a scheme of arrangement. To access the SEBI circular, click here.
- Clarified that the provisions of the above SEBI circular would not apply in prescribed situation. To access the SEBI circular, click here.

Relaxations from compliance with certain provisions of listing regulations

Relaxations from dispatch of hard copy of Annual Report and other documents as prescribed under Regulation 36(1) and Regulation 58(1) of the SEBI Listing Regulations for entities having listed specified securities/ listed non-convertible convertible securities respectively was available till 31 December 2022. SEBI has now decided to extend these relaxations till 30 September 2023. To access the SEBI circulars click here.

SEBI Board meeting

SEBI on 20 December 2022 has taken certain decisions, including amendments to:

- SEBI (Buy-back of Securities) Regulations, 2018 to streamline the process of buy-back, create a level playing field for investors and promote ease of doing business e.g., buy-back through stock exchange route to be phased out gradually, increasing the minimum utilization of the amount earmarked for buy-back through stock exchange route from existing 50% to 75%.
- SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 to:
    - Facilitate sustainable finance while safeguarding against 'greenwashing' (e.g., specification of basic dos and don'ts relating to green debt securities, to address issuers against 'green-washing' related risks.
    - Provide certain regulatory interventions for Corporate Bond market e.g., Issuers of listed debt securities should incorporate suitable provisions in their Articles of Association, to cast an obligation on the Board of Directors of the issuer to appoint the person nominated by its Debenture Trustee as a director in the event of default. Corresponding amendments are to be made in the Debenture Trust Deed. The existing listed debt issuers are required to take necessary steps by 30 September 2023.
- SEBI (Real Estate Investment Trusts) Regulations, 2014 and SEBI (Infrastructure Investment Trusts) Regulations, 2014 to streamline certain provisions e.g., tenure of auditor to be till the conclusion of the 5th annual general meeting of unit holders.

To access the SEBI Board Meeting, click here.

Review of timelines for listing of certain securities issued on a private placement basis

SEBI vide circular dated 30 November 2022 has inter alia brought clarity and standardization in the process of issuance and listing of certain securities on private placement basis (including non-convertible securities) by detailing a list of steps involved in pre/post-listing and by detailing relevant timelines both through Electronic Book Provider platform and otherwise. To access the SEBI circular, click here.

Minimum holding by sponsors/ sponsor group in REITs

SEBI has amended SEBI (Real Estate Investment Trusts) Regulations, 2014 to inter alia provide that sponsor(s) and sponsor group(s) should collectively hold a minimum of 15% of the total units of the REIT for a period of at least 3 years from the date of listing of such units pursuant to initial offer on a post-issue basis. These amendments are effective from the date of publication in the Official Gazette, i.e., 9 November 2022. To access the SEBI notification, click here.

Inclusion of units of Mutual Funds under SEBI Insider Trading norms

SEBI has amended SEBI (Prohibition of Insider Trading) Regulations, 2015 to cover dealings in units of Mutual Funds under the above Regulations so as to harmonize the regulatory provisions governing trading in securities, when in possession of Unpublished Price Sensitive Information. These amendments are effective from the date of publication in the Official Gazette i.e., 24 November 2022. To access the SEBI notification, click here.

Ring-fencing of assets and liabilities of schemes of an Alternative Investment Fund ('AIF')

SEBI has amended (Alternative Investment Funds) Regulations, 2012 to inter alia provide that the Manager and either the trustee or the trustee company or the Board of Directors or designated partners of the AIF, as the case may be, should ensure that the assets and liabilities of each scheme of an AIF are segregated and ring-fenced from other schemes of the AIF; and bank accounts and securities accounts of each scheme are segregated and ring-fenced. These amendments are effective from the date of publication in the Official Gazette on 15 November 2022. To access the SEBI notification, click here.

MCA update

Extension of timelines for conducting Annual General Meeting (AGM)/ Extra Ordinary Meeting (EGM) through electronic means

MCA have issued circulars relating to following:

- Companies whose AGMs is due in the year 2023 are allowed to conduct AGM through video conference or other audio-visual means on or before 30 September 2023 as per the prescribed framework. To access the MCA circular, click here.
- Allowed companies to conduct their EGMs through video conference or other audio-visual means or transact items through postal ballot upto 30 September 2023 as per the prescribed framework. To access the MCA circular, click here.

RBI updates

Disclosure of divergence in asset classification and provisioning

RBI vide notification dated 11 October 2022 has amended the RBI (Financial Statements - Presentation and Disclosures) Directions, 2021 to inter alia provide that a bank should make disclosures prescribed in these Directions, if either or both of the following conditions are satisfied:

- Additional provisioning for non-performing assets ('NPA') assessed by the RBI exceeds 10% of the reported profit before provisions and contingencies for the reference period and

- Additional Gross NPAs identified by the RBI exceed 10% of the reported incremental Gross NPAs for the reference period.

These amendments come into effect for disclosures in the notes to the annual financial statements of the year ending 31 March 2023 and onwards. To access the RBI notification, click here.

