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SEBI's analysis of royalty payments by listed companies to related parties

The Securities and Exchange Board of India (SEBI) recently conducted a study to examine royalty payments made by listed companies to their related parties. The analysis is based on royalty payments, amounting to less than 5 per cent of turnover to their related parties, during the period of 10 years (FY 2013-14 to 2022-23). The study, which included 233 companies across various sectors, stated following key findings:

- **Royalty payments by net-profit making companies:** In 25 per cent of covered cases, royalty payments exceeded 20 per cent of the net profits. Additionally, half of the companies that paid royalties either did not pay dividends or paid more in royalties to related parties than in dividends to non-related shareholders.
- **Royalty payments by loss-making companies:** Some companies continued to pay royalties despite incurring losses for at least five consecutive years.
- **Consistent royalty payers:** Out of 79 companies that consistently paid royalties to related parties, 11 consistently paid royalties exceeding 20 per cent of their net profits throughout the period covered in the study.

Further, the study raised concerns about inadequate disclosure, lack of justification for royalty payments, and significant payments to related parties under the guise of management or technology fees, which fall outside ambit of royalty from regulatory standpoint.

Proxy advisory firms highlighted issues with respect to the correlation between royalty payments and company revenue or profits. Some companies sought perpetual approval for such payments, which contradicts corporate governance principles. The study also found that royalty-paying companies did not show superiority over their peers, and there was considerable subjectivity in royalty valuations. Considering the observations, the study highlighted that these findings underscore concerns about corporate governance and transparency in related-party transactions.

(Source: PR No.29/2024 - SEBI study finds that 1 out of 4 times, listed companies paid royalty exceeding 20% of their net profits to Related Parties, dated 14 November 2024)

Investment in overseas mutual funds by Indian mutual funds

To simplify investments and allow mutual funds to diversify into overseas Mutual Funds (MFs) or Unit Trusts (UTs), SEBI through its circular dated 4 November 2024 permitted Indian mutual fund schemes to invest in overseas MF/UTs that have exposure to Indian securities. The investment in overseas MF/UTs is subject to exposure to Indian securities which should not exceed 25 per cent of their assets.

When investing in overseas MF/UTs, the Indian mutual fund schemes must adhere to the following guidelines:

- **Pooling:** All investor contributions to the overseas MF/UTs must be combined into a single investment vehicle.
- **Pari-passu and pro-rata:** The overseas MF/UTs should maintain a common portfolio without segregated portfolios. All investors should have equal rights and receive returns/gains from the fund proportional to their contribution.
- **Independent investment manager/Fund manager:** The overseas MF/UTs should be managed by an independent fund manager to ensure unbiased investment decisions.
- **Public disclosure:** The overseas MF/UTs must disclose their portfolios at least in quarterly intervals.
- **No advisory agreement:** To prevent conflicts of interest, Indian and overseas MF/UTs should not enter into any advisory agreement.

The circular also outlines the consequences and corrective actions in case the 25 per cent threshold is breached.

(Source: SEBI Circular, SEBI/HO/IMD/IMD-PoD-1/P/CIR/149 dated 4 November 2024)

Proposal to review definition of UPSI

Recently, SEBI through a consultation paper proposes a review of the definition of Unpublished Price Sensitive Information (UPSI) under the SEBI (Prohibition of Insider Trading) Regulations, 2015 (PIT Regulations).

The SEBI through its consultation paper highlighted inconsistencies in how companies classify UPSI, prompting the need for a clearer definition. Hence with this review, SEBI aims to align the definition of UPSI with events listed in Regulation 30 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR Regulations).

To broaden the scope of UPSI, SEBI proposed to include following events in the illustrative list of events specified in definition of UPSI (aligning the same with events specified in Regulation 30 of LODR Regulations):

a. Change in ratings assigned to instruments issued by listed entities.

b. Fund raising proposed to be undertaken.

c. Agreements by whatever name called impacting management and control of the company.

d. Fraud or defaults by a listed entity, its promoter, director, key managerial personnel, senior management, or subsidiary or arrest of key managerial personnel, senior management, promoter or director of the listed entity, whether occurred within India or abroad.

e. Changes in key managerial personnel, other than due to superannuation or end of term, and resignation of a statutory auditor or secretarial auditor.

