ACCOUNTING AND AUDITING UPDATE

July 2014

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KPMG

cutting through complexity

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Editorial

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The aviation sector in India has been encountering turbulent times in the past few years. Yet, the level of interest it generates from investors, media and the government is remarkable. This perhaps reflects the potential for growth in a market that is underserved when one considers international benchmarks. This month we focus on and highlight some of the key financial reporting and accounting issues that this sector faces.

There have been some significant recent developments in international accounting. Under IFRS, we focus on the new revenue recognition standard that promises to significantly alter current guidance and will likely be a major change for companies affected across various sectors. We would be covering the impact of the new standard on various sectors in our forthcoming issues. In addition, we focus this month on the Discussion Paper (DP) issued by the International Accounting Standards Board (IASB) on dynamic risk management activities (more commonly referred to as macro-hedge accounting). The DP is not a simplification exercise that some would have hoped for, but is lengthy and complicated and asks some fundamental questions on how the premise of closer alignment between risk management and accounting is to be achieved.

As part of our continuing series of articles that examine and highlight implementation issues and diversity in practice under the Indian GAAP, we examine areas including borrowing costs and accounting for open contracts in this month's issue.

We also cover this month, in addition to our monthly regulatory updates, an article on SEBI's review of guidelines governing stock related employee benefit schemes.

As I sign off for this month, I would like to remind you that in case you have any suggestions or inputs on topics we cover, we would be delighted to hear from you.

Happy reading!

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Accounting and financial reporting issues in the **Airline Sector**

This article aims to

- Explain accounting issues faced by the airline sector.

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The Indian aviation sector is going through sweeping changes with far reaching effects. On one hand, the new NDA led government is expected to review some of the policy related changes and on the other the entry of a foreign airline in India has ignited yet another fare war. Many of the airlines in India are going through a much prolonged rough patch with the increase in operating costs such as fuel, airport fees and debt servicing which are adding to the already negative bottom line.

In addition to the much larger business related challenges, airlines in India have to deal with numerous accounting and financial reporting issues as well. Some of these issues are very specific to the sector, while the others are likely arising out of the recent regulatory changes, especially the Companies Act 2013 (2013 Act). In this article, we have tried to analyse some of the key accounting and reporting issues faced by airlines in India under Indian GAAP.

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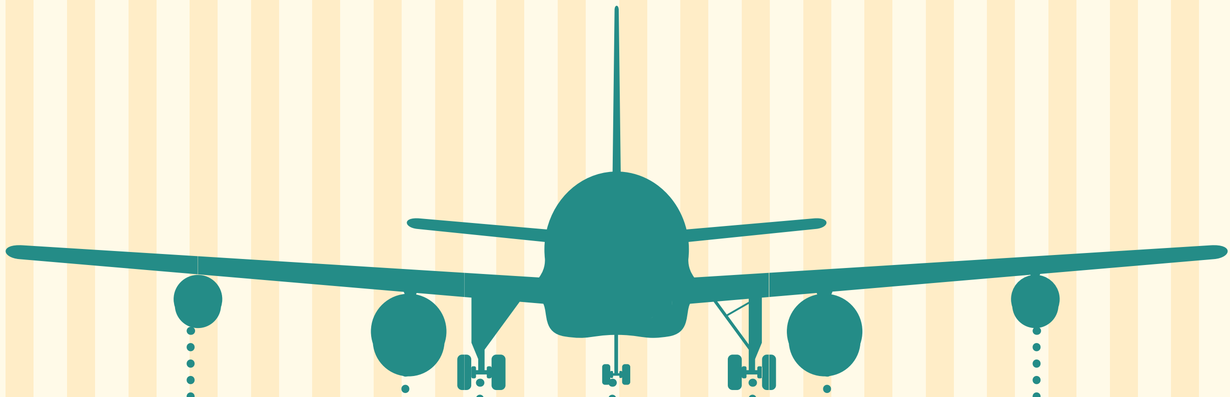

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Depreciation on aircrafts

For aircrafts carried on the balance sheet of airlines, the depreciation accounting under Indian Generally Accepted Accounting Principles (Indian GAAP) is driven by AS 6, *Depreciation Accounting,* and Schedule II of the 2013 Act, effective 1 April 2014.

Schedule XIV of the erstwhile Companies Act, 1956 (applicable for reporting periods up to 31 March 2014), gave minimum rates of deprecation, which meant that companies in India had to choose depreciation rates based on the useful life of individual assets (as required by AS 6) or the rate given in Schedule XIV of the Companies Act, 1956, whichever was higher. On the other hand, Schedule II of the 2013 Act, gives indicative useful life and residual value. Further, it states that if a company uses a useful life or residual value which is different than those given in Schedule II, justification for the different life and/or residual value should be disclosed in the financial statements.

Given the restrictions by the Companies Act,1956, most airlines in India depreciated aircrafts over 17 years (based on the rate given in Schedule XIV of the Companies Act, 1956) up until 31 March 2014. However, with the 2013 Act coming into effect from 1 April 2014, companies in India would have to review the depreciation rates in the light of their management's estimate of useful life and residual value. In case, if the useful life determined by the management is higher or lower than 20 years (the useful of aircrafts as per Schedule II of the 2013 Act) or the residual value is higher or lower than five per cent, they would have to disclose the justification for the same.

