Query No. 7

Subject: Presentation of amounts received under Channel Financing Facility as per the requirements of Schedule III to the Companies Act, 2013. [1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is an existing public limited company incorporated under the applicable provisions of the Indian Companies Act. The equity shares of the Company are listed on BSE Limited and National Stock Exchange of India Limited. The Company has three Strategic Business Units (SBUs or BUs) / segments comprising of:

- Consumer Products (CP);
- Lighting Solutions (LS); and
- Engineering and Projects Business (EPC)

2. In the CP segment, the Company deals with consumer durables which include Domestic appliances, Kitchen appliances, and Electric Fans. Some of the major products are Water Heater, Mixer & Food Processor, Room Heaters, Iron, Room Coolers, OTG, Microwave Oven, Toaster Induction Cooker, Pressure Cooker, Ceiling Fan, Table Fans and Exhaust Fans etc. The Company has country-wide presence and operates through 20 plus branches, 550 plus dealers and distributors and 230K plus retailers. The Company has one manufacturing unit in Chakan and Nashik. This segment contributes to 71% of total revenue of the Company for the current year (69% for the last year). Here, almost 70% of sales are contributed by dealers and distributors which is followed by E-Commerce, MFR, Institutional and Government customers.

In the LS segment, the Company deals with lighting products which includes LED products, lamps and tubes in consumer lighting and poles, high mast, street lighting, area lighting, etc. in professional lighting. This segment contributes to 22% of total revenue of the Company for the current year (23% for the last year).

The EPC segment is sub-divided into Power Distribution BU and Power Transmission BU. The Company has one manufacturing plant in Ranjangaon for manufacturing items for Transmission Line Tower, High mast Tower and Poles. This segment contributes to 7% of total revenue of the Company for the current year (9% for the last year). The sales contribution has decreased majorly on account of no new projects undertaken by the Company as a conscious decision taken by the Company to adopt risk calibrated approach.

3. The Company has prepared this memo / paper to discuss the presentation and disclosures required for Channel Financing Facility. The details of the facility are as mentioned below:

- The Company sells its products under CP segment to Dealers and Distributors (D&Ds) [Channel Partners] with an average credit period of 30 days. It has been evaluated and concluded that the sales meet the criteria for revenue recognition prescribed in Indian Accounting Standard (Ind AS) 115, 'Revenue from Contracts with Customers'. No interest is charged by the Company for the credit period of

[1] Opinion finalised by the Committee on 19.4.2023 and 20.4.2023.

30 days. If the payment is not made within this period, the Company charges overdue interest to the customers.

- If the D&D makes payment to the Company within 1-3 days from the date of sale, the concerned D&D is eligible for cash discount of 2%.
- In many cases, the D&Ds lack availability of working capital / banking limits available with them and, therefore, are not able to make upfront payment to the Company.
- To bridge this gap and get upfront cash against its sales, the Company has entered into a channel financing arrangement with Banks which shall provide working capital limits to D&Ds [Channel Partners] ensuring upfront payment to the Company.

4. Below are the key points in arrangement entered into between Banks and D&D for sanction of working capital limits:

- This arrangement for sanction of working capital limits [credit facility] is entered into between the Bank and the D&D.
- It is not mandatory for all D&Ds to enter into the arrangement and the D&D may, at its own discretion and requirement, apply to Bank for this credit facility.
- This arrangement letter is duly signed by the authorised person of D&D and the authorised person of Bank.
- The credit limit assignment by Bank to D&D is solely at the discretion of the Bank.
- This is usually decided considering below parameters:
    - Number of years of D&D dealing with the Company
    - Historical value of transactions between D&D and the Company
    - Basis due-diligence process of each Bank
    - Basis credit-appraisal process of each Bank
- The limits sanctioned have the following hypothecations/ security from D&D:
    - Primary: Against all stocks, receivables and current assets of the D&D
    - Collateral: first loss default guarantee (FLDG) by the Company
    - Guarantee: of D&D
- The credit facility is usually for a tenure for 12 months and is subject to renewal by Bank.
- The credit facility can be cancelled /reduced at the discretion of the Bank.
- Interest on the credit facility is computed on daily balances duly compounded and is payable on monthly basis by D&D to Bank.
- Interest rates are decided by the Bank basis the base lending rate along with consideration of credit worthiness of D&D.
- Penal charges on account of non-compliance of terms of arrangement with bank will be charged to D&D and are liable to be paid as per terms of arrangement between Bank and D&D.
- All other charges (namely, facility fee, inspection charges, documentation charges etc.) are obligations of D&D and are liable to be paid as per terms of arrangement between Bank and D&D.

