# Accounting and Auditing Update

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# Editorial

Rapid changes in stakeholder expectations, technology and economic landscapes are creating new and enhanced risks in the financial reporting structure that are expected to affect the roles and responsibilities of management, audit committees and auditors beyond the 2019 year-end financial reporting season. Therefore, companies need to be agile and should continue to look ahead and prepare for the difficult issues on the horizon. The recent American Institute of Certified Public Accountants (AICPA) conference on current Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) developments highlighted the emerging issues to be considered by companies in the US GAAP. In this edition of Accounting and Auditing Update (AAU), we cast our lens on some of the key emerging issues discussed at the conference.

In India, the automotive industry is experiencing a slowdown and this phase is likely to pose many financial reporting implications for the companies operating in the sector. In our article, we unravel some of the key financial reporting areas where there could be an impact due to slowdown in the automotive industry.

To strengthen regulatory norms in relation to Related Party Transactions (RPTs) undertaken by listed companies in India, the Securities and Exchange Board of India (SEBI) constituted a working group in November 2019 under the Chairmanship of Mr. Ramesh Srinivasan. The working group submitted its report to SEBI with proposed changes to the current provisions of RPTs such as revised definition of related party, mandatory prior approval of audit committee for all RPTs and revised materiality thresholds for prior approval of RPTs. Our article on the topic provides a summary of the key recommendations made by the working group in its report.

As is the case each month, we have also included 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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Chapter 1

# Auto sector - Impact of slowdown on financial reporting

**This article aims to:**

Analyse main areas in relation to financial reporting where there could be an impact due to slowdown.

## Introduction

**The Indian as well as global automotive industry is in the midst of a slowdown. In the first nine months of financial year 2019-20, Passenger Vehicle (PV) sales in India declined by 17 per cent[1]. Thereby, impacting the cash position of component suppliers and putting their business sustainability at risk.**

1. Article in Business Standard - 'Passenger Vehicles Sales Fall 16.40% in April-December 2019' published on 10 January 2020

The slowdown in the automobile sector in India can be attributed to factors like the general slowdown in the economy, the disruption caused by the private cab operators, difficulties in getting a loan for purchasing a car or two-wheeler, competition from electric vehicles in the coming years and the adoption of Bharat Stage (BS) VI emission standards.

While the economic cycle is blamed for the sliding sales globally, it is not the only reason. Europe's ban on diesel cars and the enforcement of safety norms across the world, global events like Brexit and US-China trade wars are factors too for the slowdown. As a result, major automobile companies are investing heavily on emerging technologies and alternative solutions to fuel. Besides, customers are waiting for better products amid the global transition to electric cars.

Many Original Equipment Manufacturers (OEMs) have announced production cuts over the past several months leading to cascading impact on the automobile ancillary units.

The automobile retail has witnessed around 200,000 job losses. A similar number is expected to have lost jobs in the ancillary industries[2].

2. Article in The Economic Times - 'Auto sector slowdown may wipe out a million jobs: SIAM' published on 5 September 2019

## Impact of slowdown on financial statements of companies in automotive industry

We have analysed main financial reporting areas where there could be an impact due to slowdown.

### Assessment of triggers for impairment

Due to continuous decline in sales and profitability over last few quarters, many OEMs have started assessing for triggers of impairment in accordance with Ind AS 36, *Impairment of Assets*. Due to the technological changes and stiff competition from other automotive players, there is a need to assess the recoverable amount of the assets.

### Valuation of inventories

OEMs may have manufactured vehicles based on expected growth forecasts in the automotive industry which are lying as unsold stocks pertaining to BS IV emission levels. As the stock pertaining to BS IV compliant vehicles would not be usable post BS VI implementation, the OEMs would face challenge while valuing such unsold stocks and there could be huge increase in provisions of inventory.

### Discounts and incentives to dealers

High stock levels with dealers forced OEMs to cut down on production. As dealers are also facing huge working capital issue, OEMs are offering discounts to end customers and incentives to dealers to increase sales. The OEMs should consider the impact of discounts and incentives on the measurement of revenue.

### Provisions for contractually agreed terms

OEMs are largely dependent on their vendors for supply of materials required for production. They enter into contracts with vendors for purchase of certain minimum required quantities of materials based on the production plan and sales forecasts. In certain cases, they may have contractually agreed to reimburse certain amounts to vendors in the event they do not procure the materials as per the agreed terms.

Many OEMs have revised their production plans and sales forecasts due to the slowdown over last few months. Accordingly, they would need to assess the amount of provisions required for such commitments given to vendors as per contractually agreed terms.

### Employee layoffs and benefits reductions

Due to decline in business and slowdown, companies could consider reductions in employee benefits plans, performance pay/bonuses to employees and introduce Voluntary Retirement Schemes (VRS) as a cost control measure.

If VRS are rolled out, then entities would need to estimate accruals for compensation to be paid to employees under these schemes.

