The auditor’s report - the principal communication from the auditor to users of audited financial statements - has undergone a significant change around the world. A more informative auditor’s report is the most visible change in auditing in more than 50 years. The United Kingdom, the Netherlands, South Africa, Australia and other countries have already seen the new auditor’s report issued with positive reaction from all stakeholders. Now in India, communication of key audit matters in the auditor’s report is effective for audits of financial statements for the periods beginning on or after 1 April 2018. In this edition of the Accounting and Auditing Update (AAU), we have included an article which illustrates sector-wise areas that could be potential key audit matters.

The new revenue standard, Ind AS 115, Revenue from Contracts with Customers changes the core principle that requires companies to evaluate their transactions in a new way. Continuing with our sector series on impact of Ind AS 115, we cover the transport, logistics and leisure sector. Our article highlights the key areas where more judgement and estimation would be required with the help of practical examples.

Banks may advance loans with prepayment clauses. Ind AS 109, Financial Instruments provides guidance on classification of financial assets at amortised cost, Fair Value Through Other Comprehensive Income (FVOCI) and Fair Value Through Profit and Loss (FVTPL). If certain criteria are met, such financial assets could be classified at amortised cost or FVOCI. In case those criteria are not met, then financial assets would be classified at FVTPL. An article on this topic demonstrates the assessment and classification of financial assets with prepayment features with the help of an illustrative.

As is the case each month, we also cover a regular round-up of some recent regulatory updates in India and internationally. We would be delighted to receive feedback/suggestions from you on the topics we should cover in the forthcoming editions of AAU.

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This article aims to:
- Illustrate sector-wise areas which could be potential key audit matters.

Introduction

International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* has been effective internationally for audits of financial statements for periods ending on or after 15 December 2016. Now in India as well, to keep the auditor’s report on Indian listed entities relevant to the stakeholders and provide them with insights into the audit process, Standard on Auditing (SA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* is effective for audits of financial statements for periods beginning on or after 1 April 2018.

The auditor’s report – the principal communication from the auditor to users of the audited financial statements – is undergoing significant change around the world. A more informative auditor’s report is the most visible change in auditing in more than 50 years.

The United Kingdom (UK), Netherlands, South Africa, Australia, and other countries have already seen the new auditor’s report issued with positive reaction from all stakeholders.

The new auditing standard requires auditors to adopt a risk-based audit approach and communicate matters of most significance, as discussed with those charged with governance, during the course of the audit, as Key Audit Matters (KAM) in their audit report. Since the areas on which the auditor generally focusses are the ones in which the investors and other users have expressed interest (in particular, areas of the financial statements that involved the most significant or complex judgements by management), the reporting of KAMs provides additional transparency that stakeholders are looking for.
The end result is a new and improved auditor’s report that provides more transparency about important aspects of the audit, and better describes what an audit is and what the auditor does.

Preparing for change

Board of Directors, Audit Committee members, Chief Financial Officer and others responsible for preparing financial statements will need to understand the implications of the extended communication from the auditor, as well as the importance of their role in the process.

KAM is not a replacement of, or supplement to, management’s perspective embodied in the financial statements. The intent is not to ‘fill the gaps’ for disclosures viewed as incomplete or missing. The auditor’s consideration of the adequacy and appropriateness of disclosures is part of forming an opinion on the financial statements.

There often will be a link between KAM and areas of complexity or significant judgement in the financial statements. Such is the nature of auditing – risk-based approach that focuses auditor attention on the matters of greatest risk of material misstatement. The intent of KAM is to provide transparency for users as to HOW this affected the auditor’s approach to the audit. It is intended to highlight for users the matters that required most auditor attention so that users can then focus greater attention on how such matters were dealt with in the financial statements and annual report.

Number of KAMs and detail

KAM would be specific to an entity and the audit that was performed in order to provide relevant and meaningful information to users. The determination of KAM involves auditor judgement about the relative importance of matters that required significant auditor attention. Therefore, SA 701 includes a judgement-based decision-making framework to help auditors determine which matters, from those communicated with those charged with governance, are KAM. The level of detail in description of the KAM is a matter of professional judgement and may vary depending on specific facts and circumstances of the particular engagement.

For a listed entity in particular, many believe there would be at least one matter that received significant audit focus and discussion with the audit committee. A possible exception may be those circumstances where a listed entity has very limited operations and the auditor determines there are no KAM because there were no matters that required significant auditor attention. In these situations, the auditor’s report would indicate that there were no KAM to communicate.

The auditing standards therefore do not prescribe or limit the number of matters to be reported as KAM – practice to date has shown that the average number of KAM communicated falls somewhere between two and six.

While KAMs would vary from entity to entity, based on specific facts and circumstances, they are generally based on those items of financial statements that are significant to the entity as a whole. Based on our experience, companies in the same sectors may have certain KAMs which are similar, considering the risk assessment and importance of the sector specific issues to the financial statements of such companies.

This article aims to highlight potential areas where significant judgement and estimates are generally required and such areas could be considered as potential KAMs. Following are the sectors:

- Automotive
- BCRE\textsuperscript{1}
- Consumer and retail
- Energy and natural resources
- Life sciences
- Technology
- Healthcare
- Media and entertainment
- Transport, leisure and sports
- Financial services

\textsuperscript{1} Building, Construction and Real Estate
Key areas that could be considered as KAMs

**Automotive**

While the automotive industry is capital intensive, the competitiveness is driving consolidation, collaboration and development in the use of technology in the sector. It has witnessed continuous innovation in its products and services. Some of the areas in the financial statements that could be considered as KAMs include:

<table>
<thead>
<tr>
<th>Area</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill and intangible assets</td>
<td>Impairment assessment are expected to be complex and are likely to contain certain judgements and assumptions. Examples are value in use method, preparation of discounted cash flow forecasts, forecast of long-term growth rates and discount rates.</td>
</tr>
<tr>
<td>Receivables and allowances</td>
<td>Entities may have different trends of rebate arrangements, and in many cases judgement would be involved in determining the revenue. Additionally, management’s estimate is involved in determining the expected credit losses after considering credit history of customers and current market conditions.</td>
</tr>
<tr>
<td>Inventories</td>
<td>Valuation of inventories could be subjective due to inherent uncertainty due to the volatility in valuation of inventories based on changes in consumer demand as sector invests in continuous innovation.</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>Another area which could involve high level of judgement while making assumptions about factors for assessing useful life, which can be inherently uncertain and could be subject to management bias.</td>
</tr>
<tr>
<td>Provision for warranty and recalls</td>
<td>Computation of provision for warranties and recalls generally involve significant analysis of historical data with respect to the level of repair and returns, and estimation of costs in respect of future warranty claims and refunds. Given that the estimates are based on facts and circumstances that may change from time to time, this is considered to be an area of significant management judgement.</td>
</tr>
</tbody>
</table>
Building, construction and real estate (BCRE)

The sector includes construction companies, real estate developers, companies that hold properties for investment purposes such as malls, car park spaces, etc. and other companies providing construction and engineering services. For many of the companies, the properties held by them and inventories for their business activities form a significant part of their financial statements. Some of the areas in the financial statements that could be considered as KAMs include:

- **Investment properties**: A disclosure of fair value of the investment property needs to be provided in the balance sheet. This area involves judgement due to subjectivity of valuation techniques and sensitivity of assumptions used for fair valuing investment properties measured under the fair value model.

- **Inventories**: Inventories are measured at cost or net realisable value, whichever is lower. Assessment the net realisable value of long-term projects may involve inherent risks in estimation of future selling price and related construction costs.

- **Revenue**: Revenue recognised over time may require comparison of costs incurred till date with total costs estimated for the project or by a survey done by an external expert. Therefore, the area is likely to involve significant judgement.

- **Property, plant and equipment**: Impairment of PPE may require computation of recoverable amounts which could be sensitive to key assumptions applied, including those relating to the discount and terminal yield rates.