Component accounting

Component accounting entails that if an item of fixed asset comprises two or more significant components, with substantially different useful lives, then each component is treated separately for depreciation purposes and depreciated over the component's useful life. Such components can either be 'physical components' (e.g., airframe, lending gear) or 'non-physical components' (e.g., major inspection and overhaul cost of aircrafts or engines). In case of a physical component, the carrying amount of the component is determined with reference to its cost/proportionate cost, whereas in case of a non-physical component, the carrying amount is estimated based on usage of the aircraft, contractual terms, technical estimates, etc. Such non-physical components are split for major expenditure that occurs at regular intervals over the life of the aircraft. Presently under Indian GAAP, component accounting is not mandatory. However, Schedule II of the 2013 Act makes it mandatory.

Therefore, effective 1 April 2014, Indian carriers would have to break-up their fixed assets, especially aircrafts, into various components retrospectively for calculation of depreciation. This will require considerable efforts since the management would have to estimate the value of components on 1 April 2014 and also allocate certain other subsequently capitalised expenses (e.g., foreign exchange differences as part of the relaxations given in para 46/46A of the AS 11, *the Effects of Changes in Foreign Exchange Rates,* in the case companies have chosen that accounting option).

Lease accounting

Under Indian GAAP, the classification of leases is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. The broad objective of the risk and reward model is to bring 'in substance purchase transactions' on the balance sheet of the lessee. The assessment of risks and rewards may be complicated if an airline has retained some risks in the lease arrangements whilst mitigating its 'downside risk' for instance by retaining the flexibility to return the aircraft to the lessor at certain points during the lease term. For example, under a long-term lease agreement, an airline company (lessee) may enter into one-sided termination clause in the lease agreement to protect itself from the fluctuation in the foreign currency both upside and downside. Each transaction has to be judged on its merits, although the following indicators, commonly seen in the industry, may suggest that the finance lease classification is appropriate:

- the tenure of a lease is for majority of the economic life of the asset. This will require careful evaluation before the lease of second hand aircrafts
- where the ownership of the asset is transferred to the lessee or there is a bargain purchase option.

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The sale and leaseback transactions are very common in the airline industry. The key reasons for entering into such transactions are to realise immediate gains in the profit and loss, generate cash flows, alter the balance sheet treatment by entering into operating lease back transactions, etc. Classification into operating lease or finance lease, in case of sale and leaseback transaction becomes important as this can decide timing of recognition of gain or loss on sale, de-recognition of aircraft costs from the books and recognition of future monthly rentals. The accounting rules around sale and lease back transactions can be summarised as below:

Condition	Treatment
Sale price = Fair value (FV)	**Recognise profit or loss immediately**
Sale price > FV	**Defer and amortise excess fair value over the asset's useful life**
Sale price < FV and, in case of a loss, not compensated by future below-market lease payments	**Recognise in the statement of profit and loss immediately**
Sale price < FV and resulting loss is compensated by future below-market lease payments	**Defer and amortise loss over the asset's useful life**

Source: AS 19, *Leases* and KPMG in India analysis

Fair Value (FV) of aircrafts is often difficult to determine, especially for second hand aircrafts although the third party desktop valuations are a good starting point. Other useful factors to be considered for determining the FV of the aircraft include discounts to list prices of the aircraft, benchmarking of periodic lease rentals, analysis of the nature of costs capitalised into the aircraft values, etc.

Accounting of spare parts

Accounting for aircraft spares is one of the most complicated areas mainly due to the high number of inventory items carried by airlines and the fact that some of these spare items are rehabilitated to a fully serviceable condition after repairs. Typically, items of aircraft spares are classified under three broad categories:

Rotables – These items have extensive life expectancy through repetitive overhaul process and their life is generally equal to the life of the aircraft or engine.

Repairable – parts which are capable of being repaired and reused, but which can only be repaired a limited number of times.

Expendables and consumables – parts which are subject to one time usage or items on which the repair cost normally exceeds the cost of the new item.

Accounting for spares under Indian GAAP is driven mainly by AS 10, *Accounting for Fixed Assets* and AS 2, *Valuation of Inventories* . As per these standards, machinery spares which can only be used in connection with an item of fixed asset and whose use is expected to be irregular, are treated as fixed assets. An airline should consider the facts whether the aircraft spares are meant to be used in relation to a specific aircraft or they would be generally used interchangeably within the aircraft fleet. If spares are general in nature and can be used interchangeably within the aircraft fleet then such spares could be, treated as inventory. Opinion of the Expert advisory committee[1] (EAC) of the Institute of Chartered Accountants of India (ICAI) dated 27 June 2005 also supports this conclusion.

Typically, AS 2 requires the carrying amount of the inventory to be charged to the statement of profit and loss at the time of issue for consumption. The spares under 'rotable' and 'repairable' category are expected to be used over more than one accounting period on a repetitive basis and do not necessarily get consumed on issuance from stores.

In practice, the airline companies do not recognise the entire value of the rotable and repairable inventory as an expense at the time of initial issue since these inventory items are generally meant to be used for more than one accounting period. They recognise the expense in the statement of profit and loss over the consumption period.

1. ICAI EAC opinion volume 25 query no.15

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Credits from aircraft or engine manufacturers

Airlines may get various types of 'credits' from aircraft manufacturers either as an incentive to purchase a manufacturer's aircraft or as liquidated damages for delay in delivery of the aircrafts. These credits can be in the form of rebate against purchase price of aircrafts or engines, marketing support, spare parts support at reduced or zero charge, discounts for future purchases, etc. The question that comes up for analysis is whether such credits are recognised in the statement of profit and loss immediately or offset against the cost of the aircraft. There is no specific guidance under Indian GAAP for the accounting for such credits. An airline company should consider the facts and circumstances and understand the substance of such credits. If such credits, in substance, represent a discount against the aircraft purchase price then the credit should be recognised as a reduction from the purchase price of the aircraft. There is no specific guidance under Indian GAAP for accounting for such credits. An airline company should consider the facts and circumstances and understand the substance of such credits. If such credits, in substance, represent a discount against the aircraft purchase price then the credit should be recognised as a reduction from the purchase price of the aircraft.