### Working capital management

Slowdown in automotive sector is also impacting companies' working capital management and companies may face liquidity issues on account of increase in inventory levels, increase in receivable levels, decrease in cash flow levels, etc. Companies are expected to revisit their strategies for working capital management to reduce the borrowing costs and use own funds to maximum possible extent.

# Conclusion

Automotive companies need to analyse the impact of slowdown on their financial statements as well as business operations and communicate these challenges with their stakeholders.

Chapter 2

# SEBI reviews norms relating to related party transactions

**This article aims to:**

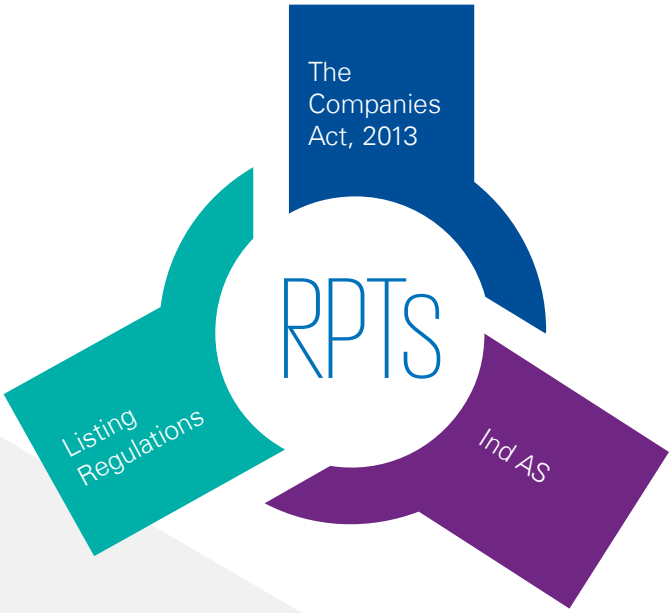
Summarise key recommendations of the SEBI working group on related party transactions.

## Background

Related party relationships are a normal feature of commerce and business. For example, entities frequently carry on parts of their activities through subsidiaries, joint ventures and associates. In those circumstances, the entity has the ability to affect the financial and operating policies of the investee through the presence of control, joint control or significant influence.

A related party relationship could have an effect on the profit or loss and financial position of an entity. Related parties may enter into transactions that unrelated parties would not. For example, an entity that sells goods to its parent at cost might not sell on those terms to another customer. Also, transactions between related parties may not be made at the same amounts as between unrelated parties.

**Applicable frameworks**




For Related Party Transactions (RPTs), the corporates in India comply with Ind AS and the Companies Act, 2013 (2013 Act). Additionally, the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) provides regulatory framework for the listed entities to comply in case of RPTs.

In May 2018, SEBI amended the Listing Regulations on various topics including RPTs based on the recommendations of the Committee on Corporate Governance constituted by SEBI under the chairmanship of Uday Kotak (the Kotak Committee).

## New development

In order to strengthen regulatory norms in relation to RPTs undertaken by listed entities in India, SEBI constituted a working group in November 2019 to review the provisions pertaining to RPTs under the Chairmanship of Mr. Ramesh Srinivasan.

The working group consisted of officials from Primary Market Advisory Committee (PMAC), industry, professional bodies, stock exchanges, intermediaries, proxy advisors, lawyers, etc. The working group reviewed the approval mechanisms for RPTs and revisited disclosure requirements relating to information relevant for the persons (including shareholders, where required) involved in the approval mechanism.

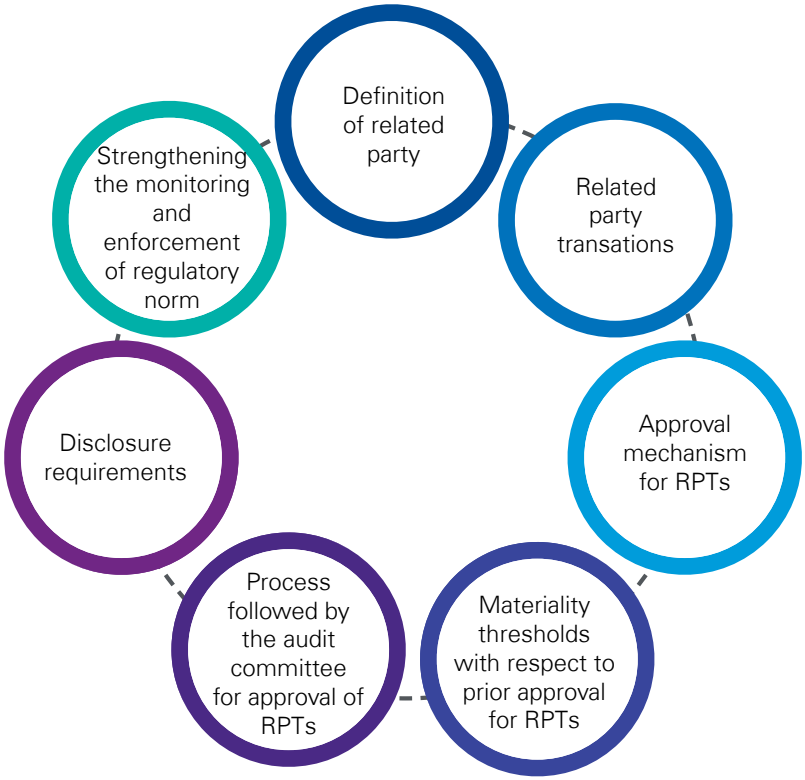
The working group submitted its report to SEBI on 22 January 2020, which includes recommendations of the working group along with the rationale for such recommendations. The SEBI has, subsequently issued the report for public comments with the timeline of 26 February 2020.