f. Resolution plan/restructuring/one-time settlement in relation to loans or borrowings from banks and financial institutions.

g. Admission of winding up petition filed by any party/creditors, admission of application by the corporate applicant or financial creditors for initiation of Corporate Insolvency Resolution Process (CIRP) of a listed corporate debtor and its approval or rejection thereof under the Insolvency Code.

h. Initiation of forensic audit (by whatever name called) by company or any other entity for detecting mis-statements in financials, misappropriation, siphoning or diversion of funds and receipt of final forensic audit report.

i. Actions initiated or orders passed by any regulatory, statutory, enforcement authority or judicial body against the listed entity or its directors, key managerial personnel, senior management, promoter or subsidiary, in relation to the listed entity.

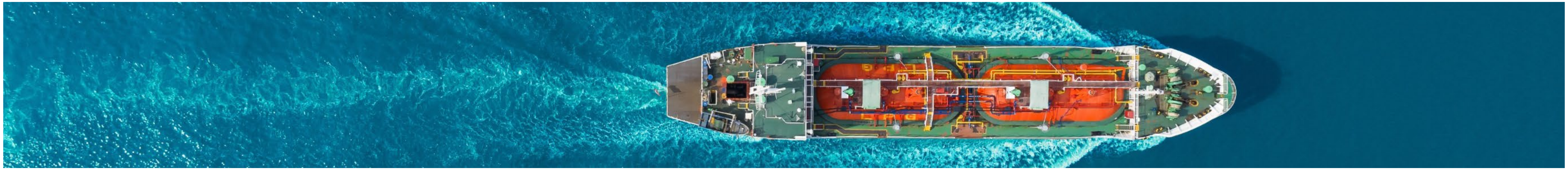
j. Mergers, de-mergers, acquisitions, delistings, disposals and expansion of business, award or termination of order/contracts not in the normal course of business and such other transactions.

k. Outcome of any litigations or disputes which may have an impact on the listed entity.

l. Giving of guarantees or indemnity of giving a surety by whatever name called for a third party.

m. Granting, withdrawal, surrender, cancellation or suspension of key licenses or regulatory approvals.

(Source: SEBI Consultation paper on "Proposed review of the definition of Unpublished Price Sensitive Information (UPSI) under SEBI (Prohibition of Insider Trading) Regulations, 2015 to bring regulatory clarity, certainty and uniformity of compliance in the ecosystem" dated 9 November 2024)



Enhancing the SME segment framework and corporate governance provisions

The SEBI has dedicated exchanges (SME exchange) for Small and Medium Enterprise (SME) segment to encourage the listing and trading of securities issued by SMEs. The SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations) also provides the framework for SME entities. The current framework includes eligibility criteria for SME IPOs, such as post-issue paid-up capital limits and simplified filing requirements. SMEs have higher minimum application amounts and minimum lots sizes for trading and lower number of minimum allottees compared to main board IPOs[1]. They also have different post-listing obligations, such as requirement of abridged half-yearly financial reporting instead of quarterly financial reporting required by the main board listed companies.

In addition to provisions of ICDR Regulations, Stock Exchanges (NSE and BSE) also have additional eligibility criteria for listing of companies on SME platform and migration from SME platform to main board. Further, post-listing obligations and disclosure requirements for companies are specified under the SEBI LODR Regulations. Most corporate governance requirements under the LODR Regulations are as of now not applicable to entities listed on SME exchanges.

Considering the surge in SME IPOs in recent years and to further strengthen pre-listing and post-listing provisions for SMEs, SEBI issued a consultation paper to review SME framework under ICDR Regulations and applicability of corporate governance provisions under the LODR Regulations. Following is the overview of the key proposal:

- **IPO process:** Increase the minimum application size from INR1 lakh to either INR2 lakh or INR4 lakh to protect the interest of smaller investors and to attract investors with greater risk-taking appetite to enhance the overall credibility of SME segment.
- **Allocation for Non-Institutional Investors (NIIs):** Proposes to align SME IPO allocation with main board IPOs by introducing sub-categories in the NII category and a draw of lots for oversubscription.
- **Allotment process:** Increase the minimum number of allottees from 50 to 200 in an IPO to ensure liquidity.
- **Offer for sale (OFS):** Restrict OFS to 20 per cent of the issue size to ensure funds are used for growth.
- **Monitoring of issue proceeds:** Reducing the threshold relating to provision for appointment of a monitoring agency from INR100 crore to INR20 crore. Further, the requirement of appointing monitoring agency shall be made mandatory in case of specific objects like funding subsidiaries repay loans, or an acquisition.
- **Lock-in period:** Increase of lock-in period for Minimum Promoter Contribution (MPC) to five years. Additionally, lock-in on promoters' holding held in excess of MPC should be released in phased manner.
- **General Corporate Purposes (GCP):** Limit GCP to 10 per cent (currently 25 per cent) of the issue size or INR10 crore, whichever is lower.
- **Corporate governance:** Enhance the applicability of provisions under LODR Regulations to SME listed entities, including stricter related party transaction norms for SMEs with specified threshold criteria, quarterly financial reporting in line with main board listed companies, and enhanced disclosure requirements for SMEs.

The period to provide comments ended on 4 December 2024.

(SEBI, "Consultation paper on Review of SME segment framework under SEBI (ICDR) Regulations, 2018, and applicability of corporate governance provisions under SEBI (LODR) Regulations, 2015 on SME companies to strengthen pre-listing and post-listing SME provisions, dated 19 November 2024)

1. A Mainboard IPO (Initial Public Offer) occurs when a privately owned company sells shares to the general public for the first time and is listed on stock markets. The post-issue paid-up capital requirement of these large organisations is a minimum of Rs. 10 crores.

Amendments to Buy-Back Regulations

Recently, the SEBI issued the SEBI (Buy-Back of Securities) (Second Amendment) Regulations, 2024 (the amendments). These amendments introduce following key changes to the SEBI (Buy-Back of Securities) Regulations, 2018:

i. **Promoter participation**: The amendment provides that if any member of the promoter or promoter group declares their intention not to participate in the buy-back, their shares will not be considered when calculating the entitlement ratio.

ii. **Public announcement date**: Prior to the amendment the buy back offer was required to be opened not later than four days from the record date, however the amendment now substitutes the term ‘record date’ with ‘date of public announcement’.

iii. **Subsisting obligations**: The buyback regulations restrict the company from issuing any shares or securities till date of expiry of buy back period. However, the amendment provides that the companies can discharge existing obligations through the conversion of warrants, stock options, sweat equity, or preference shares into equity shares. The amendment also requires that such aforesaid obligations and their potential impact must be disclosed in the public announcement.

iv. **Disclosure requirements**: The amendments introduce additional disclosure requirements under subsisting obligations.

(SEBI Notification No. SEBI/LAD-NRO/GN/2024/210, Securities and Exchange Board of India (Buy-Back of Securities) (Second Amendment) Regulations, 2024, dated 20 November 2024)

Revised criteria for classification of non-company entities

With an aim to provide a robust framework for The Institute of Chartered Accountants of India (ICAI) has updated the criteria for classifying non-company entities to determine the applicability of accounting standards. The classification would determine the extent of compliance required with the accounting standards by each category of the non-company entities. This revised scheme of applicability of Accounting Standards will come into effect for accounting periods beginning on or after 1 April 2024.

The new requirements specify non-company entities into two categories:

1. Micro, Small, and Medium Enterprises (MSMEs)
2. Large entities.

The MSME means a non-company entity which:

- Is not listed on any stock exchange whether in India or outside India
- Is not a bank, financial institution, or insurance company
- Has a turnover (excluding other income) that does not exceed IN250 crore in the immediately preceding accounting year
- Has borrowings that do not exceed INR50 crore at any time during the immediately preceding accounting year, or
- Is not a holding or subsidiary of a non-MSME entity.

Large entity is any non-company entity that does not qualify as an MSME and they are required to comply with all the Accounting Standards, whereas MSME have been provided some exemptions and relaxations which are as follows:

- MSMEs are entirely exempt from following accounting standards:
  - AS 3: Cash Flow Statements
  - AS 17: Segment Reporting
  - AS 20: Earnings per Share
  - AS 24: Discontinuing Operations
  - AS 18: Related Party Disclosures (subject to certain conditions)
  - AS 28: Impairment of Assets (subject to certain conditions)
- MSMEs have been exemption from certain paragraphs of the following standards:
  - AS 10: Property, Plant, and Equipment
  - AS 11: The Effects of Changes in Foreign Exchange Rates
  - AS 15: Employee Benefits
  - AS 19: Leases
  - AS 22: Accounting for Taxes on Income
  - AS 26: Intangible Assets
  - AS 28: Impairment of Assets
  - AS 29: Provisions, Contingent Liabilities, and Contingent Assets.