Frequent flyer programme

One of the most talked about accounting issues in the airline industry is accounting for the 'frequent flyer programme' (FFP). In a typical FFP programme, the passengers get free mileages/privilege points by flying with the airline and these points can be utilised in the future against free tickets in the same or any other airline participating in the same FFP within the specific period of time. In some other programmes, the passengers also have flexibility to utilise points against other goods and products. In the absence of any specific guidance under Indian GAAP, in practice many airlines and other entities with similar programmes, create provision on an estimated incremental cost basis (i.e., marginal costs incurred by airlines in flying the passenger for free) at the time of recognising revenue from sale of underlying tickets. Total amount of provision, calculated based on the points outstanding at each reporting date is reduced by the management's estimate of forfeiture (i.e., lapse of unutilised points).

The calculation of provision can get very complex because of changes in estimates (e.g., pattern of utilisation of points by passengers, changes in incremental cost for every sector, change in forfeiture rate, etc.) from one reporting period to the other.

The other approach is that a portion of the consideration received from the customer should be allocated to the awards and deferred as the airline's liability until the airline fulfils its obligations to deliver goods and services to the customer. This approach (currently the prescribed treatment under IFRS) requires that a portion of the revenue should be deferred as a liability till the time the obligation is fulfilled. Accordingly, the revenue under this approach is split into two components: one, a portion requiring allocation of revenue to the consideration received for goods and services immediately sold to the customer and other towards the consideration received for the goods and services to be given to the customers at the time of redemption of the awards. The amount of revenue that is deferred is based on the fair value of the services/goods to be provided in the future and not based on the fulfillment cost as was the measurement method followed in the first approach.

According to the Technical Guide on Accounting Issues in the Retail Sector issued by the ICAI, the second approach i.e., multiple element treatment of loyalty programmes is also in line with the revenue recognition requirements as prescribed under AS 9, *Revenue Recognition*. According to AS 9, revenue should be recognised only to the extent that goods and services have been provided to the customers.

Provision for redelivery expenses

When an airline company has aircrafts on lease, contractual terms of some of the lease agreements may make it obligatory for a lesssee to return the aircraft in the same technical condition as it was originally delivered. This means that the lessee has to carry out predefined repairs on aircrafts at the end of the lease term and also incur expenses to deliver the aircraft at predetermined locations. Under Indian GAAP, in practice airline companies create a provision based on an estimated amount of expenses at the time of entering into lease agreement and recognise a charge in the statement of profit and loss over the lease term.

Conclusion

In summary, the changes emanating from the 2013 Act kick in from 1 April 2014, which means listed companies would have to start reporting under the revised regulations in their first quarterly reporting dated 30 June 2014. Considering the complexity of the changes and their impact on financials, it will be challenging for the listed companies to comply with the 2013 Act in such a short period. Further, the Institute of Chartered Accountants of India has recently put out a revised roadmap for adoption of Ind-AS (Indian Accounting Standards that are converged with International Financial Reporting Standards) from 1 April 2016. Even though some of the changes brought about by the 2013 Act will partly align the reporting under Indian GAAP with Ind-AS, there are some more changes expected on adoption of Ind-AS by companies in India. For example, capitalisation of foreign exchange differences as part of fixed assets is prohibited under Ind-AS, deferral of revenue for accrual of mileage points, discounting of lease deposits and provision for redelivery expenses, etc. would be required.

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IFRS 15 an overview[1]

This article aims to

- Provide an overview of the five-step revenue recognition model in the new standard
- Highlight the sectors that are likely to be significantly affected by the new standard.

On 28 May 2014, the FASB[2] and the IASB[3] issued a new accounting standard ASC Topic 606/IFRS 15 Revenue from Contracts with Customers. The new standard replaces IAS 11 *Construction Contracts,* IAS 18 *Revenue*, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers and SIC-31 Revenue-Barter Transactions Involving Advertising Services*.

The standard took over five years to be developed and involved issuance of a joint discussion paper and two joint exposure drafts, consideration of public comment letters and feedback from other outreach efforts and during the process, held a number of joint and separate meetings to re-deliberate key aspects of the standard. The objectives of the converged standard are as follows:

- To simplify preparation of financial statements by reducing the number of requirements by having one revenue framework.
- To remove inconsistencies and weaknesses in existing requirements.
- To provide a more robust framework for addressing revenue issues.
- To provide more useful information through improved disclosure requirements.

The new revenue model will apply to all industries and all types of revenue generating transactions. The new requirements are expected to affect different companies in different ways. Also, the new model on revenue is expected to have impacts throughout the company and may not be limited only to the recognition, measurement and disclosure requirements of the revenue standard. In this article, we are providing an overview of the standard, the sectors that are likely to get significantly affected and key impacts of the new revenue model.

Revenue is a key performance metric for many entities and IFRS 15 introduces a new framework- five step model - for the analysis of revenue transactions. The model specifies that revenue should be recognised when (or as) an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled.