This article aims to summarise key recommendations of the working group report.

## Recommendations

The recommendations in the report suggest changes to current regulatory framework by amending certain provisions of the Listing Regulations.

The recommendations of the working group have been consolidated into seven themes as described in the diagram below.




## 1. Definition of related party

### Background

Listing Regulations define related party as defined under both the 2013 Act and the applicable accounting standards (or Ind AS). Additionally, any person or entity belonging to the promoter or promoter group of the listed entity and holding 20 per cent or more of shareholding in the listed entity would be deemed to be a related party.

### Recommendation

The working group proposes that all persons or entities belonging to the 'promoter' or 'promoter group', irrespective of their shareholding in the listed entity, should be deemed to be related parties. Additionally, it is proposed to include significant shareholders within the purview of 'related parties even if they do not form part of the 'promoter' or 'promoter group'. Therefore, similar to the provisions of the 2013 Act and Ind AS 28, *Investments in Associates and Joint Ventures,* a shareholder or any entity would be considered as a related party when directly or indirectly (including their relatives) hold 20 per cent or more of the equity shareholding in the listed entity.

## 2. Related party transactions

### Background

As per Listing Regulations, related party transaction means transfer of resources, services or obligations between a listed entity and a related party regardless of whether a price is charged or not and a 'transaction' with a related party would be construed to include a single transaction or a group of transactions.

### Recommendation

The working group recommended broadening the definition of RPTs to include transactions which are undertaken, whether directly or indirectly, with the intention of benefitting related parties. The definition of related party transactions should be amended and the proposed definition includes transactions carried out between:

i. The listed entity or any of its subsidiaries on the one hand and a related party of the listed entity or any of its subsidiaries on the other hand or

ii. The listed entity or any of its subsidiaries on the one hand and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries.

The above transactions would be considered as RPTs regardless of whether a price is charged.

Additionally, it is proposed to exclude certain transactions which have similar effect for all shareholders such as payment of dividend, sub-division or consolidation of securities, buy-back, rights and bonus issue of securities. The transactions which are specifically provided under other regulations, such as preferential allotment, would also be excluded from the purview of RPTs.

## 3. Approval mechanism for RPTs

**Background**

Currently, Listing Regulations and the 2013 Act provide approval mechanism for RPTs. Listing Regulations require approval of the audit committee for all RPTs, whereas Section 188(1) of the 2013 Act, requires approval of the board of directors of the company for specific RPTs, with an exemption for transactions in the ordinary course of business and on an arm's length basis.

Additionally, Listing Regulations require approval of shareholders for all material RPTs and for transactions listed in Section 188(1) of the 2013 Act exceeding specified threshold, with an exemption for transactions in the ordinary course of business and on an arm's length basis.

**Recommendation**

Considering the current regulatory framework governing transactions of subsidiaries of a listed entity, the working group recommended to strengthen the laws for regulation and oversight of RPTs undertaken by a subsidiary with the related parties of the listed entity or its subsidiaries. It is recommended that prior approval of the audit committee of the listed entity should be made mandatory for all RPTs and subsequent material modifications.

A RPT to which a subsidiary of a listed entity is a party (but the listed entity is not a party) would require prior approval of the audit committee of the listed entity only if the value of such transaction (whether entered into individually or taken together with previous transactions during a financial year) exceeds 10 per cent of the annual total revenues, total assets or net worth of the subsidiary (on a standalone basis) for the immediately preceding financial year, whichever is lower.

An exception from taking approval of the audit committee and shareholders of the parent listed entity (subject to materiality thresholds) should be given for listed subsidiaries, since they are independently subject to the Listing Regulations framework on RPTs. Further, the working group suggested that an explanation be added to clarify that for RPTs of unlisted subsidiaries of a listed subsidiary, prior approval of the audit committee or shareholders, as applicable, of the listed subsidiary would suffice.

Additionally, in line with the exemption given to transactions between a holding company and its wholly-owned subsidiary from the requirements of audit committee and shareholders' approval, it is recommended that transactions between two wholly-owned subsidiaries of the listed holding company should be exempt from these requirements.

## 4. Materiality thresholds with respect to prior approval for RPTs

**Background**

Regulation 23 of the Listing Regulations requires approval of the shareholders for RPTs, which individually or taken together with the previous transactions during that financial year exceed 10 per cent of the annual consolidated turnover of such entity in accordance with the last audited financial statements.