- **Litigations**: Real estate and construction companies may have various matters under litigation. This area involves assessment of the subject matter of litigation, management assessment of the merits of the litigation and the likely exposure on the company. Therefore, provision on subject matters under litigations are likely to involve significant management judgement.

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2. Currently, as per Ind AS 40, Investment Property, investment properties are required to be measured at cost, however, the Institute of Chartered Accountants of India (ICAI) through an exposure draft issued in June 2018, have proposed an amendment to Ind AS 40 to permit companies to adopt either a cost model or fair value model. This exposure draft is pending notification by the Ministry of Corporate Affairs.
The consumer and retail sector includes companies providing retailing, food and beverage and other consumer goods and services. With an increase in e-commerce, the sector witnessed an increase in investments in intangibles. Some of the areas in the financial statements that could be considered as KAMs include:

- **Goodwill and intangible assets:** Impairment of goodwill and intangible assets is a potential area of KAM because the assessment of goodwill requires the computation of value-in-use by preparing discounted cash flow forecasts for each cash generating unit to which goodwill has been allocated and comparing the net present value of the forecast cash flows with the carrying values of the related assets. The preparation of discounted cash flow forecasts is likely to involve exercise of significant management judgement, in particular in estimating future sales growth rates, expected margins and the discount rates applied.

- **Inventories:** In order to compute provisions for slow/non-moving inventories, there is a need to estimate demand of new products and the duration of product lifecycles in order to estimate the amounts of inventories which expected to be sold in the future. This area is expected to involve significant degree of management judgement.

- **Property, plant and equipment:** Impairment of PPE generally involves a number of complex assumptions, and in many cases will be required to be made for each operating unit individually.

- **Revenue:** Revenue being one of the key performance indicators is susceptible to errors and manipulation due to misstatement of timing of revenue recognition and measurement of revenue. High volume of individually small transactions, makes fraud/error detection difficult.

- **Receivables and allowances:** Allowance for doubtful debts requires the application of management judgement. Trade allowances and rebates given to customers are likely to involve estimates and judgements due to customer-specific contractual arrangements.

- **Indirect tax contingent liabilities:** Contingent liability disclosures for indirect tax require the management to make judgements and estimates in relation to the issues and exposures. Considering the complex nature of the tax regulations and jurisprudence make this a particular area of judgement.
Energy and natural resources (ENR)

The sector includes companies dealing in metals, chemicals, power, mining and other natural resources and engaged in manufacturing activities. Being a capital intensive sector, PPE and inventories pay a pivotal role in its development.

Some of the areas in the financial statements that could be considered as KAMs include:

- **Property, plant and equipment**: For the ENR sector, PPE is one of the quantitatively significant item in the financial statements. PPE could be considered as a potential area of KAM due to:
  - Capitalisation of new projects: Capitalisation of new projects generally involve significant judgement to determine internal and other costs incurred for the project that should be capitalised.
  - Impairment assessment of PPE: Impairment of PPE involves a number of complex assumptions and management judgement, particularly in estimating future selling prices for crude oil and natural gas (where prices for these products are fluctuating) future production profiles and determining appropriate discount rates.

- **Receivables and allowances**: Impairment allowances for bad and doubtful debts are determined based on management’s estimate of the expected credit losses, considering the payment history of the company’s customers, customer specific conditions and relevant current factors in terms of liquidity and profitability of customers. This area is likely to involve a significant degree of management judgement.

- **Goodwill and intangible assets**: Capitalisation of intangible assets developed internally involves significant judgement in both determining when the criteria for capitalisation are met and in identifying the relevant costs to be capitalised, and whether the criteria continue to be met for ongoing projects. Another area is impairment of goodwill and intangible assets as the exercise generally involves significant management judgement.

- **Inventories**: For companies in the metal industry, determining the physical quantity of in-process metal is complex, and requires certain specific procedures. Further, the result of these procedures may not be accurate. Therefore, the area involves significant management judgement and estimation while valuing inventory.
The life sciences sector includes companies that are engaged in the research and development of new medicines/molecules and production of medicines and other pharmaceutical ingredients. Some of the areas in the financial statements that could be considered as KAMs include:

- **Goodwill and intangible assets**: The inherent uncertainty of the performance of new/acquired products and sector volatility are likely to increase the risk of impairment. Impairment assessments require significant management judgement and complex estimation, which increases the risk of error or potential management bias.

- **Revenue**: Complex terms of contracts with distributors may require significant management estimation and judgement in determining the timing of revenue recognition and measurement of revenue. Where revenue is derived from several business segments, and agreements with customers contain more than one performance obligation, the management needs to determine the basis for allocating the consideration received between the separate performance obligations based on relative stand-alone selling prices. Determination of performance obligations and stand-alone selling prices are likely to involve judgements and estimates.

- **Receivables and allowances**: Impairment allowances for bad and doubtful debts are determined based on the management’s estimate of the expected credit losses, considering the payment history of the company’s customers, customer specific conditions and relevant current factors in terms of liquidity and profitability of customers. This area is likely to involve a significant degree of management judgement.

- **Acquisitions**: Acquisition accounting is considered a significant judgement area:
  a. Allocation of acquisition amount to fair value of identifiable assets and liabilities acquired, identification and fair valuation of previously unrecognised intangible assets acquired and recognition of goodwill/bargain purchase gain.
  b. Impairment assessment for intangible assets acquired are likely to require complex estimates.
Technology

The sector mainly includes companies that are providing information technology services. These companies witness complex revenue agreements with customers.

Some of the areas in the financial statements that could be considered as KAMs include:

- **Revenue**: Companies in the technology sector earn revenue primarily from providing IT services, consulting and business solutions. The contracts of the company can be complex and are tailored specifically for each customer. Given the high level of automation, complexity of systems and the judgements involved while applying the revenue recognition standard, including the period over which to recognise revenue, recognition of revenue is considered as a key judgement area.

- **IT systems and controls**: Considering that companies in the technology sector have a high level of automation across processes, a high level of reliance is likely to be placed on a company’s IT systems and key automated controls.

- **Goodwill and intangible assets**: Due to the inherent uncertainty involved in forecasting and discounting future cash flows which forms the basis of the recoverability assessment and the subjectivity of key assumptions in impairment models, this is a potential area of KAM.

- **Taxation**: Significant judgements and management decisions may be made with regard to uncertain tax positions while computing taxation provisions. These matters are subject to management bias and may lead to litigations and disputes.
Healthcare

The healthcare sector includes hospitals, companies providing diagnostic services, and companies manufacturing and trading in medical devices. Many of the companies in the sector own the buildings and machines used by them in the normal course of business, hence it is considered as a capital intensive sector. Some of the areas in the financial statements that could be considered as key audit matters include:

- **Deferred tax assets on losses**: While recognising deferred tax assets, the Indian Accounting Standards require companies to forecast future taxable profits to determine whether they would be sufficient to recover all or part of these deferred tax assets. Considering the capital intensive nature of the sector, many companies (especially hospitals) take longer period to make themselves profitable. Therefore, significant amount of judgement is likely to be applied while analysing whether deferred tax asset can be recognised on business losses.

- **Impairment of investments**: Companies in this sector may have invested in equity and debt securities of their group entities (being subsidiaries, associates and joint ventures), which could be significant to the overall financial statements. These investments are required to be reviewed at the end of each reporting period to determine whether there is objective evidence of impairment. Computing the cash flows for such investments may involve the exercise of significant management judgement, and hence may be considered as a key audit matter.