1. IFRS 15, Revenue from Contracts with Customers and KPMG's Publication First Impressions: Revenue from contracts with customers
2. U.S. Financial Accounting Standards Board
3. International Accounting Standards Board

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Scope of the standard

The new standard applies to contracts to deliver goods or services to a customer. 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. The standard does not cover following contracts:

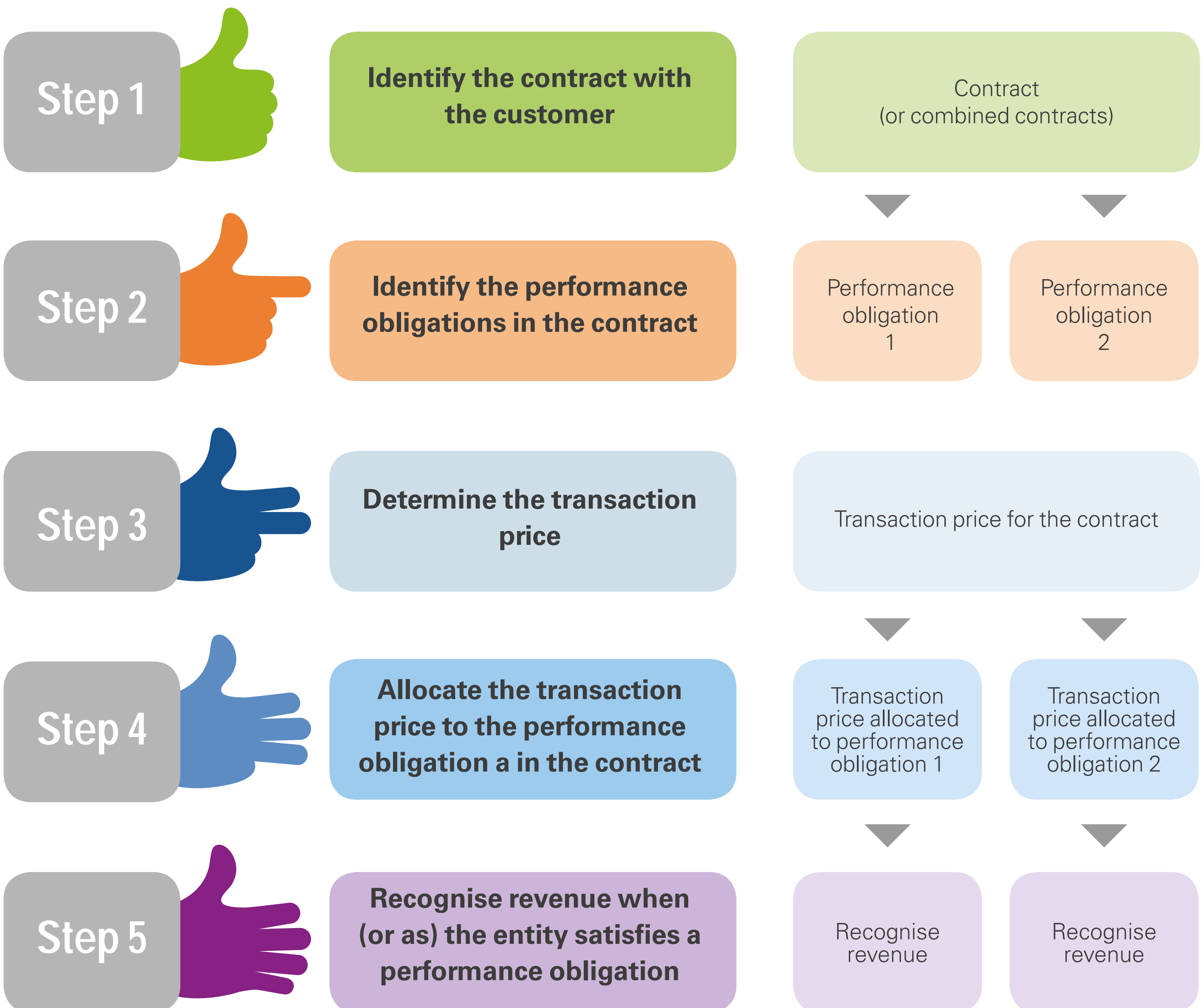
- Leases
- Insurance[4]
- Rights or obligations that are in the scope to certain financial instruments guidance –e .g., derivative contracts
- Guarantees other than product or service warranties (U.S. GAAP only)[5]
- Non-monetary exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.

A contract with a customer may be partially in the scope of the new standard and partially in the scope of other accounting guidance – e.g., a contract for a lease of an asset and maintenance of the leased equipment or a financial services contract with a cash deposit and treasury services.

This standard specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this standard to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this standard to the portfolio would not differ materially from applying this standard to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

Five step model

The core principle of the revenue recognition model is that an entity should recognise as revenue the amount that reflects the consideration to which the entity expects to be entitled in exchange for goods or services when (or as) it transfers control to the customer. To achieve that core principle, the new standard establishes a five-step model:



Source: KPMG's publication First Impressions: Revenue from contracts with customers 2014

4. The FASB version of the revenue recognition standard only scopes out insurance contracts issued by insurance entities that are in the scope of ASC Topic 944 Financial Services - Insurance
5. The FASB version of the revenue recognition standard scopes out guarantees that are in the scope of ASC Topic 460 Guarantees

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Step 1: Identify the contract with a customer

The new standard defines a contract as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. In some instances, two or more contracts are combined and accounted for as a single contract with a customer. An entity would account for a contract with a customer under IFRS 15 only when all of the following criteria are met:

*The thresold differs under IFRS and U.S. GAAP due to different meaning of the term 'probable'.
Source: KPMG's publication First Impressions: Revenue from contracts with customers 2014.

Sectors likely to be significantly affected: Aerospace and defence, health care (U.S.), life sciences, real estate

Step 2: Identify the performance obligations in the contract

An entiy would need to identify each promise to deliver goods or service in a contract with a customer. A promise constitutes a performance obligation if the promised good or service is distinct. A good or service is distinct if it meets the following two criteria:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer
- The entity's promise to transfer goods or service to the customer is separately identifiable from other promises in the contract.

The new standard includes additional guidance compared to existing revenue standard to help determine whether the above criteria are met.