Whereas, the 2013 Act exempts RPTs carried out in the ordinary course of business and which are on an arm's length from the requirements of shareholders' approval.

**Recommendation**

The working group deliberated on the current framework and suggested to reduce the percentage threshold for materiality and also introduce a numerical threshold for seeking shareholders' approval for RPTs.

It is recommended that the materiality threshold in Regulation 23(1) may be amended to 5 per cent of the annual total revenues, total assets or net worth of the listed entity on a consolidated basis or INR1,000 crore, whichever is lower. Further, the net worth criterion would not apply to companies with negative net worth. Companies would be permitted to specify a lower materiality threshold as per their RPT policies.

## 5. Process followed by the audit committee for approval of RPTs

**Background**

Regulation 18 of the Listing Regulations requires all listed entities to constitute an audit committee. Additionally, Listing Regulations cast responsibility on an audit committee for approving RPTs. However, there is no specific requirement on the minimum information that should be provided to the audit committee while seeking approval for a proposed RPT.

**Recommendation**

After deliberations, the working group suggested that the management of the listed entity should mandatorily provide the prescribed information to the audit committee for approval of a proposed RPT such as:

1. Type, material terms and particulars of RPT
2. Name of the related party and its relationship with the listed entity or its subsidiary, including nature of its concern or interest (financial or otherwise)
3. Tenure of the transaction
4. Value of the transaction
5. The percentage of the listed entity's annual total revenues, total assets and net worth, on a consolidated basis, that is represented by the value of the proposed RPT (and for a related party transaction involving a subsidiary, such percentage calculated on the basis of the subsidiary's annual total revenues on a standalone basis)
6. Where the transaction relates to any loans, inter-corporate deposits, advances or investments made or given by the listed entity or its subsidiary:
   a) Details of the source of funds in connection with the proposed RPT
   b) Where any financial indebtedness is incurred to make or give loans, inter-corporate deposits — nature of indebtedness, cost of funds, and tenure
   c) Applicable terms, including covenants, tenure, interest rate and repayment schedule, whether secured or unsecured and if secured, the nature of security
   d) The purpose for which the funds will be utilised by the ultimate beneficiary of such funds pursuant to the RPT
7. Justification as to why the RPT is in the interest of the listed entity
8. A copy of the valuation or other external party report, if any such report has been relied upon and
9. Any other information that may be relevant.

## 6. Disclosure requirements – Information to be provided to shareholders for consideration of RPTs

**Background**

The 2013 Act requires that the notice for general meeting should be annexed with an explanatory statement containing prescribed information in respect of proposed RPT. Further, Listing Regulations provide that the recommendation of the board of directors of the listed

entity on each item of special business is required to be disclosed in the statement to be annexed to the notice to the shareholders.

**Recommendation**

The working group recommended that the notice that is being sent to shareholders seeking approval for any proposed RPT should include certain prescribed information as a part of the explanatory statement such as:

- Summary of the information provided by the management of the listed entity to the audit committee
- The recommendation of the audit committee in respect of the proposed transaction, specifying justification for why the transaction is in the interest of the listed entity
- Whether the approval of the related party transaction by the audit committee was unanimous
- Statement that the valuation or other external report, if any, relied upon by the listed entity in relation to the proposed transaction will be available for inspection at the registered office of the listed entity.

The working group also recommended the format and timeline of communication and suggested that a listed entity should make the RPT disclosure to the stock exchange and publish on its website every six months on the date of publication of its standalone and consolidated financial results. Additionally, working group has suggested a detailed format for the RPTs disclosures as compared to existing format under Ind AS.

## 7. Strengthening the monitoring and enforcement of regulatory norm

The working group considered improvements in monitoring and enforcements in three main areas:

i. **Use of structured data (iXBRL) to augment enforcement:** Listing Regulations mandate that the disclosures provided by a listed entity to the stock exchanges should be in XBRL format. The working group recommended that there should be one filing format, which could be based on 'inline XBRL' (iXBRL), an open standard that enables a single document to provide both human-readable and structured, machine-readable data.

ii. **Introduction of standardised identifiers to identify RPTs:** The working group suggested use of Permanent Account Number (PAN) of the parties involved in RPTs as a standardised identification of related parties.

iii. **Capacity building:** The working group recommended for capacity building, both human and technological, at SEBI and the stock exchanges.