In this process, the Company is not a party to the credit arrangement entered into between Bank and D&D and only supports Bank with recommendation letter to Bank before sanction of credit facility to D&D.

- The credit limit facility between Bank and D&D is usually for 90 days.
- The 90 days here would be considered as credit period assigned by Bank to D&D.
- D&D shall make payment to bank within a period of 90 days [Principal amount].
- In case of default, the Bank shall levy overdue interest to the D&D.
- 90 days here would commence from approval obtained by D&D from Bank for credit limit basis verification of underlying documents submitted by the Company.
- Once the above approval is obtained, the Banks make payment on behalf of D&D to the Company.
- The Company receives full payment, net of cash discount of 2%. There are no discounting charges when Bank makes the payment to the Company on behalf of D&Ds.

In the above process, the borrower under the credit arrangement shall be the D&D and not the Company

5. Defaults by the D&D in repayment of principal /interest on due date triggers the following:

- As the assets of D&D are hypothecated and Guarantee is given by D&D, first recovery process is initiated by Bank against the D&D.
- If D&D is unable to honour above, the Bank has a right to call upon the Company for recovery of sums due. This is basis the fact that the Company has given the FLDG to the Bank in this arrangement.
- The FLDG and channel financing facility are two separate arrangements. In this FLDG arrangement, D&D [Channel Partner] is not a party to the same.

6. Below are the key points in arrangement entered into between Banks and the Company for FLDG:

- The channel financing facility arrangement is entered between Bank and the Company.
- This arrangement specifies maximum limit for which finance can be given by Bank to D&D on recommendation of the Company.
- Terms on documentation required by the Company to comply with post-sanction of channel financing facility majorly include relevant documents [namely, invoice copy, D&D financing agreement, etc.] to be submitted by the Company to Bank to initiate disbursement of fund by banks.
- Terms and conditions applicable to Bank and the Company in case of default by D&D to honour the payment to Bank on the due date.

7. The Company has evaluated the complete arrangement based on the requirements of Indian Accounting Standard (Ind AS) 109, ‘Financial Instruments’ related to derecognition of financial assets and believes that the FLDG arrangement means that the Company has retained all significant risks and rewards of receivables from D&D. Hence, it cannot derecognise the receivables. Rather, it needs to recognise the amount received under the arrangement as an obligation in the balance sheet. This is based on paragraphs 3.2.6, 3.2.7, 3.2.15 and B3.2.5 of Ind AS 109, reproduced below:

“3.2.6 When an entity transfers a financial asset (see paragraph 3.2.4), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.

(c) ….

3.2.7 The transfer of risks and rewards (see paragraph 3.2.6) is evaluated by comparing the entity’s exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (eg because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender’s return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its *fair value* at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 3.2.5).”

“Transfers that do not qualify for derecognition

3.2.15 If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.”

“B3.2.5 Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender’s return;

(b) a securities lending agreement;

(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur."

8. An issue arises on presentation of the above amount received from banks by the Company. In addition to paragraph 3.2.15 of Ind AS 109 (reproduced in paragraph 7 above), the querist has drawn attention to the following extract from paragraph 8.2.8 of the 'Guidance Note on Division II-Ind AS Schedule III to the Companies Act, 2013 (Revised, January, 2022)', issued by the Institute of Chartered Accountants of India:

> "Loans payable on demand should be treated as part of current borrowings. Current borrowings will include all loans payable within a period of 12 months from the date of the loan. In the case of current borrowings, the period and amount of defaults existing as at the date of the Balance Sheet should be disclosed (item-wise)."

The Company's views are as below:

- As per the above guidance, Ind AS 109 requires recognition of the monies collected as a financial liability.
- It does not require the amount to be presented as a borrowing. In the Company's view, whether the amount is borrowing for the Company or not, depends on nature of arrangement.