Sectors likely to be significantly affected: licensors, real estate, software, telecommunications

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding the amount collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity would consider the effects of all the following:

- variable consideration and constraining estimates of variable consideration
- the existence of a significant financing component in the contract
- non-cash consideration
- consideration payable to a customer.

There are two key areas that should be considered when determining the transaction price, and they are variable consideration and the existence of a significant financing component.

Variable consideration: An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone. Depending on the facts and circumstances, entities would have to estimate the amount of variable consideration either by using the expected value or the most likely amount.

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However, an entity may have to constrain the amount of variable consideration that it includes in the transaction price. When this 'constraint' applies, entities include variable consideration in the transaction price only to the extent that it is 'highly probable'[6] that a significant reversal – i.e., a significant downward adjustment in the amount of cumulative revenue recognised – will not subsequently occur.

To assess whether – and to what extent – they should apply this constraint, entities will consider both:

- the likelihood of a revenue reversal arising from an uncertain future event
- the magnitude of the reversal of that uncertain future event were to occur.

This assessment needs to be updated at each reporting date.

Significant financing component: In determining the transaction price, an entity would be required to adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provide the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. As a practical expedient, an entity need not adjust the transaction price in a contract for the effects of a significant financing component if it expects to receive payment within 12 months of transferring the promised goods or services.

Sectors likely to be significantly affected: Aerospace and defence, asset managers, building and construction, health care (U.S.)

Step 4: Allocate the transaction price to performance obligations

An entity would allocate the transaction price to each performance obligation (or distinct good or service) in proportion to its stand-alone selling price. The best evidence of the stand-alone selling price is an observable price from stand-alone sales of that good or service to similarly situated customers. However, if the stand-alone selling price is not directly observable, entities should estimate it by either:

- evaluating the market in which they sell goods or services and estimating the price customers would be willing to pay
- forecasting expected costs plus an appropriate margin
- in limited circumstances, subtracting the sum of observable stand-alone selling prices of other goods or services in the contract from the total transaction price.

When specified criteria are met, a discount or variable consideration may be allocated to one or more but not all, distinct goods or services.

Sectors likely to be significantly affected: Software, telecommunications

Step 5:Recognise revenue when (or as) the entity satisfies a performance obligation

An entity would recognise revenue when (or as) it satisfies a performance obligation by transferring control of a good or service to a customer. Control may be transferred either at a point in time or over time. Under the new standard, the revenue recognition is a control based model and not risks and rewards model.

A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity would recognise revenue over time by selecting an appropriate method for measuring the entity's progress towards complete satisfaction of that performance obligation.

The standard provides specific application guidance for assessing whether revenue from a distinct licence of intellectual property is recognised at a point in time or over time.

Sectors likely to be significantly affected: Aerospace and defence, building and construction, contract manufacturers, licensors, real estate, software

6. The IFRS version of the revenue recognition standard uses the term 'highly probable' – which is a significantly higher threshold than 'more likely than not' – with the intention of converging with the meaning of the term 'probable' as used in U.S. GAAP.

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Other guidance available

The new standard also provides guidance on accounting for:

- incremental costs of obtaining a contract and some costs to fulfil a contract
- contract modifications
- sales with a right of return
- warranties
- principal versus agent considerations
- repurchase agreements
- performance obligations satisfied over time
- methods for measuring progress towards complete satisfaction of a performance obligation
- bill-and-hold arrangements
- consignment arrangements
- customer acceptance
- customer options for additional good or services
- customers' unexercised rights
- non-refundable up-front fees
- disaggregation of revenue disclosures.

Presentation and disclosures

The new standard also includes a cohesive set of disclosure requirements that are expected to result in an entity providing users of financial statements with extensive information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts with customers. Specifically, the standard requires an entity to provide information about:

- contracts with customers
  - disaggregation of revenue
  - changes in contract assets, liabilities and costs
  - performance obligations
  - transaction price allocated to remaining performance obligations
- significant judgements, and changes in judgements in applying the requirements
  - determining the timing of satisfaction of performance obligations
  - determining the transaction price and amounts allocated to performance obligations
- assets recognised from the costs to obtain or fulfil a contract with a customer.

Effective date and transition

For entities applying IFRS, the new standard is effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted only under IFRS. For public entities applying U.S. GAAP, it is effective for annual periods beginning on or after 15 December 2016 and interim periods thereafter (there is a one year deferral for non-public entities).

An entity may choose to adopt the new either:

- retrospectively with or without practical expedients
- through a cumulative effect adjustment as of the start of the first period for which it applies the new standard.

The standard provides elaborate transition guidance.

Key impacts

Revenue may be recognised at a point in time or over time

- if you currently use the stage-of-completion method or otherwise enter into long-term contracts, you will have to evaluate whether to recognise revenue on contract completion or as the contract is fulfilled. If you recognise it over time, the manner in which progress towards completion is measured may change.
- Applying new criteria in this area will require detailed review of contract terms and evaluation of the nature of your performance obligations.

Revenue recognition may be accelerated or deferred

For complex transactions with multiple components and/or variable consideration, or when the work is carried out for an extended period of time, applying the standard may lead to revenue being accelerated or deferred.

Revisions may be required

Revisions/updates may be needed for tax planning, covenant compliance, sales incentive plans, sales and contracting processes, IT systems, accounting processes, internal controls, etc.

New estimates and jugdements will be required

The standard introduces new estimates and judgemental thresholds that will affect the amount or timing of revenue recognised. Judgements and estimates will need updating, potentially leading to more financial statement adjustments for changes in estimates in subsequent periods.