- **Evaluating relationship between entities**: Ind AS 110, *Consolidated Financial Statements*, requires entities to consolidate those investees over which they have ‘control’, irrespective of the shareholding pattern of the investee. Considering the complexity of arrangements between entities, there is a significant amount of judgement involved in evaluating whether the investor controls/jointly controls the investee or has significant influence over it.
The media and entertainment sector includes television, print and other online media. It also includes art houses and publishing houses. Some of the areas in the financial statements that could be considered as KAMs include:

- **Amortisation of intangibles/inventories**: Generally the content procured/produced by media and entertainment companies is capitalised as inventory/intangibles. Considering the various rights attached to the contents (especially in case of online portals), it is imperative for the management to determine the manner and period of amortising the inventory and intangibles.

- **Revenue recognition**: Ind AS 115 is now applicable for revenue recognition for contracts with customers, accordingly, there are various aspects of the standard that need to be assessed, considering the nature of industry and the contracts, some of matters that involve significant management judgement are timing of revenue recognition, basis of allocation of transaction price to various performance obligations and recognition of revenue on a gross or net basis.

- **Receivables and allowances**: Customers may have different credit profiles and the timing of settlement of accounts receivable could be influenced by sector norms and the economic environment in which the customers operate. The allowances for doubtful debts are based on management’s estimate of the expected credit losses to be incurred, which is estimated by taking into account the credit history of the group’s customers and current market and customer-specific conditions.

- **Goodwill and intangible assets**: Due to the inherent uncertainty involved in forecasting and discounting future cash flows which forms the basis of the recoverability assessment and the subjectivity of key assumptions in impairment models, this is a potential area of KAM.
Transport, leisure and sports sector includes companies providing shipping, transport and logistic and tourism and hospitality services. With a growing emphasis on alternative transport modes, there has been a rapid increase in infrastructure investments and thus an increase in capital investments.

- **Revenue**: Valuation and recording of customer loyalty points provided by various air and other travel companies, and deferment of revenue till redemption of loyalty points is a complex area.

  Certain companies in the ‘leisure’ sector such as theme parks obtain revenues from a number of different channels, such as admissions ticketing income, annual passes, spend in attractions. Due to the low value of individual transactions, it could be difficult to detect errors. However the high volume of transactions mean that systemic failure could lead to errors that aggregate into material balances.

- **Property, plant and equipment**: Companies providing shipping, transport, logistics, tourism and hospitality services are capital intensive. Considering the economic environment in which they operate, impairment assessment should be performed on the trigger of impairment of PPE. Various judgements are involved while assessing impairment:
  - **Identifying cash generating unit**: The hotel industry, especially larger group of hotels, that own many hotel units, face a challenge in identifying the Cash Generating Unit (CGU) while assessing impairment. Evaluating CGUs is a complex area and involves a significant degree of management judgement and estimation.
  - **Impairment computation**: Judgements involved in computing recoverable amounts of PPE could be complex as they are dependent on assumptions about the future, such as revenue, growth rates and discount rates.

- **Goodwill and intangible assets**: Impairment assessments prepared by management are complex and can be inherently subjective and require significant judgement and estimation, which increases the risk of error or potential management bias. Additionally, expenses incurred for internally developing intangible assets need to be assessed to determine whether they can be capitalised.

- **Provisions and accruals**: Companies providing shipping, transport and logistics services, may face claims and litigations from regulators, customers and suppliers that arise during the normal course of business. The assessment of the provision for such claims involves estimates based on past claims experienced and recent claim developments. The ultimate claim amount is dependent on future external events, which are inherently uncertain and actual claims may, therefore, deviate from management estimations.

- **Receivables and allowances**: Recoverability of trade receivables is could be another potential area of KAM as companies in this sector provide services to customers in various sectors such as oil and gas, construction etc. These customers have different credit profiles and the timing of settlement of trade receivables can be influenced by the individual customer/sector performance. Allowances for doubtful debts are based on management’s assessment of individual receivable items, which is estimated by taking into account customer-specific conditions, the repayment history of the customers and their on-going relationship.
Financial services

The financial services sector includes banks, non-banking financial companies and investment management funds. Many of these companies deal with investments and other financial instruments, the recognition and measurement of which is complex in the Ind AS environment. Some of the areas in the financial statements that could be considered as KAMs include:

- **Investments valuation**: Selection of the basis of valuation of investments is a potential area of KAM.
- **Receivables and allowances**: Significant judgement and assumption in recoverability of loan and impairment assessment based on the expected credit loss model. Another area of judgement is valuation of collateral which could have significant impact over recoverability.
- **Financial instruments**: Fair valuation of financial instruments is complex and involves significant accounting judgement.
- **Goodwill and intangible assets**: Estimation in fair value of goodwill and other intangible assets involves significant judgment and estimate and identification of cash generating unit’s for impairment

Consider

The inclusion of KAM in the auditor’s report is intended highlight ‘through the eyes of the auditor’, matters of most significance and those that were subject to significant judgement by management and auditor in the in the course of audit.
Ind AS 115: Impact on transport, logistics and leisure sector

This article aims to:
- Explain the impact of the new revenue standard with the help of examples.

Background

Accounting for contracts in the transportation, logistics and leisure sector is undergoing a change due to the application of the new revenue recognition standard. In this edition of Accounting and Auditing Update (AAU), we focus on the transportation, logistics and leisure sector. Our article highlights the significant areas (e.g. determination of performance obligations, variable consideration, contract manufacturing arrangements, etc.) where old guidance in Ind ASs is expected to change due to implementation of Ind AS 115.

Therefore, there is a need for a deeper understanding of the impact of requirements of the new standard and determine the sector specific impact, both on the business operations and financial reporting. For transportation, logistics and leisure sector, which is one of the largest and fastest growing sectors in the country, certain Ind AS 115 impacts affect the heart of business performance i.e. sales and timing of recognising revenue, customer incentives and other performance obligations, which may be embedded in the sale of products made to customers.

The transportation, logistics and leisure sector includes companies associated with shipping, railways, airlines, ports, container freight station, leisure and logistics. Customers generally pay a fee for the movement of cargo or passengers between two or more specified points, or for use of hotel/recreation space for a particular duration of time. While arrangements with customers are not too complex, the same have the ability to be modified to increase/reduce the extent of services. The industry also offers rewards/incentives to its customers in the form of volume discounts/rebates, loyalty programmes, etc.
From 1 April 2018, new revenue standard, Ind AS 115, *Revenue from Contracts with Customers* is applicable for companies following the Ind AS road map framework. This new standard replaces the existing revenue recognition principles set out by Ind ASs i.e. Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue*. The new standard comes with a concept of recognising revenue at a point in time or over time, provides more guidance on separating goods and services (in case of bundled contracts) and also provides guidance on measuring the transaction price.

Ind AS 115 follows a core principle that an entity recognises revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. As per the standard, a customer is ‘a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration’.

### 1. Identify the contract

The assessment of whether a contract with a customer exists under the new revenue guidance is less driven by the form of the arrangement, but whether an agreement between two parties (either written, oral, or implied) creates legally enforceable rights and obligations between them. The purpose of the collectibility assessment under the new guidance is to determine whether there is a substantive contract between the company and the customer. This differs from the guidance given in Ind AS 18 in which collectability is a constraint on revenue recognition.

Companies should consider any history of entering into amendments or side agreements to a contract that either change the terms of, or add to, the rights and obligations of a contract. These can be verbal or written, and could include cancellation, termination, or other provisions. They could also provide customers with options or discounts, or change the substance of the arrangement. All of these have implications for revenue recognition. Therefore, understanding the entire contract, including any amendments, is important to the accounting conclusion.

It is quite common in this sector to enter into ‘Master Service Agreements’ (‘MSA’), which defines broadly the general scope of services to be provided and the timelines over which the same are to be provided.

However, without explicit underlying details of the exact scope of services, these MSAs by themselves may not qualify to be a contract under this standard.

The new guidance also eliminates the cash-basis method of revenue recognition that is often applied today if collectibility is not reasonably assured or probable. Any cash received is recognised as a contract liability until either collectibility of the transaction price is probable or one of the criteria for recognition is met. This could result in revenue being recorded later than under current guidance in some situations.