# Our comments

The recommendations of the working group aim to strengthen the approval and disclosure processes to assist the audit committee and shareholders to make informed decision with respect to RPTs. The formation of working group and recommended changes represent SEBI's effort to make the regulations more investor friendly. Some of the key observations are:

- **Definition of related party and RPTs broadened:** The working group has recommended changes to the related party definition and widened the scope of parties and transactions to fall within the purview of the RPTs. This change could entail many practical challenges, e.g. companies would need to establish processes to identify such transactions and understand if the purpose of any transaction is to benefit a related party, especially in complex structures where listed entities may have number of subsidiaries.
- **Approval process:** Prior approval of an audit committee of a listed entity would be mandatory to transactions carried out between a listed entity entity, any of its subsidiary and a related party of the listed entity or its subsidiaries. An audit committee approval would also be required for any transaction between listed entity, its subsidiaries and any other person or entity if its purpose and effect is to benefit a related party of the listed entity or any of its subsidiaries. Additionally, all subsequent material modifications to RPTs have been proposed to require prior approval of an audit committee.
- **Extensive information to be placed before audit committee:** It is proposed that with respect to the type, material terms and particulars of related party - each type of RPT with a single party should be disclosed separately and there should be no clubbing or netting of transactions of the same type. However, RPTs with the same counter party and of the same type may be aggregated.

  The audit committee should be aware of the value of a proposed RPT as a proportion of the annual total revenues, total assets and net worth of the consolidated entity. The working group also suggested that the audit committee should undertake an annual review of the status of long-term (more than one year) or recurring RPTs. Further, justification for each individual transaction must be provided, unless there are a series of transactions interdependent on each other, in which case the justification for the entire series need to be furnished.
- **Revised materiality threshold:** The materiality threshold should be amended to 5 per cent of the annual total revenues, total assets or net worth of the listed entity on a consolidated basis or INR1,000 crore, whichever is lower. The working group felt that the threshold of 10 per cent of the consolidated turnover appears to be high, particularly in case of listed entities with a high turnover, as several RPTs may not be placed before the shareholders for approval. The intent of revising threshold is to cover such RPTs which otherwise would not get covered due to high threshold.
- **Disclosure of RPTs:** It is proposed that a listed entity would be required to promptly make the disclosure to the stock exchange along with its financial results and publish the same on the website instead of submitting within 30 days from the date of publication of standalone/consolidated financial results. Additionally, a detailed format for disclosure has been proposed.

Chapter 3

# US GAAP – Recent emerging issues

**This article aims to:**

Provide an overview of the recent emerging issues under the US GAAP.

**Rapid changes in stakeholder expectations, technology and economic landscapes are creating new and enhanced risks in the financial reporting structure that are expected to affect the roles and responsibilities of management, audit committees and auditors beyond the 2019 year-end financial reporting season. The recent American Institute of Certified Public Accountants (AICPA) conference[1] on current Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) developments concentrated on events of rapid change.**

**In this article, we will highlight some of the emerging issues discussed at the conference and which are relevant for companies to take note of.**

1 The conference was held in December 2019.

## Interest rate reforms

The shift in the benchmark interest rates with alternative nearly risk-free interest rates is expected to have a cascading effect beyond contract terms into the operations and financial reporting of many companies. Therefore, companies are advised not to underestimate the consequences and complexity of the reference rate reform. Also, they should focus on making appropriate disclosures about the effect of the reform.

To address some of the pre-replacement issues, in September 2019, the International Accounting Standards Board (IASB) has issued amendments to International Financial Reporting Standard (IFRS) 9, *Financial Instruments,* International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* and IFRS 7, *Financial Instruments: Disclosures.* The amendments provide targeted relief for financial instruments qualifying for hedge accounting during the lead-up to the rate reform.

On the other hand, the Financial Accounting Standards Board (FASB) is expected to issue a final Accounting Standards Update (ASU) in the first quarter of 2020 which will provide companies with optional financial reporting and accounting relief to reduce the cost and complexity associated with accounting for contracts and hedging relationships affected by reference rate reform.

## New accounting standards

Companies have already implemented the new accounting standard on revenue and leases and will be implementing the credit losses standard in 2020. Some of the key observations relating to the implementation of revenue and leases standards have been outlined below.

- **Revenue recognition:** Determining whether an entity is a principal or an agent, can be an area of challenge when two parties are involved in providing services to a customer, particularly if some of the services can only be provided by a specific service provider. The issue has been discussed with the help of an example. A company had a contractual relationship with a customer but could not legally provide some of the services promised in the contract. As a result, the company had to rely on another service provider to deliver the restricted services and give that provider discretion in determining how to fulfil its obligations. Since in the given case the company could define the scope of the services to be performed on its behalf which thereby gives sufficient control over those services, it was concluded that the company was the principal in the transaction.

  Another area of judgement in applying the revenue recognition standard is determining whether promises to transfer the goods or services to a customer are separately identifiable or can be combined into one performance obligation. The issue has been analysed with the help of an example. A company has provided software and necessary updates to allow developers to build and deploy their apps on third-party platforms. In the given case, the

software and the updates to the software have been treated as a single performance obligation as the combined output of these two promises was greater than or substantively different from the individual promises. Once they are combined, they give the app developers the ability to deploy and monitise content using third-party platforms of their choice.

