

**NANGIA & CO LLP**  
CHARTERED ACCOUNTANTS

# Assurance Gazette

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## Foreword

We are thrilled to present the Assurance Gazette for March 2024. This edition offers comprehensive guidance regarding the presentation and disclosure of a channel financing arrangement within the financial statements of the supplier, including an analysis of a recent opinion issued by the EAC (Expert Advisory Committee) concerning the same topic.

We aim to provide you timely information on recent accounting and auditing related updates in a lucid manner.

Hope you will find it useful and informative.



# Presentation of “Channel Financing Arrangements in Financial Statements”

## Introduction

Channel financing – financial arrangement that extends working capital loans to channel partners, such as distributors, dealers, or buyers, who are involved in contracts to procure goods or services from a corporate entity.

The arrangement encompasses three distinct entities: a company responsible for supplying the goods or services or supplier, a channel partner engaged in the acquisition of said goods or services or the Distributor, and a financial institution or Bank. Ordinarily, this framework facilitates the expeditious receipt of payment by the supplier company from the financial institution, occurring prior to the settlement of payment by the channel partner with the same financial institution.

In the process of accounting for the funds received from the financial institution, the supplier is tasked with determining whether to offset the received amount against the receivable sum from the distributor or to establish a new liability. In addressing this decision, the supplier is required to adhere to the principles governing the derecognition of financial assets outlined in Ind AS 109, Financial Instruments.

The Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) has discussed how to classify and present amounts received by an entity under a channel financing arrangement.

## Background of case scenario

The supplier company predominantly specializes in the sale of household appliances to dealers and distributors, with customary payment terms set at 30 days. Distributors availing themselves of early payment within 1-3 days are eligible for a 2% discount, while those exceeding the stipulated 30-day period are subject to overdue interest charges.

Despite the established payment terms, numerous distributors encounter cash flow constraints, impeding their ability to remit immediate payments to the supplier. In response, the supplier has implemented a channel financing system in collaboration with banks. This system furnishes distributors with working capital, facilitating upfront payment to the supplier for their procurements.

Under this arrangement, the bank assesses the creditworthiness of the distributor and extends a credit limit secured against their assets. Any interest, penalties, or ancillary charges associated with this credit fall within the purview of the distributor's responsibility. The supplier's involvement is confined to proffering a recommendation letter to the bank concerning the distributor's creditworthiness, without direct involvement in the contractual agreement between the bank and distributor.

To assuage the bank's concerns, the supplier furnishes a First Loss Default Guarantee (FLDG). This entails that in the event of default by the distributor, whereby the bank is unable to recoup the outstanding amount, the bank reserves the right to seek reimbursement from the supplier.

In essence, this arrangement empowers distributors to secure working capital from banks for prompt payment to the supplier. Additionally, the supplier's provision of a guarantee to the bank serves as a safeguard in the event of distributor default, thereby safeguarding the bank's financial interests.

## Accounting for a channel financing arrangement undertaken by an entity

- Assessing whether the arrangement would lead to the derecognition of the trade receivable.

In the process of recording the funds received from the bank, Supplier Company must assess whether the arrangement satisfies the derecognition criteria outlined in Ind AS 109. This entails determining whether Supplier Company has effectively transferred both its entitlement to receive cash flows from the Distributor and substantially all risks and rewards associated with ownership of the receivable to the bank.

### Derecognition criteria outlined in Ind AS 109

- Evaluating these conditions to the facts of the company

### Has the entity effectively transferred nearly all risks and rewards?

- No – The entity has provided an FLDG to the bank

### Have the entitlements to the cash flows from the assets lapsed?

- No - Since Company A has not received amounts from the D&D

### Has the entity retained a significant portion of the risks and rewards?

- Yes – As per the FLDG provided to the bank, the bank has full recourse to Company A in case the D&D defaults.

### Has the entity relinquished its entitlement to receive the cash flows from the asset?

- Yes - The right to receive cash flows from the D&D has been transferred to the bank

**Continue to acknowledge the asset.**



The company has assumed all risks and rewards associated with receivables from Distributor through the First Loss Default Guarantee (FLDG) arrangement with the bank, it is precluded from derecognizing the receivables. Instead, it must account for the amount received from the bank under the arrangement as a liability in the financial statements.