Further, this sector experiences various modifications to existing contracts (e.g. upgradation of class of travel in railway/airlines, upgradation of rooms in hotels, inclusion of additional services like last mile travel, etc.) Ind AS 115 has specific guidance on when a modification should be treated as part of original contract or when it should be treated as termination of existing contract and creation of a new contract. The examples given above of upgradation of class of travel would normally fall under the former eventuality whereas change in date of travel/or availing additional services are likely to result in creation of a new contract.

### 2. Identify performance obligations

Many entities in this sector provide multiple products or services to their customers as part of a single arrangement. Management must identify the separate performance obligations in an arrangement based on the terms of the contract and the company’s customary business practices. A bundle of goods and services might be accounted for as a single performance obligation in certain situations.

A performance obligation is a promise in a contract to transfer to a customer either:

- A good or service (or a bundle of goods or services) that is distinct, or
- A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.
A promised good or service is distinct from other goods and services in the contract if meets two criteria:

**Criterion 1: Capable of being distinct**
Customer can benefit from the good or service on its own or together with other readily available resources

**Criterion 2: Distinct within the context of contract**
Promise to transfer good or service is separately identifiable from other promises in the contract

![Diagram showing decision process for distinct performance obligation](source)

Assessing whether goods and services are capable of being distinct is similar to determining if deliverables have stand-alone value or are separate components, although the definitions are not identical. Under the new guidance, management will assess if the customer can benefit from the good or service with ‘resources that are readily available to the customer’ which could be a good or service sold separately by the entity or another entity, or a good or service the customer has already obtained.

**Examples**

**Customer loyalty programmes - Airline and hospitality**

Many airlines and hotels operate customer loyalty programmes in which customers can earn loyalty points, either by travelling with the airline/staying in a hotel, or making qualifying purchases with an airline partner. Customers can use the points to buy future travels or stays, upgrade to a higher travel class or purchase goods from the issuing airline/hotel and/or its redemption partners. A customer loyalty programme that provides a customer with a material right is accounted for as a separate performance obligation under the new standard.

**Turnkey projects - Logistics**

In the Third-party logistics (3PL) or Fourth-party logistics (4PL) business, an entity takes over the end-to-end responsibility of transport goods from origination to destination. This service includes multiple distinct services viz. land transport, custom and port services, ocean transport, installation, etc. As per the new standard, some of these segments will be treated as a distinct performance obligation.
Seaside and offshore services - Port sector

A typical port operator provides core services like wharfage, pilotage, stevedoring and loading/unloading of cargo. In addition, they also provide additional services like storage, transshipment, internal shifting, etc. Management will need to assess whether these services are separate performance obligations based on the facts of the customers’ arrangement.

Import/export services - Container Freight Stations (CFS)

CFSs provide both import and export related services, in addition to stuffing and de-stuffing cargo and storing the same as well. Historically, all the CFS services were considered as one performance obligation. However, it is likely that the core CFS operation of storage and stuffing/de-stuffing and the non-core operation of transportation of cargo could be considered as distinct performance obligations.

3. Determine transaction price

The transaction price is the consideration to which the entity expects to be entitled in exchange for goods or services. Determination of the transaction price may be simple when the contract price is fixed and paid at the time services are provided. However, it may require more judgement if the consideration contains an element of variable or contingent consideration. Common forms of variable consideration in the transportation and logistics sector include discounts, volume rebates and performance bonuses.

Variable consideration (e.g. discounts and rebates) included in the transaction price is normally subject to a constraint. Management will need to determine if there is a portion of the variable consideration (that is, a minimum amount) that would not result in a significant revenue reversal and include that amount in the transaction price.

The revenue standard provides factors to consider when assessing whether a variable consideration should be constrained. Management should reassess the estimate of variable consideration at each reporting period.

Additionally, customers may not exercise all of their contractual rights related to a contract, such as rebates and other incentive offers. These unexercised rights are often referred to as breakage. Management should adjust for changes in expectations when updating the estimated amount of consideration to which an entity expects to be entitled.

Management might need to put into place new processes to monitor estimates on an ongoing basis as more experience is obtained.
Demurrage claims - Shipping

A shipping company enters into a voyage charter contract with a customer to transport goods from point A to point B. The shipping company may experience delays in loading and unloading the cargo (referred to as demurrage), which are not the responsibility of the shipping company. The additional amount to be paid to the shipping company is calculated in accordance with the terms of the contract. Demurrage claims are often negotiated, resulting in adjustments to the contract price, and can take a long time to resolve. The amount of demurrage claims might be difficult to estimate and are likely to vary depending on the counterparty and the type of delay. Based on past experience, the entity would be required to include in the transaction price any portion of the claim that meets the probable threshold. The time taken to resolve claims or the external factors involved are not factors that would allow the entity to avoid including in the transaction price a minimum amount that meets the threshold.

Volume rebates - Rail/road transport, CFS, freight forwarders, etc.

Transport companies enter into a contract to transport goods from point A to point B for INR1,000. The customer earns a rebate of INR100 for each load if the customer transports at least 10,000 loads annually. Based on past experience, management believes there is a 50 per cent likelihood that the customer will ship 10,000 loads and earn the rebate of INR100 per load. As per the new revenue standard, the transaction price is INR900 per load, which reflects the amount to which the transporter expects to be entitled based on its estimate of loads to be transported. There are only two possible outcomes regarding the variable consideration (e.g. the rebate). The customer will be entitled to either INR900 or an additional INR100 per load. Any amounts collected in excess of INR900 per load (that is, the additional INR100 per load prior to earning the rebate) would be recorded as a liability. These estimates should be monitored and adjusted, as necessary, using a cumulative catch-up approach. For instance, should circumstances change and it becomes probable that the customer will not be entitled to the rebate, the extra INR100 per load would be included in the transaction price for the loads previously shipped at that point.

Time value of money - all sectors

An entity needs to adjust the amount of promised consideration to reflect the time value of money if the contract includes a significant financing component. A significant financing component does not exist if the timing of delivery is at the customer’s discretion (for example, in the case of customer loyalty points) or the difference between the promised consideration and the cash selling price arises for reasons other than financing. As a practical expedient, a company need not assess whether a contract has a significant financing component if it expects at contract inception that the period between payment and the transfer of services will be one year or less. We do not expect a significant change to current practice for many entities in transportation, logistics and leisure sector in connection with the time value of money because payment terms do not often extend over more than one year from the time of contract performance.
4. Allocate transaction price

Transportation, logistics and leisure sector may provide multiple goods or services to their customers as part of a single arrangement. As we discussed above, the entities will have to identify different performance obligations and therefore, will need to allocate the transaction price to the separate performance obligations in one contract. This allocation should be based on the relative stand-alone selling price of each separate performance obligation. The standard recommends use of directly observable price in this respect, however, in its absence, the standard requires the entity to estimate the stand-alone selling price (viz. adjusted market price, cost plus margin or residual approach).

Examples

Customer loyalty programmes - Airline and hospitality

As discussed earlier, points/awards issued under customer loyalty programmes are separate performance obligations if they provide the customer with a material right that the customer would not receive without buying the initial product or service (for example, the original flight/hotel stay). The transaction price is allocated between the initial purchase and the award credits based on the actual or estimated stand-alone selling price of each performance obligation. The portion of the transaction price allocated to the award credits is not recognised as revenue until the credits are redeemed or expire.

The stand-alone selling price of the award credits is not usually directly observable and will, therefore, need to be estimated. The estimate should reflect the discount achieved by customers when spending award credits, adjusted for the likelihood that the credits will be forfeited (breakage). For example, an airline recognises revenue from the award credits on a gross basis when the customer redeems them for goods or services that the airline provides.