- **Leases:** Collectability for lessors is an important matter under the leases standard. For example, in a sales-type lease if collectability of lease payments is not probable at the inception of lease, the lessor cannot derecognise the asset and should defer from recognising any income or loss. Some of the other key areas to be considered are as follows:
  - *Lease reassessments:* Companies should understand which estimates and judgements require periodic reassessment. They can accordingly, design and implement processes and internal controls to timely identify events or changes in circumstances that trigger reassessment of lease.
  - *Right-of-Use (ROU) assets impairment:* Companies should evaluate ROU assets under ASC 360, *Property, Plant, and Equipment* framework (that applies to long-lived non-financial assets). The key considerations while incorporating the ROU assets into ASC 360 framework are as follows:
    a. Companies should make accounting policy decision (e.g. about whether to include or exclude operating lease liability under ASC 360 assets group)
    b. Determine the fair value of ROU of assets and understand the interaction between ASC 360's impairment guidance and ASC 842's reassessment requirements.

## Critical Audit Matters (CAMs)

One of the most significant change made to the auditor's report is reporting of CAMs. The requirement for auditors to communicate CAMs under PCAOB standard AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* for large accelerated filers is applicable from fiscal years ended on or after 30 June 2019 and for all the other companies from fiscal year ending on or after 15 December 2020.

Following observations have been made with respect to the implementation of CAM:

- Communications that are tailored to the specific facts and circumstances of the audit are likely to be more meaningful to investors and other financial statements users. Information is more meaningful if it avoids general language about audit procedures performed, including the related control testing and instead describes the procedures performed that were responsive to the principal considerations that led the matter to be identified as a CAM.
- Investors and other financial statement users are required to understand that CAMs are intended to be unique to each individual audit, so that they should be cautious about drawing comparisons among companies.

As per a publication issued by the PCAOB, most of the CAMs reported in the audit reports belong to areas of revenue, business combinations, impairment and taxes.

## Non-GAAP financial measures

Non-GAAP financial measures need to be unbiased, transparent and consistent with full disclosure of how they are calculated and how they reconcile to the GAAP measures. Further, it has been suggested that it would be inappropriate to exclude credit losses determined under the new standard from non-GAAP measures.

## Audit committees

Audit committees serve a key role in protecting investors and can have a significant and positive effect on audit quality. It has been emphasised that auditor independence is fundamental to the operating of an efficient market system and should be a top priority of audit committees to ensure that they are getting an independent view of management's work. Therefore, audit committees are the front-line in ensuring auditor independence.

## Technological changes

New technologies are creating opportunities and risks for companies. New sources of company-compiled data (e.g. about customer behaviour, supply chain dynamics) have gained recognition as valuable, though intangible, enterprise assets. This has fueled increased stakeholder desire for more information and an increased focus on cyber-risk management. Technological changes are also affecting audit. For example, data and analytics application affects not only how audits are conducted but

also the auditor's skills to identify an outlier. The IASB is also re-examining financial statement presentation in light of the increased digitisation of financial analysis. Accordingly, it is exploring to standardise the subtotals and other financial statement captions on the income statement.

## Others

Companies can also get affected from other emerging issues such as Brexit and cybersecurity incidents.

In case of material effect from such events, companies are expected to at least make the following disclosures:

- How the risk is assessed and how it affects the operations
- How management is mitigating the risk
- Role of board of directors in evaluating the risk and monitoring management's response
- A statement that the effect of the risk is unknown and cannot be quantified at the current time, if applicable and
- The issuer's evolution – i.e. as more facts become known about the effect on operations and related risks, the disclosure should become more detailed.

Source: KPMG LLP's publication 'SEC Issues & Trends' issued in December 2019 and Quarterly Outlook – December 2019 edition.

# Chapter 4

## Regulatory updates

## MCA issues the Companies (Auditor's Report) Order, 2020

### Background

Section 143(11) of the Companies Act, 2013 (2013 Act) provides that the Central Government (CG) may, in consultation with the National Financial Reporting Authority (NFRA) by general or special order direct that the auditor's report of specified class of companies should also include a statement on such matters as may be specified in that order. Accordingly, on 29 March 2016, the Ministry of Corporate Affairs (MCA) issued the Companies (Auditor's Report) Order, 2016 (CARO 2016).

### New development

On 25 February 2020, the MCA issues the Companies (Auditor's Report) Order, 2020 (CARO 2020) which supersedes CARO 2016. CARO 2020 will come into force from the date of its publication in the official gazette.