Disclosure of material items

RBI vide notification dated 13 December 2022 has inter alia decided that commercial banks should also disclose the particulars of all items in the notes to accounts wherever any item under the Schedule of Other Liabilities and Provisions - "Others (including provisions)" or Schedule of Other Assets - "Others" exceeds 1% of the total assets. These instructions come into effect for disclosures in the notes to the annual financial statements for the year ending 31 March 2023 and onwards. To access the RBI notification, click here.

Risk weights for exposures to corporates and NBFCs

RBI vide notification dated 10 October 2022 has advised that a bank loan rating without the prescribed disclosure by the External Credit Assessment Institutions would not be eligible for being reckoned for capital computation by banks. Banks should treat such exposures as unrated and assign applicable risk weights. To access the RBI notification, click here.

Amendments to unhedged foreign currency exposure norms

RBI vide notification dated 10 October 2022 has issued RBI (Unhedged Foreign Currency Exposure) Directions, 2022 to inter alia provide clarity in the definition of 'entities' for which banks should assess unhedged foreign currency exposure, exempted exposures/ entities, alternative method for smaller entities, assessment of unhedged foreign currency exposure of entities incorporated outside India by overseas subsidiaries/ branches of Indian banks, etc. These Directions would come into force from 1 January 2023. To access the RBI Directions, click here.

Multiple NBFCs in a Group - Classification in Middle Layer

RBI vide notification dated 11 October 2022 has provided that if consolidated asset size of NBFCs in a Group is INR 1,000 crore and above, then each Investment and Credit Company, Micro Finance Institution, NBFC-Factor and Mortgage Guarantee Company lying in the Group would be classified as an NBFC in the Middle Layer and consequently, regulations as applicable to the Middle Layer would be applicable to them.

Statutory auditors are required to certify the asset size (as on 31 March) of all the NBFCs in the Group every year. The certificate should be furnished to the Department of Supervision of the Reserve Bank under whose jurisdiction the NBFCs are registered. These guidelines shall be effective from 1 October 2022. To access the RBI notification, click here.

Review of regulatory framework for Asset Reconstruction Companies (ARCs)

RBI vide notification dated 11 October 2022 has amended the extant regulatory framework for ARCs for enabling them to function in a more transparent and efficient manner. These amendments are effective immediately or as indicated otherwise. To access the RBI notification, click here.

ICAI updates

Revised disclosure checklists

ICAI has issued the disclosure checklists relating to:

- Indian Accounting Standards (revised November 2022). This disclosure checklist is applicable for the accounting period beginning on or after 1 April 2022. To access the checklist click here.
- Accounting Standards (revised October 2022). The checklist contains disclosure requirements of accounting standards and certain pronouncements of ICAI as on 1 April 2022. To access the checklist, click here.

Compliance of financial reporting requirements

ICAI has released Volume II of its study on compliance of financial reporting requirements (Ind AS Framework). The publication includes instances of non-compliances with respect to financial reporting requirements such as Ind AS, Standards on Auditing, Schedule III to the Companies Act, 2013, CARO etc., observed during the course of review of general-purpose financial statements of various enterprises To access the publication, click here.

Further, Quality Review Board has released its publication–Report on Audit Quality (2021-22). To access the publication, click here.

Guidance Note to report on transfer pricing requirements (Revised 2022 Edition)

ICAI has issued the revised guidance note to report under section 92E of the Income-Tax Act, 1961 (Transfer Pricing). To access the revised guidance note, click here.

Exposure drafts of Amendments to Ind AS 1 and Ind AS 116

ICAI has issued the following exposure drafts:

- Classification of liabilities as current or non-current and non-current liabilities with covenants - Amendments to Ind AS 1, Presentation of Financial Statements
- Lease liability in a sale and leaseback – Amendments to Ind AS 116, Leases.

Comments can be submitted by 30 January 2023.

To access the exposure drafts, click here.

We acknowledge contribution from

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- Nilanjan Paul
- Dilpesh Chouhan
- Amrish Darji
- Disha Mehta

Contact us

Please write to : faas.in@in.ey.com in case you have any queries, feedback or inputs.

EY offices

Ahmedabad
22nd Floor, B Wing, Privilon
Ambli BRT Road, Behind Iskcon
Temple, Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

Bengaluru
12th & 13th floor
"UB City", Canberra Block
No. 24, Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 6727 5000

Ground Floor, 'A' wing
Divyasree Chambers
11, O'Shaughnessy Road
Langford Gardens
Bengaluru - 560 025
Tel: + 91 80 6727 5000

Chandigarh
Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A
Industrial & Business Park, Phase-I
Chandigarh - 160 002
Tel: + 91 172 6717800

Chennai
Tidel Park, 6th & 7th Floor
A Block, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: + 91 44 6654 8100

Delhi NCR
Golf View Corporate Tower B
Sector 42, Sector Road
Gurugram - 122 002
Tel: + 91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad
THE SKYVIEW 10
18th Floor, "SOUTH LOBBY"
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jamshedpur
1st Floor, Shantiniketan Building
Holding No. 1, SB Shop Area
Bistupur, Jamshedpur – 831 001
Tel: + 91 657 663 1000

Kochi
9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: + 91 484 433 4000

Kolkata
22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: + 91 33 6615 3400

Mumbai
14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: + 91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000

Pune
C-401, 4th floor
Panchshil Tech Park, Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 4912 6000

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