Adjustments for expected forfeitures (breakage) are likely to affect the timing of revenue recognition. The stand-alone selling price of award credits will be reduced to reflect the award credits not expected to be redeemed. This requirement could result in less revenue allocated to award credits as compared to Ind AS 18’s multiple-element model.

Further, an airline/hotel that operates a programme in which points can be redeemed with a third party needs to consider whether it is a principal or an agent in the arrangement. This requires management to first consider the nature of its performance obligation. The entity should recognise revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement.
5. Recognise revenue and costs

Transportation or freight services are generally provided over a period of time ranging from one day to multiple months. The new standard requires that revenue be recognised as an entity satisfies a performance obligation by transferring control of a good or service. A performance obligation can be satisfied over time or at a point in time.

A performance obligation is satisfied over time if any one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits as the entity performs
- The entity’s performance creates or enhances an asset that the customer controls, as the asset is created or enhanced
- The entity’s performance does not create an asset with an alternative use, and the entity has an enforceable right to payment for performance completed to date.

An entity should recognise revenue over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. If a performance obligation is not satisfied over time, then the entity satisfies the performance obligation at a point in time.

Transportation services will likely meet the criteria for revenue recognition over time as the customer simultaneously receives and consumes the benefit as the entity performs. It is observed that the customer benefits from the entity’s performance as it occurs if another entity would not need to substantially re-perform the entity’s performance (for example, distance already travelled) to date. An entity should disregard any contractual or practical limitations when it assesses whether the customer simultaneously receives and consumes the benefits and whether another entity would need to substantially re-perform the performance completed to date. For example, the assessment would not consider contractual provisions that restrict an entity from transferring its obligations to another entity.

Examples

Transportation revenue

A trucking company enters into a contract with a customer to transport goods from Mumbai to Delhi. The customer has an unconditional obligation to pay for the service when the service has been completed, which is when the goods reach Delhi. These types of contracts will typically meet the criteria for revenue recognition over time. If the trucking company transports the goods midway to the destination, another transportation company could fulfil the remaining obligation to the customer without having to re-perform the services provided to date. The obligation to provide transportation services is therefore satisfied over time, and revenue should be recognised over the period of performance (generally the period from when transport of the goods begins from Mumbai through delivery to Delhi).

Breakage revenue - Airlines

Airlines usually sell tickets in advance for full consideration. Some tickets are not used for travel and cannot be exchanged or refunded. Certain flexible air tickets include a right to re-schedule if the customer does not fly on the scheduled flight date, but the customer may decide not to travel. Those partially or wholly unused tickets are often referred to as ‘ticket breakage’.

An entity considers the variable consideration guidance to determine whether - and to what extent - it recognises breakage. It determines the amount of breakage to which it is entitled as the amount for which it is considered highly probable that a significant reversal will not occur in the future. This amount is recognised as revenue in proportion to the pattern of rights exercised by the customer when the entity expects to be entitled to breakage. Otherwise, the entity recognises breakage when the likelihood of the customer exercising its remaining rights becomes remote.
6. Principal versus agent (gross versus net)

Certain arrangements involve two or more unrelated parties that contribute to providing a specified good or service to a customer. In these instances, management will need to determine whether the company has promised to provide the specified good or service itself (as a principal) or to arrange for those specified goods or services to be provided by another party (as an agent). This determination often requires judgement, and different conclusions can significantly impact the amount and timing of revenue recognition.

Management should first understand the relationships and contractual arrangements among the various parties. This includes identifying the specified good or service being provided to the end customer and determining whether the company controls that good or service before it is transferred to the end customer.

As per the new standard, an entity is the principal and should report revenue on a gross basis if it controls the specified good or service before it is transferred to the customer. Conversely, it is an agent and should report revenue on a net basis if its obligation is to arrange for another party to provide goods or services (i.e., the entity does not control the specified good or service before it is transferred to the customer).

The principal versus agent assessment is performed at the performance obligation level, not at the contract level. An entity may act as a principal with respect to certain performance obligations in the contract and an agent with respect to others.

Examples

**Principal versus agent assessment - Airlines**

Airlines often sell tickets to customers that include flight segments to be flown by another airline, or enter into contracts for transporting cargo with another airline. In these cases, an airline determines whether it acts as principal or agent in the transaction and accounts for revenue accordingly, i.e. on a gross or a net basis. Airlines usually charge government- and airport-based passenger taxes and fees at the time of the ticket sale. Often, these are subsequently remitted to the relevant authorities. Airlines may also make discretionary fuel surcharges, which are not remitted to any authorities, and may or may not be explicitly stated in the airfare. Therefore, it is important to analyse all relevant facts and circumstances to evaluate whether an airline is acting as principal or agent in each case.

**Principal versus agent assessment - Freight forwarders /3PL/4PL**

A freight forwarder, in addition to arrangement for transportation of cargo from point A to point B, also provides additional services of payment of statutory dues (viz. custom duty), custom clearance, etc. which is normally carried out on behalf of the customer. While custom clearance could classify as a separate performance obligation, and therefore be treated as an act of a principal, payment of custom duty to the authorities on behalf of the customer would be treated as an agency act, and therefore would not be considered as part of revenue.

Conclusion

Revenue is a key performance measure for companies operating across all the sectors and the transportation, logistics and leisure sector is no exception. Given the significant amount of judgement involved at each stage, companies, therefore, need to plan and invest time in effective implementation of the new standard.

The standard is pervasive in nature and, in addition to the financial reporting impact, companies in the sector would also have to assess impact on business contracts, processes as well as the need to educate stakeholders such as investors and analysts.
This article aims to:
- Demonstrate the assessment of the classification of financial instruments with prepayment features and determine when compensation is considered ‘reasonable’.

**Background**

Indian Accounting Standard (Ind AS) 109, *Financial Instruments*, prescribes that financial assets should be classified and subsequently measured at amortised cost, Fair Value Through Other Comprehensive Income (FVOCI) or Fair Value Through Profit or Loss (FVTPL) on the basis of the entity’s business model for managing financial assets and its contractual cash flow characteristics. For assets that are in a ‘hold-to-collect’ or ‘hold-to-collect and sell’ business model, entities need to assess whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are Solely Payments of Principal and Interest (SPPI).

Ind AS 109 states that for the purpose of the contractual cash flow characteristics test, the ‘principal’ is the fair value of the asset on initial recognition, and may change over time – for example, when there are repayments of principal. ‘Interest’ is consideration for the time value of money and credit risk, and can also include consideration for other basic lending risks and costs, and a profit margin.

The contractual cash flows of some financial assets may change over their lives. For such assets, an entity determines whether the contractual cash flows that could arise both before and after the change in contractual cash flows meet the SPPI criterion - for example financial assets with variable interest rates, prepayment features or extension options.

In this article, we aim to illustrate the SPPI assessment performed for loans with prepayment features in order to ascertain their classification and subsequent measurement.
Example: Loans with prepayment option

Bank C (the bank) provides banking and other financial services to both retail and corporate customers. On 1 April 2019 it advanced a housing loan to Mr. A, a retail banking customer and a term loan to P Private Limited, a corporate banking customer. The key features of the loans are given hereunder:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Housing loan</th>
<th>Term loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of loan</td>
<td>INR4,000,000</td>
<td>INR50,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>8.95 per cent</td>
<td>12.5 per cent</td>
</tr>
<tr>
<td>Effective Interest Rate (EIR) of the loan</td>
<td>9.5 per cent</td>
<td>13.4 per cent</td>
</tr>
<tr>
<td>Period of loan</td>
<td>10 years</td>
<td>Five years</td>
</tr>
<tr>
<td>Repayment term</td>
<td>The loan would be repaid by way of an Equated Monthly Instalment (EMI) of INR50,562 over a period of 10 years.</td>
<td>The loan would be repaid in five annual installments beginning 31 March 2020</td>
</tr>
<tr>
<td>Prepayment clause</td>
<td>Prepayment is not permitted for the first six years of the loan. Prepayment made post that, would require the customer to pay an additional charge of 0.25 per cent on the principal amount repaid.</td>
<td>Prepayment is permitted after the company has paid the second annual instalment. Five per cent of the nominal amount of loan would be paid as bank fee.</td>
</tr>
<tr>
<td>Business model of the loan</td>
<td>Held-to-collect</td>
<td>Held-to-collect and sell</td>
</tr>
</tbody>
</table>

As per its policy, Bank C invests its excess cash in government securities, this includes amounts received from customers on prepayment of loan. It expects the government bond rates with maturity of one to three years to bear an interest rate of 6.25 per cent per annum². A fee between 1.5-3.5 per cent of the prepaid amount is generally collected by the bank as compensation for early repayment, to cover administration costs.