Some of the key features of CARO 2020 are as follows:

- **Applicability:** CARO 2020 will be applicable to every company including a foreign company except the following:
  a. A banking company
  b. An insurance company
  c. A company licensed to operate under Section 8 of the 2013 Act
  d. A one-person company and a small company as defined under the 2013 Act
  e. A private limited company which meets all of the following:
     i. It is not a subsidiary or holding company of a public company
     ii. Its paid-up capital and reserves and surplus do not exceed INR1 crore as on the balance sheet date
     iii. Its total borrowings do not exceed INR1 crore from any bank or financial institution at any point of time during the financial year
     iv. Its total revenue as disclosed in Scheduled III to the 2013 Act (including revenue from discontinuing operations) do not exceed INR10 crore during the financial year as per the financial statements.
- **Amendments to clauses:** Certain modifications made to the existing requirements are as follows:
  — The term 'fixed assets' has been replaced with Property, Plant and Equipment (PPE). New requirement to report whether the company is maintaining proper records showing full particulars of intangible assets.
  — With respect to reporting of whether title deeds of immovable properties are held in the name of the company, all immovable properties are covered except properties where the company is the lessee and the lease agreements are in favour of the lessee. Format for disclosure of properties not held in the name of the company has also been specified.
  — Reporting of material discrepancies in physical verification of inventory has been replaced with reporting of discrepancies of 10 per cent or more in aggregate for each class of inventory.

- **New clauses:** CARO 2020 introduces new reporting requirements for an auditor. Accordingly, an auditor is required to report:
  - Whether the company has been sanctioned working capital limits during any point of time of the year, in excess of INR5 crore in aggregate from banks or financial institutions on the basis of security of current assets. Also, whether the quarterly returns or statements filed by the company with such banks or financial institutions agree with the books of account of the company.
  - Whether the company has revalued its PPE including right-of-use assets and/or intangible assets during the year end. Also specify the amount, if the change is 10 per cent or more in aggregate of the net carrying value of each class of PPE or intangible assets.
  - Whether any transaction not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income-tax Act, 1961. If yes, then whether the previously unrecorded income has been properly recorded in the books of account during the year.
  - Whether funds raised on short-term basis have been utilised for long-term purposes. If yes, the nature and amount to be specified.
  - Whether it has considered the whistle-blower complaints, if any, received during the year.
  - Whether the company has an internal audit system commensurate with the size and nature of its business.

(Source: MCA order dated 25 February 2020)

## MCA notifies provisions relating to takeover offer for unlisted companies

### Background

Currently, Section 230 and 232 of the 2013 Act read with the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 (Arrangement Rules) govern the provisions relating to a scheme of arrangement undertaken by a company. Different forms of arrangements which can be taken up by companies under Section 230 and 232 of the 2013 Act are as follows:

a. Reorganisation of the company's share capital by the consolidation of shares of different classes or by the division of shares into shares of different classes, or by both of those methods

b. Reduction of share capital

c. Corporate debt restructuring (consented by not less than 75 per cent of the secured creditors)

d. Buy-back of securities

e. Takeover offer

f. Merger/amalgamation of any two or more companies

g. Demerger/division of companies.

The provisions of Section 230 and Section 232 of the 2013 Act (other than those relating to the takeover offer) came into effect from 15 December 2016.

### New development

The MCA notified the provisions relating to takeover offer i.e. Section 230(11) and 230(12) under the 2013 Act with effect from 3 February 2020. Also, related amendment has been made to the Arrangement Rules and the National Company Law Tribunal (NCLT) Rules, 2016 (NCLT Rules).

The key features of the notified provisions are as follows:

- **Eligibility for takeover offer (Section 230(11) and Rule 5 of the Arrangement Rules):**
  - *In case of listed companies:* Takeover offer would be governed by the regulations prescribed by the Securities and Exchange Board of India (SEBI) i.e. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.
  - *In case of companies other than listed companies:* An application for the takeover offer can be made to the NCLT by a member which along with any other member holds not less than three-fourth shares[1] in the company. The application should be filed for acquiring any part of the remaining shares of the company.

    The requirement to file an application to the NCLT by a member holding three-fourth shares of the company for acquiring its remaining shares does not apply to a transfer/transmission of shares

1. *Shares* means 'equity shares of the company carrying voting rights, and includes any securities, such as depository receipts, which entitles the holder thereof to exercise voting rights.'

through a contract, arrangement or succession or transfer of shares pursuant to statutory or regulatory requirement.

- **Particulars of a takeover application (Rule 5 of the Arrangement Rules):** The application for a takeover arrangement should contain the following:

  a. Report of a registered valuer disclosing the details of the valuation of the shares proposed to be acquired by the member after considering certain factors. Those are as follows:

     i. The highest price paid by any person or group of persons for acquisition of shares during last 12 months and

     ii. The fair price of shares of the company to be determined by the registered valuer after considering valuation parameters including return on net worth, book value of shares, earning per share, price earning multiple vis-a-vis the industry average and other parameters as are customary for valuation of shares of such companies.

  b. Details of a bank account, to be opened separately, by the member wherein a sum of amount not less than one-half of total consideration of the takeover offer is deposited.

- **Redressal of grievances (Section 230(12) read with Section 80A of the NCLT Rules):** In the event of any grievance with respect to the takeover offer of companies (other than listed companies), an aggrieved party may make an application to the NCLT in Form NCLT-1 along with prescribed documents. The NCLT may, on an application, pass such order as it may deem fit.

**Effective date:** The amendments to the NCLT Rules and Arrangement Rules came into effect from the date of their publication in the official gazette i.e. 6 February 2020 and 7 February 2020 respectively.