Entities will need to communicate with stakeholders

Investors and other stakeholders will want to understand the impact of the new standard on the overall business-probably before it becomes effective. Areas of interest may include the effect on financial results, the costs of implementation, any proposed changes to business practices, the transition approach selected, and whether they intend to adopt early (IFRS users, entities other than public business entities and certain not-for profit entities reporting under U.S. GAAP).

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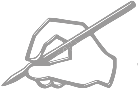
Accounting for dynamic risk management activities

IASB's discussion paper on macro-hedge accounting



This article aims to

- To provide an overview of the discussion paper on macro-hedge accounting[1].

The IASB[2] issued its long awaited discussion paper on macro-hedge accounting on 17 April 2014 as the first due process document for this project. As the project involves fundamental accounting questions, the IASB has not proceeded straight to issuing an exposure draft. The DP poses some very interesting and challenging questions and could potentially change our current understanding of hedge accounting and how it is applied in the financial statements. We provide a brief overview of some of the key aspects of this lengthy DP in this article.

1. Source: KPMG's IN THE HEADLINES May 2014, Issue 2014/06
2. International Accounting Standards Board

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Background and interaction with IFRS 9

Since November 2008, the IASB has been working to replace its financial instruments standard (IAS 39[3]) with an improved and simplified standard, IFRS 9 *Financial Instruments*. The IASB has split the hedge accounting phase of the project into two parts: general hedge accounting and macro-hedge accounting. On 19 November 2013, the IASB issued a new general hedge accounting standard – part of IFRS 9 *Financial Instruments* (2013).

The IASB has tentatively decided that the effective date of IFRS 9 will be 1 January 2018. To avoid jeopardising this date, the macro-hedge accounting project has been carved out from the development of IFRS 9.

Because of the close interaction between the general hedge accounting and macro-hedge accounting models, the IASB permits a company to make an accounting policy choice to defer adoption of IFRS 9 (2013)'s general hedge accounting model until the standard resulting from the macro-hedge accounting project is effective. In addition, the IASB carried forward the exception permitting fair value hedge accounting for a portfolio hedge of interest rate risk in paragraph 81A of IAS 39 to the general hedge accounting model of IFRS 9 (2013).

For companies in India and especially banking and financial services entities, this DP should be of interest as it points to the direction of accounting standard setting, given the RBI's likely preference to apply the IFRS 9 guidance over IAS 39, when entities in India adopt Ind AS accounting standards.

The need to align macro-hedge accounting with risk management

Although current standard (IAS 39) provides for a model of macro-hedge accounting, there are numerous constraints that various stakeholders have complained about that limit their ability to reflect some common dynamic risk management activities accurately under this accounting model. Without an accounting model that reflects many dynamic risk management activities, it can be difficult to faithfully represent a company's risk positions in its financial statements. Resultantly, the criticism has been that companies are often left with focussing on reducing volatility in the statement of profit and loss rather than truly reflecting their risk management activities.

Similar to the general hedge accounting model finalised in November 2013, the macro-hedge accounting model aims to better reflect companies' risk management activities while reducing the operational complexities of hedge accounting. The project involves fundamental accounting questions and is not simply a modification to existing hedge accounting models.

Challenges with existing accounting requirements

Current IFRS may result in different measurement or recognition for items that have the same or similar risks. For example, banks often use interest rate derivatives to reduce the interest rate risk arising from loans and deposits. However, loans and deposits are generally accounted for on an amortised cost basis, whereas interest rate derivatives are accounted for at fair value through profit or loss (FVTPL). These different accounting requirements can result in volatility in the statement of profit and loss.

To address such accounting mismatches, current IFRS (IAS 39) allows companies to select either a fair value hedge model or a cash flow hedge model. However, these models do not necessarily portray dynamic risk management – in the example above, the bank's main risk management objective may be to protect the net interest margin from the interest rate risk in its interest rate exposures. The current accounting requirements can also be operationally onerous, because one-to-one designation is usually required between the hedged item and the hedging instrument, and hedging relationships need to be tracked and frequently adjusted to match the dynamic nature of open portfolios.

As an exception, the current IFRS contains special requirements for 'fair value hedge accounting for a portfolio hedge of interest rate risk'. This allows some hedged items to be included on a 'behaviouralised basis' – e.g.,prepayable fixed interest rate mortgages – rather than on a contractual cash flow basis, which accommodates some aspects of dynamic risk management. However, this model can only be applied for hedges of interest rate risk and can not be used for other types of risk – e.g., commodity price risk and foreign exchange risk. In addition, a company can not designate a *net* amount comprising both assets and liabilities. Entities have found these requirements difficult to apply in practice and have questioned whether they result in useful information in their financial statements.

A wide range of industries affected

As a starting point, the IASB's focus has been on developing a model for banks to use to account for dynamic risk management of interest rate risk. Macro-hedge accounting for these dynamic risk management activities may have a pervasive impact on a bank's financial position, performance, and operations – including the need for systems to capture and model the risk profiles of large groups of financial instruments.

However, dynamic risk management activities are not restricted to banks' interest rate risk management. Companies across a number of industries engage in dynamic risk management activities, covering a broad range of strategies, techniques and approaches. These activities may manage risks such as interest rate risk, commodity price risk and foreign exchange risk.

3. IAS 39 Financial Instruments: Recognition and Measurement

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Portfolio revaluation approach

To help stimulate debate, the DP puts forward an outline of one possible approach to macro-hedge accounting, a 'portfolio revaluation approach' (PRA), which in some ways is similar to the fair value hedge model.

Accounting under the PRA

Managed exposures
Managed exposures would be identified and remeasured for changes in the managed risk, with the gain or loss recognised in the statement of profit and loss. The remeasurement would be based on a present value technique.