Accounting issue

On original recognition of the loans advanced (the financial assets), Bank C needs to undertake a comprehensive review of the loan documentation to assess whether the contractual cash flows that arise over the life of the loans meet the SPPI criterion. If the SPPI criterion is met, then the housing loan and term loan would be classified and subsequently measured at amortised cost and at FVOCI respectively. In case this criterion is not met, then the loans will be classified and measured at FVTPL.

Accounting guidance

As per Ind AS 109, financial instruments with prepayment features may change the timing or amount of contractual cash flows, however, they may meet the SPPI criterion under certain conditions as given in figure 1 below:

1. The prepayment fees considered in this illustration may not represent the current industry practice, and have been adopted for illustrative purposes only.
2. This interest rate is not representative of the current market, and has been assumed for the purpose of the illustration.
3. In October 2017, the International Accounting Standards Board (IASB) made a limited scope amendment to International Financial Reporting Standard (IFRS) 9, Financial Instruments with which Ind AS 109 is aligned. The amendment specifies that the compensation for early termination of the contract should be ‘reasonable compensation’, and may not be additional. A similar amendment has been proposed to be made in Ind AS 109 by way of an exposure draft issued by the Institute of Chartered Accountants of India (ICAI) on 12 June 2018.

Source: KPMG in India’s analysis 2018, read with Insights into IFRS, KPMG IFRG Ltd’s publication, 2018, 15th edition.
Analysis

Bank C needs to first evaluate the nature of the prepayment feature. It also needs to consider what the prepayment amount would be at each date on which the prepayment feature is exercisable, to determine for all cases whether the prepayment amount substantially represents ‘unpaid amounts of principal and interest’.

Housing loan

Prepayment of the housing loan is permitted post the sixth year, accordingly, for the purpose of evaluation, we may consider that the loan is prepaid at the end of year seven, eight and nine. In each case, the amount paid would include the principal amount outstanding on the date of prepayment and a fee, as given in the loan agreement.

As per Ind AS 109, a prepayment feature whose prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract meets the SPPI criterion. Accordingly, Bank C needs to evaluate the purpose for which the fee is collected. An evaluation of this has been presented in table 1 below:

Table 1: Evaluating prepayment features of housing loan

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amounts at the end of the (Amount in INR in thousands)</th>
<th>Seventh year</th>
<th>Eighth year</th>
<th>Ninth year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount repaid</td>
<td></td>
<td>1,591</td>
<td>1,107</td>
<td>578</td>
</tr>
<tr>
<td>Additional charge</td>
<td></td>
<td>4</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total amount paid by borrower (A)</strong></td>
<td></td>
<td><strong>1,595</strong></td>
<td><strong>1,110</strong></td>
<td><strong>580</strong></td>
</tr>
<tr>
<td>Principal amount outstanding</td>
<td></td>
<td>1,591</td>
<td>1,107</td>
<td>578</td>
</tr>
<tr>
<td>Add: Present value of earnings foregone (at coupon rate)</td>
<td></td>
<td>199</td>
<td>95</td>
<td>26</td>
</tr>
<tr>
<td>Less: Present value of notional interest earned (discounted at EIR of the loan)</td>
<td></td>
<td>(250)</td>
<td>(121)</td>
<td>(33)</td>
</tr>
<tr>
<td><strong>Amount expected to be received by bank (B)</strong></td>
<td></td>
<td><strong>1,540</strong></td>
<td><strong>1,081</strong></td>
<td><strong>571</strong></td>
</tr>
<tr>
<td>Excess amount paid by borrower (A-B)</td>
<td></td>
<td>55</td>
<td>29</td>
<td>9</td>
</tr>
<tr>
<td>Excess amount paid as a percentage of principal outstanding</td>
<td></td>
<td>3.4%</td>
<td>2.6%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Source: KPMG in India’s analysis, 2018

A. Total amount paid by borrower

Amounts paid by the borrower at the end of years seven, eight and nine represent the principal amount as on those dates, and an additional 0.25 per cent fee on the principal amount prepaid, as mentioned in the loan agreement.

B. Compensation to be received

The amount expected to be received by the bank on prepayment of the loan includes the principal amount outstanding on the date of prepayment and other amounts to cover its notional loss on prepayment. This includes:

- Present value of earnings foregone: This represents the amount that the bank would have earned, had the borrower continued to hold the loan as per its original tenure. It is calculated at the coupon rate of the loan and represents the interest foregone on account of prepayment of the loan. This amount is discounted at the EIR to represent the present value on the date when the prepayment is expected.

- Present value of notional interest earned: As per the bank’s policy, excess cash, including prepayments of loans received, are invested in government bonds. Accordingly, the present value of the total compensation expected to be received by the bank would reduce to the extent of the present value of the notional interest\(^4\) it would earn on the prepaid amount that would be invested in government bonds.

\(^4\) The present value of the notional interest earned would be computed by discounting the notional interest earned on the government bond at the EIR of the loan.
The amount paid by the borrower is higher than the expected compensation. The bank needs to evaluate whether the additional compensation paid by the borrower is ‘reasonable’⁵. While Ind AS 109 does not define what is considered to be ‘reasonable’, it states that under a basic lending arrangement, SPPI is met, when interest compensates an entity for:

• Time value of money
• Credit risk associated with the principal amount outstanding
• Other basic lending risks (for example, liquidity risk)
• Costs (for example administrative costs) associated with holding the financial asset for a particular period of time, and
• A profit margin.

In the above case study, since the excess amount received is within the range of 1.5 – 3.5 per cent of the prepaid amount, which, as given in this illustration⁶ is generally collected by Bank C for administration fees, it meets the SPPI criterion, since it compensates the bank for meeting certain costs associated with the loan. Since the SPPI criterion is met, and the asset is held under a business model of ‘hold-to-collect’, it is classified and subsequently measured at amortised cost.

**Term loan**

A similar analysis is performed for the term loans issued by the bank, where the prepayment amount is assessed on each date when the prepayment is exercisable.

In the above case study, since the additional compensation in year two is within the range of administration fees generally collected by the bank. However, this criteria should be met at every prepayment date of the instrument. Accordingly, this needs to be assessed for prepayment at the end of year three and four. Since the amounts paid by the borrower at the end of years three and four would exceed the amount that the bank generally collects as its administration costs, the additional compensation paid by the borrower includes compensation for other factors. This may not substantially represent ‘unpaid amounts of principal and interest’ and thus may not be considered to be ‘reasonable’ in the context of this illustration. Since the SPPI criterion is not met, the term loan will be classified and measured at FVTPL.

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⁵ Since the term ‘reasonable’ has not been defined by Ind AS 109, assessment of whether the compensation paid by the borrower meets this criteria is highly judgemental. Entities should consider both qualitative and quantitative factors when performing this assessment.

⁶ Every entity would be required to evaluate this based on the facts and circumstances of their condition.