- Classification and presentation of liability recognised

The amount received from the bank will be acknowledged as a financial obligation in the financial statements. The Expert Advisory Committee (EAC) meticulously examined the specifics of the case and referenced the guidance provided in Schedule III (Division II) of the Companies Act, 2013 (2013 Act).

The EAC noted the presence of a channel financing arrangement between the company and the bank, it highlighted that the credit limit agreement is established directly between the bank and the Distributor. In the event of default, the bank's initial recourse is towards recovery from the Distributor. Should the Distributor fail to fulfil its obligations, the bank retains the option to activate the terms of the First Loss Default Guarantee (FLDG) and seek reimbursement from the company. Furthermore, the terms of the arrangement specify that the company's borrowing limits remain unaffected by any outstanding channel financing balances.

Moreover, Division II of Schedule III to the 2013 Act provides various options for presenting current financial liabilities, including Borrowings, Trade Payables, and Other financial liabilities. Current borrowings encompass all loans payable within 12 months from the loan's initiation, including those payable upon demand.

Upon thorough examination of the case particulars and the provisions of Division II of Schedule III to the 2013 Act, the EAC determined that the amount received by the Supplier under the channel financing arrangement does not constitute borrowings. Consequently, it should be classified and reported as 'other financial liabilities' in the balance sheet, with comprehensive disclosures to explain the nature of the facility.

However, in the event of default by the Distributor leading to an outstanding amount owed by the company to the bank as of the reporting date, the said amount must be reclassified as 'Loans repayable on demand from bank' under 'Current Borrowings,' in compliance with the terms of the FLDG.



## Meet our Experts



**Vikas Gupta**  
Partner - Audit & Assurance  
vikas.gupta@nangia.com



**Prateek Agarwal**  
Partner - Audit & Assurance  
prateek.agarwal@nangia.com



**Vikram Singh Pratap**  
Partner - Audit & Assurance  
vikram.pratap@nangia.com



**Jaspreet Singh Bedi**  
Partner - Audit & Assurance  
jaspreet.bedi@nangia.com



**Vijaya Uppiretla**  
Partner - Audit & Assurance  
vijaya.uppiretla@nangia.com

## With Inputs from



**Avneet Singh**  
Director - Audit & Assurance  
avneet.singh@nangia.com



**Shalu Kedia**  
Director - Audit & Assurance  
shalu.kedia@nangia.com



**Sudipti Palgotra**  
Manager - Audit & Assurance  
sudipti.palgotra@nangia.com

### Noida

(Delhi NCR - Corporate Office)  
A-109, sector 136, Noida 201304, India  
T : +91 120 259 8000

### Delhi

B-27, Soami Nagar, New Delhi-110017, India  
T : +91 120 2598000

### Gurugram

001-005, Emaar Digital Greens Tower-A 10<sup>th</sup>  
Floor, Golf Course Extension Road, Sector 61,  
Gurgaon-122102, India  
T: 0124-4301551

### Mumbai

4th Floor, Iconic Tower, Urmi Estate, 95 Ganpatrao  
Kadam Marg, Lower Parel, Mumbai- 400 013, India  
T: +91 22 4474 3400

### Chennai

Palladium Bayan, Level 5, 129-140, Greams Road,  
Thousand Lights, Chennai 600006, India  
T: +91-44-46549201

### Bengaluru

Prestige Obelisk, Level 4, No 3 Kasturba Road,  
Bengaluru - 560 001, Karnataka, India  
T: +91 80 2248 4555

### Pune

3<sup>rd</sup> Floor, Park Plaza, CTS 1085, Ganeshkhind  
Road, Next to Pune Central Mall, Shivajinagar,  
Pune - 411005

### Dehradun

First Floor, "IDA" 46 E. C. Road, Dehradun - 248001,  
Uttarakhand  
T: +91 135 271 6300

[www.nangia.com](http://www.nangia.com) | [query@nangia.com](mailto:query@nangia.com)