(Source: MCA notification no. G.S.R.79(E), G.S.R. 80(E) and S.O. 525(E) dated 3 February 2020)

## Filing of Ind AS financial statements by NBFCs

On 30 January 2020, the MCA issued amendments to the Companies (Accounts) Rules. As per the amendments, every Non-Banking Financial Company (NBFC) which is required to comply with Ind AS should file their separate financial statements together with Form AOC-4 NBFC (Ind AS) and the consolidated financial statements with Form AOC-4 CFS NBFC (Ind AS) with the Registrar of Companies (ROC) in the prescribed format. The amendments are effective from 5 February 2020.

Further, MCA through a circular dated 30 January 2020 provided that the last date of filing the above-mentioned forms for the financial year 2018-19 without payment of additional fees would be 31 March 2020.

(Source: MCA notification no. G.S.R.60(E) and general circular no.02/2020 dated 30 January 2020)

## Educational material on Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*

Recently, the Institute of Chartered Accountants of India (ICAI) has issued an educational material on Ind AS 20. The publication aims to provide guidance on implementing the requirements of the standard with the help of examples. It also covers major differences between Ind AS 20 and International Accounting Standard (IAS) 20, *Accounting for Government Grants and Disclosure of Government Assistance.*

(Source: Educational material on Ind AS 20 issued by ICAI in February 2020)

## IIRC begins the process of refreshing the international <IR> Framework

### Background

In December 2013, the International Integrated Reporting Council (IIRC) released the Integrated Reporting (<IR>) Framework. The <IR> Framework explains the fundamental concepts underpinning the integrated reporting and includes the guiding principles and content elements that govern the preparation of an integrated report.[2]

### New development

In order to ensure <IR> Framework's continued relevance in an evolving business and policy environment, the IIRC recently began the process of revising the <IR> Framework. As part of the process, the IIRC seeks inputs on identified key themes raised by users and preparers of integrated reports. Each of the theme has been outlined in three topic papers.

2. An integrated report is used to assess the organisation's ability to create value over time.

The key proposals highlighted in these topic papers are as follows:

| Topic paper | Key proposals |
|---|---|
| **Responsibility for an integrated report** | • Shift the focus from a statement of responsibility for the integrated report to an explanation of the processes underpinning its preparation<br>• Support the disclosure of process-related information through supplementary guidance<br>• Explain the meaning and scope of the term 'those charged with governance'. |
| **Business model considerations** | • Explore illustrative examples and visual techniques to elevate the significance of outcomes[3]<br>• Explain the link between outcomes and value creation by including an illustrative example<br>• Promote balance in the reporting of outcomes i.e. address an inherent bias introduced by the <IR> Framework's repeated use of the term 'value creation' and reinforce the importance of providing evidence for claims and conclusions<br>• Reinforce the inclusion of impacts in integrated reporting i.e. clarify that the <IR> Framework's use of outcomes includes broader effects on society and nature. |
| **Charting a path forward** | • Changes to the purpose of an integrated report i.e. shift from a financial capital focus to multi-capitalism<br>• Role of technology in corporate reporting i.e. views on how technology might influence the field of corporate reporting in the years to come<br>• Assurance in integrated reporting i.e. further ways in which the <IR> Framework can enhance the assurance-readiness of integrated reports. |

(Source: KPMG in India's analysis, 2020 based on IIRC topic papers on international <IR> Framework revision)

The comments on the proposals are invited up to 20 March 2020.

(Source: Topic papers on international <IR> Framework revision issued by IIRC on 20 February 2020)

3 The internal and external consequences (positive and negative) for the capitals as a result of an organisation's business activities and outputs.

# Notes


## 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

**IRDAI defers the effective date for implementation of Ind AS in the insurance sector till further notice**

**24 January 2020**

**Background**

Indian Accounting Standards (Ind AS) was initially applicable to companies in the insurance sector from accounting periods beginning from 1 April 2018. The Insurance Regulatory and Development Authority of India (IRDAI) through its circular dated 28 June 2017, deferred the implementation of Ind AS up by two years i.e. up to 31 March 2020. However, such companies were required to submit proforma Ind AS financial statements on a quarterly basis in the prescribed format to IRDAI.

**New development**

The IRDAI through its circular dated 21 January 2020, has further deferred the implementation of Ind AS in the insurance sector until finalisation of International Financial Reporting Standard (IFRS) 17, *Insurance Contracts* by the International Accounting Standards Board (IASB). Also, the requirement to submit proforma Ind AS financial statements by insurance companies on a quarterly basis to IRDAI has been withdrawn.

This issue of First Notes provides an overview of the circular issued by IRDAI.


## Voices on Reporting

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

On 26 February 2020, KPMG in India organised a VOR webinar to discuss key implementation issues in relation to business combination standard for technology sector.

Please visit KPMG in India's website to access the audio recording and presentation.

#KPMG josh

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