9. The Company has not interpreted the monies received from Bank as borrowings, on account of the following considerations:

- The credit limit arrangement for assigning working capital limits to D&D is between Bank and D&D.
- This arrangement letter is duly signed by authorised person of D&D and authorised person of Bank.
- The credit limit assignment by Bank to D&D is solely at the discretion of the Bank and is decided basis the parameters as assessed under the norms of the Bank.
- The interest, principal, and other charges as applicable are obligations of D&D.
- The recovery process or reasonable steps in case of default are firstly performed against the D&D.
- The Bank, at its discretion, can cancel/ reduce the credit limit.
- The Company's drawing powers/ borrowing limits are not blocked for outstanding channel finance balances.
- The Company has merely given FLDG. The Company, at this stage, has no obligation to make payment to the Bank. Such an obligation will arise only if there is a default on the part of the D&D and the Bank invokes the FLDG. Thus, ideally, it is like a contingent liability for the Company. It needs to be presented as a financial liability only, due to the specific requirements of Ind AS 109 as stated in paragraph 8 above.

10. Transactions are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The following points are relevant:

- In case of the Company, considering above facts, both from economic reality perspective and from legal form perspective, the above transaction cannot be interpreted as borrowings, as the bank is making payment on behalf of dealers and the dealers have a right to cash discount on paying the invoices early through this arrangement also.

- Irrespective of whether the dealer is on credit arrangement with bank or not, there is no change in the credit terms of D&D with the Company. However, once the D&Ds opt for the credit limit arrangement, D&Ds cannot request the Bank to make payment at the end of the usual credit period of 30 days allowed by the Company.

- Obligation to pay interest and principal is with D&Ds. They have hypothecated their assets against the facility.

- Further, though this arrangement may *prima facie* indicate recourse factoring, the key differentiation remains that these facilities are opened on the credit worthiness of the D&D and not that of the Company and the Company is only guaranteeing the facility/credit limit to enable the D&D to manage working capital requirements.

11. Further, the Company has not interpreted the monies received as loans repayable on demand, on account of the following considerations:

- Channel Financing Facility given by bank to the Company is an independent programme and D&D is not a party to this arrangement.

- In the Company's view, both the credit limit arrangement (between Bank and D&D) and the Channel Financing Facility (between Bank and the Company) should be seen and accounted for separately.

- Banks have a right to raise a demand on the Company only in case of default by D&D, which is a contingent event.

12. The Company has assessed two separate events as mentioned below:

Event 1: In case of no default done by D&D during the credit period:

Sums received from Bank can be construed as financial guarantee liability and can be presented and disclosed as other current financial liabilities at the reporting date. Here, Bank does not have a right to demand the settlement of the loan, unless the contingent event of default by the D&D happens and, hence, the entire liability cannot be interpreted as loans repayable on demand.

Event 2: In case of default done by D&D on due date:

Such sums not paid by D&D on due date and remaining not paid at the reporting date can be interpreted for presentation and disclosure as borrowings, as these can be termed as loans payable on demand.

B. Query

13. The querist has sought the opinion of the Expert Advisory Committee as to whether the amount received from banks by the Company under the channel financing facility shall be shown under 'Other Current Financial Liabilities' or 'Current Borrowings' as per presentation and disclosure requirements of Schedule III to the Companies Act 2013.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised by the querist relates to the classification and presentation of amounts received by the Company from the Bank under the channel financing facility in the balance sheet as per the requirements of Schedule III to the Companies Act, 2013. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case, such as, revenue recognition as per the requirements of Ind AS 115, presentation of liability by the dealers and distributors (D&Ds), measurement of receivables and associated liability, accounting for cash discount, accounting for financial guarantee liability (if any) on account of First-Loss Default Guarantee (FLDG) by the Company etc. Further, the Opinion hereinafter has been expressed in the context of Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time.

At the outset, the Committee notes that the requirements for derecognition of financial asset(s) are contained in Ind AS 109. However, as the issue raised in the query only relates to the presentation of amounts received by the Company from the bank under the channel financing facility in the balance sheet as per the requirements of Schedule III to the Companies Act, 2013, the Committee has not examined the appropriateness of the accounting treatment as per Ind AS 109. The Committee therefore presumes that the Company has correctly not derecognised the receivables as per the requirements of Ind AS 109 and has recognised a corresponding liability for the amount received from bank as per the requirements of that Ind AS.