Hedging instruments
Risk management derivatives – i.e., hedging instruments – would continue to be measured at FVTPL.

Result of hedge accounting
The performance of a company's dynamic risk management activities would be captured by the net effect of the above measurements in the statement of profit and loss.

Other risks
Risks that are not managed would not be included in this approach – i.e., this is not a full fair value model.

The IASB expects the PRA to be operationally easier to apply than the current hedge accounting models because:

- the accounting result would be consistent with risk management activities
- it would not require a specific linkage between managed exposures and risk management derivatives.

Scope alternatives for the PRA

The DP presents two scope alternatives for the application of the PRA, which differ based on whether the PRA would capture all three elements of dynamic risk management – i.e., risk identification, analysis and mitigation through hedging.

Dynamic Risk management approach
The PRA would be applied if any one of the three elements of dynamic risk management are present – e.g., the PRA would apply to all net open risk positions regardless of whether they have been hedged.

Risk mitigation approach
The PRA would be applied only when all three elements of dynamic risk management are present – e.g., the PRA would only apply when the company has undertaken risk mitigation activities through hedging.

The PRA could be limited to only dynamically managed sub-portfolios that have been hedged. Alternatively, the PRA could be applied to proportions of portfolios if hedged positions are determined as a proportion of a dynamically managed portfolio.

Alignment with risk management

A key question is to what extent dynamic risk management activities should be reflected in the accounting. The DP discusses a number of items that would broaden the scope of the PRA as compared with the current hedge accounting models.

The DP asks whether the following items should be eligible for inclusion in the managed exposure for interest rate risk:

- pipeline transactions – i.e., forecast volumes of drawdowns of fixed interest rate products at advertised rates
- equity model book – i.e., companies' own equity where it is managed to earn a minimum target return similar to interest
- behaviouralised expected cash flows related to core demand deposit liabilities and prepayment risk.

The DP also considers other aspects of dynamic risk management, including the use of risk limits, and the roles of transfer pricing and internal funding indexes.

There is a trade-off to consider: the more such items are incorporated into the PRA, the closer hedge accounting may be aligned with dynamic risk management activities. But the broader the scope, the less consistent it may be with conventional accounting concepts.

Mandatory or optional?

The DP asks whether application of the PRA should be mandatory or optional. Hedge accounting has historically been voluntary, so mandating the PRA for dynamic risk management activities would be a significant change.

Comment period

The longer than usual comment period of six months is a welcome decision, reflecting the complexity of this issue, the broad range of risk management practices, and the potentially pervasive impact on banks' financial position and performance. Corporates will also need this additional time to get to grips with what is, for many, a new concept.

We strongly encourage constituents to participate in the development of a transparent, operational and decision-useful macro-hedge accounting model. Comments are due to the IASB by 17 October 2014.

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Borrowing costs

Certain implementation issues

This article aims to

- Discuss certain implementation issues relating to borrowing costs
- Highlight the differences in accounting under IFRS and Indian GAAP.

In capital intensive industries, borrowing costs is a significant expenditure and accordingly, accounting thereof assumes importance. Like many other items of expenditure, the basic accounting issue with regard to borrowing costs has always been the determination of the portion of borrowing costs that can be capitalised. This determination has a significant impact on the statement of profit and loss of many companies and sometimes, involves considerable degree of judgement. Though under Indian GAAP, AS 16, *Borrowing Costs*, deals with the accounting for borrowing costs; in many cases, the practical implementation of the principles enunciated by the said standard poses challenges and are subject to different interpretations. This is evident from the fact that while AS16 is almost the same as the corresponding IFRS (IAS 23), due to the overall Indian GAAP framework including certain opinions issued by the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), the amount of borrowing cost to be capitalised may vary under Indian GAAP. This article aims to touch upon some of these aspects.

The application of 'avoidable cost' concept

AS 16 para 8 states that "*the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those* ***borrowing costs that would have been avoided*** *if the expenditure on the qualifying asset had not been made*". AS 16 further states that it may be difficult to identify a direct relationship between a particular borrowing and a qualifying asset, and to determine the borrowings that could otherwise have been avoided. Such kind of difficulty occurs, for example, when the financing activity of an enterprise is co-ordinated centrally or when a range of debt instruments are used to borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and requires companies to exercise judgement while capitalising borrowing costs. While this is the same principle as in IAS 23, the phrase 'borrowing costs that would have been avoided' (referred to as 'avoidable cost' concept) has been interpreted differently under both Indian GAAP and IFRS.

There are few EAC opinions, that while dealing with facts and circumstances of the specific cases, dealt with the concept of 'avoidable cost'.

One of the EAC opinions[1], states as follows:

"in deciding which borrowings should be considered for the purpose of arriving at the capitalisation rate, ***those borrowings should be excluded which were borrowed for a specific purpose (other than the capital expenditure under consideration)*** *unless there is evidence that the same were used for the capital expenditure under consideration."*

Another EAC[2] opinion states as follows:

'While raising funds by means of an equity issue, the offer document concerned normally states the purpose for which the funds are raised. In the present case, in the absence of any evidence regarding the use of the funds, if the offer document clearly states that the equity capital was issued for the purpose of financing projects, including acquisition of qualifying assets, the ***funds used from the current accounts may be considered to be out of equity funds. In such a case, the question of 'avoidable borrowing costs', as stipulated in AS 16, does not arise since there would be no borrowings for acquisition of qualifying assets****'.*

1. ICAI EAC Opinion query no. 29 Volume 23
2. ICAI EAC Opinion query no. 15 Volume 22

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Based on the EAC opinions, following principles emerge:

- When a qualifying asset has been funded by internal accruals
- When the funds have been borrowed for specific purpose other than capital expenditure, then the borrowing cost incurred by an entity should not be capitalised.