The MSMEs are required to disclose their status as an MSME and the fact that they have availed these exemptions in a note to its financial statements. Furthermore, entities which are required to apply Accounting Standards under any other regulatory requirements are not eligible to avail these exemptions.

This new classification replaces the criteria issued in March 2021, aiming to simplify compliance for MSMEs while ensuring transparency.

(Source: ICAI Announcement - Revised Criteria for classification of Non-company entities for applicability of Accounting Standards.)

Proposed amendments to the Environment (Protection) Act, 1986

The Ministry of Environment, Forestry and Climate Change (MoEFCC) through its notification dated 1 November 2024 proposed amendments to the Environment (Protection) Act, 1986. The proposed amendments aim to tackle air pollution from the aluminum industry by implementing stricter emission standards for plants, refineries, and furnaces. The proposed changes include the mandatory use of cleaner fuels, such as Low sulfur Diesel Oil (LDO), and measures to reduce fluoride emissions that will not only protect the air quality but also safeguard the surrounding vegetation and ecosystems.

The proposal is open for comments till 31 December 2024.

(Source: MoEFCC Draft Notification G.S.R. 680(E), dated 1 November 2024)

New rules issued for environmental compliances

The MoEFCC has recently introduced a series of rules aimed at enforcing penalty clauses for non-compliance or violations under various environmental acts. These rules are designed to establish a systematic approach for conducting inquiries into violations related to water management, waste management, and air pollution. The following rules outline the procedures for filing complaints against violators, initiating inquiries, and imposing penalties:

- Water (Prevention and Control of Pollution) (Manner of Holding Inquiry and Imposition of Penalty) Rules, 2024 related to Water provisions under the Water (Prevention and Control of Pollution) Act, 1974.
- E-Waste (Management) Second Amendment Rules, 2024 under the E-Waste (Management) Rules, 2022
- Hazardous and Other Wastes (Management and Transboundary Movement) Second Amendment Rules, 2024 under Hazardous and Other Wastes (Management and Transboundary Movement) Rules, 2016
- Air (Prevention and Control of Pollution) (Manner of Holding Inquiry and Imposition of Penalty) Rules, 2024 under Air (Prevention and Control of Pollution) Act, 1981

(Sources: MoEFCC Notifications G.S.R. 696(E)., dated 11 November 2024; G.S.R. 699(E) dated, 12 November 2024; G.S.R. 698(E)., dated 12 November 2024 and G.S.R. 701(E)., dated 12 November 2024)

Comprehensive guide to implementing ISSB standards for sustainability reporting

With an aim to support the global implementation of IFRS S1 and IFRS S2 standards[2] issued by the International Sustainability Standards Board (ISSB), the IFRS foundation has released a comprehensive guide. The guide would assist companies to identify and disclose material information about sustainability-related risks and opportunities that could impact cash flows, access to finance, or cost of capital.

Key points from the guide include:

- Key focus of the guide is to explain the sustainability-related risks and opportunities as per IFRS S1 focusing on a company's dependencies and impacts.
- It emphasises on integrated thinking, considering the interconnectedness of a company with its stakeholders, society, economy, and environment throughout the companies value chain.
- Guidance on how companies can use existing processes for materiality judgements, particularly those already applying IFRS Accounting Standards.
- Considerations for aligning sustainability disclosures with financial statements of a company.

This guide aims to help companies provide relevant sustainability information to meet investor and broader stakeholder needs (including those applying European Sustainability Reporting Standards (ESRS) or Global Reporting Initiative (GRI) Standards).

(Source: IFRS foundation announcement dated 19 November 2024)

2. General Requirements for Disclosure of Sustainability-related Financial Information (IFRS S1) and Climate-related Disclosures (IFRS S2).

IASB proposes enhancements to provisions recognition and measurement standards

The International Accounting Standards Board (IASB) has released an exposure draft to enhance the guidelines for recognising and measuring provisions on company balance sheets. Provisions are liabilities with uncertain timing or amounts. Investors need clear and comparable information about these provisions to evaluate future cash flows and financial positions. The IASB's proposed improvements aim to help companies apply the requirements more consistently and provide better information to investors.