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### Table 2: Evaluating prepayment features of term loan

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amounts at the end of the (Amount in INR in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Second Year</td>
</tr>
<tr>
<td>Principal amount repaid</td>
<td>30,000</td>
</tr>
<tr>
<td>Additional charge</td>
<td>2,500</td>
</tr>
<tr>
<td><strong>Total amount paid by borrower (A)</strong></td>
<td><strong>32,500</strong></td>
</tr>
<tr>
<td>Principal amount outstanding</td>
<td>30,000</td>
</tr>
<tr>
<td>Add: Present value of earnings foregone (at EIR)</td>
<td>6,110</td>
</tr>
<tr>
<td>Less: Present value of notional interest earned</td>
<td>(4,399)</td>
</tr>
<tr>
<td><strong>Compensation to be received (B)</strong></td>
<td><strong>31,711</strong></td>
</tr>
<tr>
<td>Excess amount paid by borrower (A-B)</td>
<td>789</td>
</tr>
<tr>
<td>Excess amount paid as a percentage of principal outstanding</td>
<td>2.6%</td>
</tr>
</tbody>
</table>

Source: KPMG in India’s analysis, 2018
Consider this

- On the date of prepayment of the loan, the unamortised processing fees should be charged to the statement of profit and loss.

- Determining ‘unpaid amounts of principal and interest’ requires consideration of the economic characteristics of the contract and may require judgement. In particular, it may be necessary to determine whether individual cash flows required by the contract (in the absence of the prepayment feature) represent payments of interest or repayments or advances of principal and how rights to interest are considered to arise over time. For example, for assets that are originated or purchased at a premium above the par amount repayable on maturity, contractual coupons (i.e. what the contract labels as interest) may represent in part repayments of principal for the purpose of evaluating the SPPI criterion.

- If a financial asset would otherwise meet the SPPI criterion, but fails to do so only as a result of a contractual term that permits or requires prepayment before maturity, or permits or requires the holder to put the instrument back to the issuer, the asset can be measured at amortised cost or FVOCI if:
  - The relevant business model condition is satisfied
  - The entity acquired or originated the financial asset at a premium or discount to the contractual par amount
  - The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for early termination, and
  - On initial recognition of the financial asset, the fair value of the prepayment feature is insignificant.

- Assessment of what is considered as ‘reasonable’ compensation may differ depending on whether prepayment is at the option of the borrower or lender.

- In October 2017, IASB made limited scope amendments to IFRS 9, allowing particular financial assets with prepayment features that may result in negative compensation- e.g. the lender receives less than the par amount and accrued interest and effectively compensates the borrower for the borrower’s early termination of the contract- to be measured at amortised cost or at FVOCI (subject to business model assessment). Before the amendments, these instruments were measured at FVTPL because the SPPI criterion would not be met when the party that chooses to terminate the contract early may receive compensation for doing so.

The amendments have also removed the requirement for the compensation to be ‘additional’. Accordingly, a prepayment amount that is less than the unpaid amounts of principal and interest (or less than the contractual par amount plus accrued interest) may meet the SPPI criterion if it is determined to include reasonable compensation for early termination.

Similar amendments have been proposed to be made in Ind AS 109, as per the exposure draft of the amendments to Ind AS 109 issued in June 2018.
IRDAI has issued a ‘Report of the working group on new standard on Insurance Contracts (Equivalent to IFRS 17, Insurance Contracts)\n
Background
The International Accounting Standards Board (IASB) on 18 May 2017, issued IFRS 17 Insurance Contracts. IFRS 17 replaces IFRS 4, Insurance Contracts which was in the nature of an interim standard pending the completion of the project on insurance contracts by the IASB.

The release of IFRS 17 standard led Insurance and Regulatory Development Authority of India (IRDAI) to review its position in the matter of implementation of Ind AS in the insurance sector. Considering the peculiarities involved in implementing Ind AS in insurance sector, IRDAI deferred the implementation of Ind AS in the insurance sector in India for a period of two years. Accordingly, Ind AS for Indian insurance companies was made applicable from 1 April 2020 (instead of 1 April 2018).

In order to commence work on early adoption of new standard on insurance contracts in India, a working group was constituted by the IRDAI on 21 August 2017.

The role of the working group was to:

a. Review of the new standard IFRS 17 and to identify relevant areas/aspects, which require suitable adoption in the Indian context

b. Identify changes arising out of new standard on insurance contracts
   • To be carried out in the draft regulations/ formats recommended by the Implementation Group vide their report dated 29 December 2016
   • To be carried out in other regulations/ guidelines, etc.

c. Any other aspects that may arise in the course of implementation of the standard in the insurance sector.
**New development**

On 6 December 2018, the working group has released its report along with draft regulations on preparation of financial statements by insurance companies. The major recommendations are as follows:

a. Single format of financial statements without distinguishing between life and other than life insurance business has been recommended. The recommendation is made considering IFRS 17 differentiates measurement of insurance contracts based on duration of contracts and does not distinguish between life and general insurance business.

b. Cash flow statement under direct method has been recommended. The IRDAI may examine whether reinsurance companies can be permitted indirect method of preparing cash flow statement.

c. Information presently required to be disclosed in the management report may be presented along with the board of directors’ report in a manner similar to that of corporate governance report.

d. Information primarily relevant to policyholders like fund-wise revenue account, balance sheet and additional disclosures may be presented by insurers on their respective websites instead of annexing these to financial statements.

e. Ind AS compliant balance sheet of insurance companies may be used as a basis to carry out adjustments for solvency computations.

f. The IRDAI may request Institute of Chartered Accountants of India (ICAI) and Institute of Actuaries of India (IAI) to bring out/publish education material on application of Ind AS 117, Insurance Contracts.

(Source: Report of the working group on new standard on Insurance Contracts (Equivalent to IFRS 17 issued by IRDAI)’)

**SEBI issues framework for fund raising by issuance of debt securities by large corporates**

The Securities and Exchange Board of India (SEBI), through its circular dated 26 November 2018, has prescribed a framework for fund raising by listed entities qualifying as large corporates as per the prescribed criteria.

**Applicability**

The framework is applicable for prescribed large entities from the accounting period beginning on or after 1 April 2019.

**Criteria to be considered as a large corporate**

The framework would be applicable for all listed entities (except for scheduled commercial banks), which as on last day of the financial year (i.e. 31 March or 31 December) satisfying all of the following:

- Have their specified securities or debt securities or non-convertible redeemable preference shares, listed on a recognised stock exchange(s) in terms of SEBI Listing Regulations, 2015
- Have an outstanding long term borrowing of INR100 crore or above, where outstanding long-term borrowings shall mean any outstanding borrowing with original maturity of more than one year and shall exclude external commercial borrowings and inter-corporate borrowings between a parent and subsidiary(ies)
- Have a credit rating of ‘AA and above’, where credit rating shall be of the unsupported bank borrowing or plain vanilla bonds of an entity, which have no structuring/support built in; and in case, where an issuer has multiple ratings from multiple rating agencies, highest of such rating shall be considered for the purpose of applicability of this framework.

**Framework**

The framework inter alia provides as follows:

- A large corporate (as specified above) should raise not less than 25 per cent of its incremental borrowings (during the financial year subsequent to the financial year in which it is identified as a large corporate) by way of issuance of debt securities, as defined under SEBI (Issue and Listing of Debt Securities) Regulations, 2008.
- A large corporate should make prescribed disclosures to the stock exchanges. These disclosures should be certified both by the Company Secretary (CS) and the Chief Financial Officer (CFO). The disclosures are as follows:
  - Within 30 days from the beginning of the financial year, disclose the fact that it is identified as a large corporate
  - Within 45 days of the end of the financial year, the details of the incremental borrowings done during the financial year
- The above disclosures would also form part of audited annual financial results of the entity.