15. The Committee notes that in the extant case, there is a channel financing facility between the Company and the Bank, while the credit limit arrangement is between the Bank and the D&Ds. However, though independently evaluated and entered into, the credit limit arrangement is sanctioned to the D&Ds pursuant to the recommendations of the Company and the first loss default guarantee (FLDG) given by the Company, in addition to the security and collateral provided by the D&Ds. The D&Ds may or may not opt for the credit limit arrangement. The Banks make payment to the Company. Interest, principal and all other charges are also payable by the D&D. In case of default, the Bank first initiates recovery process against the D&Ds and if the D&D is unable to honour its dues, the Bank can invoke the FLDG and recover the same from the Company. The Committee further notes that the querist has specifically stated (in paragraph 9 above) that the Company's drawing powers/ borrowing limits are not blocked for outstanding channel financing balances.

16. From the above, the Committee understands that in the extant case, the primary liability to pay the amount received from the bank by the Company against trade receivables/invoices is that of D&D and the Company has no obligation to make payment to Bank until there is a default by the D&D. Further, although the Company is giving FLDG and its recommendation to the bank but the credit arrangement is entered into between the Bank and the D&D wherein the amount of loan, rate of interest and other terms and conditions have

been agreed upon considering the credit worthiness, asset hypothecation, etc. of the D&D only. The Company's drawing powers/ borrowing limits are also not impacted due to outstanding channel finance balances. Thus, in the view of the Committee, the amount received by the Bank under the channel financing facility is not in the nature of borrowings as understood in the common business parlance and the Company is treating the amount received from the bank as a liability because it is unable to derecognise the receivables in view of the application of the requirements of Ind AS 109.

17. With regard to its presentation in the balance sheet, the Committee notes that Division II of Schedule III to the Companies Act, 2013 requires the following presentation:

Current Liabilities	
(a) Financial Liabilities (i) Borrowings (ia) Lease liabilities (ii) Trade payables (A) Total outstanding dues of micro enterprise and small enterprises (B) Total outstanding dues of creditors other than micro enterprises and small enterprises (iii) Other financial liabilities (other than those specified in item (c)) (b) Other current liabilities (c) Provisions (d) Current Tax Liabilities (Net)	

Further, 'General Instructions for Preparation of Balance Sheet' provide as follows:

"**F. Current Liabilities**

I. Borrowings:

(i) Borrowings shall be classified as-

(a) Loans repayable on demand

(I) from banks

(II) from other parties

(b) Loans from related parties

(c) Deposits

(d) Other loans (specify nature);

…"

Further, in this regard the Committee also notes the following requirements of the Guidance Note on Division II-Ind AS Schedule III to the Companies Act, 2013 (Revised, January, 2022):

"**8.2.8. Current Borrowings**

(i) Current Borrowings shall be classified as:

(a) Loans repayable on demand

- from banks;
- from other parties.

(b) Loans from related parties;
(c) Deposits;
(d) Other loans (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the Balance Sheet date in repayment of borrowings and interest shall be specified separately in each case.

(v) Current maturities of long-term borrowings shall be disclosed separately

Loans payable on demand should be treated as part of current borrowings. Current borrowings will include all loans payable within a period of 12 months from the date of the loan. In the case of current borrowings, the period and amount of defaults existing as at the date of the Balance Sheet should be disclosed (item-wise).
…"

From the above, the Committee is of the view that in the extant case, since the amount received from the Bank under the channel financing facility is not of the nature of borrowings as discussed in paragraph 16 above, the same should be presented and classified as 'other financial liability' in the balance sheet as per the requirements of Schedule III to the Companies Act, 2013. Further, since the credit period is 90 days (three months), the same is in the nature of current liability. Therefore, the amount received from bank should be presented as 'other financial liabilities' under 'financial liabilities' under the line item 'Current Liabilities'. Further, appropriate disclosures should be given to explain the nature of the facility. However, if there is any default on the part of the D&D and the amount is yet to be paid to the Bank by the Company at the reporting date, the same should be reclassified as 'Loans repayable on demand from bank' under 'Current Borrowings' in accordance with the terms of the FLDG.

D. Opinion

18. On the basis of the above, the Committee is of the opinion that the amount received from bank under channel financing arrangement is not in the nature of 'borrowings' and should be presented as 'other financial liabilities' under 'financial liabilities' under the line item 'Current Liabilities', as discussed in paragraph 17 above. Further, appropriate disclosures should be given to explain the nature of the facility. However, if there is any default on the part of the D&D and the amount is yet to be paid to the Bank by the Company at the reporting date, the same should be reclassified as 'Loans repayable on demand from bank' under 'Current Borrowings' in accordance with the terms of the FLDG.

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