The amendments to IAS 37 would clarify how companies should assess and measure provisions. They would also require companies to disclose more details about the measurement process. These changes are particularly relevant for companies with significant long-term decommissioning obligations or those subject to government levies and similar charges.

The consultation is open for comments until 12 March 2025.

(Source: IASB proposes targeted improvements to requirements for provisions, dated 12 November 2024)

ISSA 5000 introduced

The International Auditing and Assurance Standards Board (IAASB) has introduced the International Standard on Sustainability Assurance (ISSA) 5000, General Requirements for Sustainability Assurance Engagements. This standard aims to enhance the trust and confidence of investors, regulators, and other stakeholders in sustainability information. The newly standard would serve as a comprehensive, stand-alone guideline suitable for any sustainability assurance engagements applicable to sustainability information across various topics and prepared under multiple frameworks. Additionally, the standard is profession-agnostic, making it suitable for use by both professional accountants and non-accountant assurance practitioners.

Sustainability information pertains to various sustainability matters like climate, labor practices, and biodiversity. An entity's disclosures may cover different aspects such as risks, opportunities, metrics, and key performance indicators. Laws, regulations, or sustainability reporting frameworks may define these matters and provide guidance or requirements for reporting them.

Sustainability information will be required to be reported in accordance with the criteria applicable to such information. The criteria may outline the process by which the entity identifies sustainability matters to be reported, including the application of materiality in identifying such matters and the reporting boundary. ISSA 5000 applies to all assurance engagements on sustainability information regardless of how that information is presented. It covers both reasonable and limited assurance engagements with each requirement of this standard applying to both types unless otherwise stated.

This ISSA is effective for assurance engagements on sustainability information reported for periods beginning on or after 15 December 2026 and earlier adoption is permitted.

(Source: International Standard on Sustainability Assurance 5000 – General requirements for sustainability assurance engagements, issued by IAASB dated 12 November 2024)

FASB issues a new standard to enhance expense disclosures in financial statements

Recently, the Financial Accounting Standards Board (FASB) has released an Accounting Standards Update (ASU) aimed at improving financial reporting by requiring public companies to provide more detailed disclosures about certain expenses in the notes to financial statements. This update intended to enhance transparency and understanding of a company's financial performance. The update was highly prioritised by investors during FASB's 2021 agenda consultation, highlighting the need for more detailed expense information to better understand company performance and future cash flows. Some key points are as follows:

- **Enhanced disclosures:** Public companies must now disclose additional details about specific expenses in their interim and annual financial statements, including:
  a. Purchases of inventory
  b. Employee compensation
  c. Depreciation
  d. Intangible asset amortisation
  e. Depreciation, depletion, and amortisation related to oil- and gas-producing activities
- **Qualitative descriptions:** Companies must provide qualitative descriptions of amounts not separately disaggregated in expense captions.
- **Selling expenses:** Disclosure of total selling expenses and, for annual reports, a definition of selling expenses is required.

The amendments are effective for annual reporting periods beginning after 15 December 2026, and interim periods beginning after 15 December 2027. Early adoption is permitted.

(Source: FASB Issues Standard That Improves Disclosures about Income Statement Expenses, dated 4 November 2024)

ASU to improve accounting guidance for induced conversion of convertible debt instruments

The FASB has issued an ASU to enhance the relevance and consistency of the induced conversion guidance in Subtopic 470-20, *Debt—Debt with Conversion and Other Options.* Current Generally Accepted Accounting Principles (GAAP) provides guidance on whether settlements of convertible instruments at terms different from the original conversion terms should be accounted for as induced conversions or debt extinguishments. However, this guidance was primarily for share-settled convertible debt instruments, which led to questions about its application to settlement of convertible debt instruments with cash conversion and other features.

The ASU clarifies how to determine if certain settlements of convertible debt instruments, including those with cash conversion features or those not currently convertible, should be accounted for as induced conversions.

The amendments in the ASU are effective for annual reporting periods starting after 15 December 2025, with early adoption permitted.

(Source: FASB statement, “FASB issued standard that improves accounting guidance for induced conversion of convertible debit instruments”, dated 26 November 2024)

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