Disclosure of significant beneficial ownership in the shareholding pattern

Section 89 of the Companies Act, 2013 (2013 Act) requires every person who holds or acquires a beneficial interest in share of a company and the person registered as holder of shares but does not hold the beneficial interest in such shares, required to make a declaration to the company specifying the nature of his/her interest, particulars of beneficial interest as prescribed. The 2013 Act defines significant beneficial owner as a person who is not a registered shareholder of the company but the person either individually or jointly owns at least 10 per cent stake in the company or directly or indirectly exercises significant control over the company.

Further, the Companies (Significant Beneficial Owners) Rules, 2018 specifies various requirements pertaining to disclosures regarding significant beneficial owners. With an aim to increase transparency to investors, SEBI through its circular dated 7 December 2018 has prescribed the format for disclosure of significant beneficial owners. All listed entities would need to disclose details pertaining to significant beneficial owners in the format prescribed at Annexure to aforementioned circular.

The circular will come into force from the quarter ended 31 March 2019.


SEBI proposes norms for direct listing of equity shares within and outside India

On 12 June 2018, SEBI formed an ‘Expert committee for listing of equity shares of companies incorporated in India on foreign stock exchanges and of companies incorporated outside India on Indian stock exchanges’ (the committee). The role of the committee, inter alia, was to make recommendations for a suitable framework to facilitate direct listing of equity shares of Indian companies on foreign stock exchanges and of foreign companies on Indian stock exchanges.

Accordingly, on 4 December 2018, SEBI released the report of the committee with a proposed framework for such direct listing.

The key recommendations in the report can be summarised under the following heads:

Preparation of Consolidated Financial Statements (CFS)

The framework suggested following with respect to preparation and presentation of financial results by a company in the respective cases:

- **Indian companies listing on foreign stock exchanges**: The relevant accounting standards of the country of listing would be applicable to the Indian companies which may require preparation/presentation of CFS either in accordance with accounting/auditing standards applicable to domestic companies in such jurisdiction or comparable global standards.

  However, for statutory reporting purposes, such Indian companies would be required to prepare its CFS as per the applicable Ind AS

- **Foreign companies listing on Indian stock exchanges**: Foreign companies listing on Indian stock exchanges would be required to prepare and disclose CFS (in English language) in accordance with one of the given accounting standards

  a. Ind AS
  b. IFRS
  c. US GAAP or
  d. Local GAAP of country of incorporation

Accordingly, if CFS have been prepared in accordance with IFRS or US GAAP, the foreign company would be required to annex a summary of significant differences between IFRS/US GAAP and Ind AS (without quantification).

If the foreign company opts to prepare and disclose the CFS as per country of incorporation’s local GAAP, then it would have to present a quantitative reconciliation statement between country of incorporation’s local GAAP and Ind AS for the periods presented. Additionally, a summary of significant differences between the country of incorporation’s local GAAP and Ind AS would be required.

Minimum float for listing

The proposed framework requires that at least 10 per cent of the paid-up capital of the foreign company should be listed on Indian stock exchange(s). Also, the issue size of a foreign company (for listing in India) should be at least INR1,000 crore with allotment to at least 200 investors.

Identification of promoter(s)/promoter group not required

The committee proposed that the norms relating to identification of promoter(s)/promoter group would not be applicable to a foreign company listing on Indian stock exchange(s).
Norms relating to prospectus and private placement not applicable

The committee in its report has proposed to request MCA to issue a clarification to the fact that provisions of Chapter III of the 2013 Act (i.e. prospectus, allotment of securities and private placement) would not apply to listing of equity shares by an Indian company on foreign stock exchange(s).


ICAI has issued an exposure draft on revised Guidance Note on reports in the company’s prospectus

The SEBI has issued the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 which amended the SEBI ICDR, 2009 with the aim of simplifying the law, eliminating redundancies and inconsistencies and updating references to the 2013 Act. The revised regulations have been reorganised for various issues of securities issues like Initial Public Offer (IPO), further public offers, rights issues, etc.

In view of the revised ICDR Regulations, 2018, ICAI has issued an exposure draft on revised Guidance Note on reports in the company’s prospectus (Guidance Note).

The exposure draft provides guidance relating to reporting requirements in relation to financial information to be included in the prospectus in case of IPO in accordance with SEBI ICDR, 2018. This Guidance Note would also be applicable to other types of filings for the issue of securities (equity shares, debentures and notes, etc.) such as:

- Letter of offer (in case of right issue)
- Placement document (in case of Qualified Institutional Buyers (QIBs))

The Guidance Note also includes guidance relating to offer or sale of the securities in India.

The period to provide comments is up to 21 December 2018.

(Source: Exposure draft - Guidance Note on Reports in Company Prospectuses (Revised 2018) issued by ICAI).

ICAI issued standard on internal audit

The ICAI issued revised preface to the framework, basic principles and standards on internal audit. The standards on internal audit are a set of minimum requirements that apply to all members while performing internal audit of any entity or body corporate. The non-members performing internal audit, the standards are recommendatory in nature.

Further, the revised standards on internal audit would be made mandatory in a phased manner. The standards would be applicable for all internal audits beginning on or after a date to be notified by ICAI.

(Source: Standards on Internal Audit (SIAs) as issued by ICAI dated 27 November 2018).

Implementation guides issued by ICAI

Recently ICAI has issued following implementation guides:

- **Resignation/withdrawal from an engagement to perform audit of financial statements**

  The implementation guide provides guidance on various aspects of auditors’ resignation like circumstances leading to withdrawal/resignation, procedure to be followed by auditors in case of resignation, auditor’s responsibilities and professional obligations to be complied with by auditors.

  The appendix to the implementation guide also contains references to Standard on Auditing, SQC 1 and ICAI’s Code of Ethics which deal with auditors’ resignation.

  The implementation guide is applicable in case of audits of all listed entities. In case of audits of banks, insurance companies and other corporate entities, the guidance given in this implementation guide is to be followed, wherever applicable.

- **Implementation guide on SA 230 (Revised)**

  SA 230, *Audit Documentation* provides the basic principles of audit documentations which is to be considered by auditors while complying with requirements of SA 230 and specific documentation requirements of other SAs.

  In 2013, AASB of ICAI had issued the Implementation Guide to SA 230 to provide practical implementation guidance relating to SA 230. Recently, ICAI issued the revised implementation guide on SA 230 since audit documentation is an essential element of audit quality and has always been a critical component of an audit process as it evidences the work done by the auditor. The implementation guide explains the requirements of the SA 230 and also contains Frequently Asked Questions (FAQs) on SA 230.

  (Source: Implementation guides issued by ICAI).
KPMG in India’s IFRS institute
Visit KPMG in India’s IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

First Notes
First Notes: NFRA Rules notified
13 December 2018
The Companies Act, 2013 (2013 Act) empowered the Central Government (CG) to constitute a National Financial Reporting Authority (NFRA) to advise on matters relating to both accounting and auditing standards as well as for other issues relating to monitoring and compliance of such standards. Accordingly, the Ministry of Corporate Affairs (MCA) appointed 1 October 2018 as the date of constitution of the NFRA.

New development
On 13 November 2018, MCA notified the NFRA Rules, 2018 (the Rules) and these are effective from 14 November 2018. These Rules lay down the procedure for NFRA to monitor and enforce compliance with both accounting and auditing standards, oversee the quality of service and undertake investigation of the auditors of the companies and bodies corporates that are governed by NFRA.

This edition of First Notes contains a brief summary of the Rules.

Voices on Reporting
KPMG in India is pleased to present Voices on Reporting – a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

In the special session held on 12 December 2018, we focussed on the Transport, Leisure and Sports sector. In this session we discussed the key significant areas relating to Ind AS 115, Revenue from Contracts with Customers, and IFRS 16, Leases on transport, leisure and sports sector, where current guidance under Ind AS is expected to change due to implementation of new standards.

Please access KPMG in India website for audio recording and presentation.