However, the corresponding position taken internationally is different since IFRS considers that money is fungible. To illustrate, a company has outstanding borrowings of INR100. During the year, the company raised INR150 through issuance of equity shares. The proceeds from equity are deposited in a common bank account from which expenditure on qualifying assets amounting to INR125 has been made during the year and the amount has also been used for other corporate activities. Considering the positions taken by above EAC opinions, the borrowing cost will not be capitalised under Indian GAAP since it would be considered to be funded from equity capital. However, under IFRS, the borrowing cost would be considered to be eligible for capitalisation since had the expenditure on qualifying assets not have been made during the year, the company would have repaid the borrowings and, accordingly, the borrowing costs would have been avoided. Therefore, different interpretation of 'avoidable cost' under Indian GAAP and IFRS may lead to significantly different results.

Group borrowings

Another area where practice may differ under Indian GAAP and IFRS would be cases where one entity in the group, say a parent company, borrows the funds and these funds are invested in a subsidiary entity through equity infusion. The subsidiary entity uses these funds for construction of a qualifying asset. The subsidiary entity does not have any other source of funding. In the separate financial statements of the parent company, the borrowing costs can not be capitalised since investment in equity shares in the subsidiary entity is not a qualifying asset. Similarly, in the separate financial statements of the subsidiary entity also, the borrowing costs can not be capitalised since there are no borrowings by the subsidiary entity.

The issue arises whether in the consolidated financial statements, borrowing costs can be capitalised under the Indian GAAP. One view is that under Indian GAAP, line by line consolidation is carried out and, except elimination of unrealised gains/losses arising on inter-company eliminations, no other adjustment is required. This view is also supported by the fact that for the measurement of tax expense in the consolidated financial statements, Indian GAAP specifically requires that the tax expense of the parent company and the subsidiary companies are added on line by line basis and no adjustment is carried out.

The other view is that in the consolidated financial statements, the accounting treatment should reflect that the parent and the subsidiary are considered as one single entity. As per this view, in the above situation, in the consolidated financial statements, the borrowing costs should be capitalised, even though it is not capitalised either in the separate financial statements of the parent company or its subsidiaries.

Under IFRS, IAS 23 contains specific guidance on group borrowings and the latter view is required to be followed. However, under Indian GAAP, AS 16 does not have specific guidance on group borrowings, and overall accounting framework of line by line addition (including the position taken for tax expense), the practice may vary.

Adjustment of foreign exchange gains as a part of borrowing costs

As per AS 16, borrowing costs include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (AS 16 para 4(e). As per this requirement, exchange loss on foreign currency loan is capitalised to the extent it amounts to adjustment towards interest costs. With regard to foreign exchange gains arising on the foreign currency borrowings, as per one of the EAC opinions, it should be reduced from the cost of the fixed asset to the extent the exchange loss has been capitalised as per the provisions of paragraph 4(e) of AS 16. Any excess exchange gain should be accounted for as income for the year in which the same arises. Since borrowing costs can be capitalised only with respect to a qualifying asset as per AS 16, as per EAC opinion, decapitalisation can be done only during the period over which the fixed asset towards which the foreign currency loan has been taken continues to be a qualifying asset. In view of the above, as per this EAC opinion[3], the exchange gain can be considered as an adjustment to the interest costs only to the extent of exchange loss capitalised in the past.

However, it is important to note that in 2009[4] and 2011[5], the Ministry of Corporate Affairs (MCA) relaxed the accounting principles of AS 11, The Effects of Changes in Foreign Exchange Rates, by adding new paragraphs (no. 46 and 46 A). The MCA[6] also clarified that paragraph 6 of AS 11 and paragraph 4(e) of AS 16 shall not apply to a company which is applying clause 46A of AS 11. The essence of the clarification is that a company applying para 46A of AS 11would not bifurcate exchange differences (on long-term foreign currency monetary items) between (i) those regarded as an adjustment to borrowing costs and (ii) others. Thus, it will account for the entire exchange differences as per AS 11.

Under IFRS, borrowing costs may include foreign exchange differences to the extent that these differences are regarded as an adjustment to interest costs. If exchange differences qualify for capitalisation, then both exchange gains and losses should be considered in determining the amount to capitalise. There is no further guidance under IFRS on the conditions under which foreign exchange differences may be capitalised and judgement is required to apply the requirements to the particular circumstances of the entity.

Conclusion

While the accounting principles for borrowing costs appear to be straight-forward, the application thereof may require careful evaluation of positions taken under Indian GAAP, including various opinions issued by the EAC. Further, in the context of proposed convergence with IFRS through the issuance of Ind AS, the ICAI should also consider the overall status of those EAC opinions, which result into GAAP differences, though there are no such differences/carve-out from IFRS as far as accounting principles are concerned.

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3. ICAI EAC Opinion query no. 13 Volume 28
4. MCA notification dated 31 March 2009
5. MCA further introduced two notifications dated 29 December 2011
6. MCA notification dated 29 December 2011

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Commodity contracts: Accounting for open purchase/ sale contracts

This article aims to

- Discuss the accounting challenges relating to open purchase/open sales contracts under AS 2 and AS 30.

In India, in the agro-commodity sector, the size of operations is generally large and the companies enter into complex contracts relating to purchase and sale of agro-based commodities. Companies engaged in trading of agro-based commodities may enter into contract for purchase and sale of commodities on a back-to-back basis for delivery at future dates to earn a margin from trading activities. If a trading contract is not entered into on a back to back basis, companies also take corresponding position on commodity exchanges to hedge movement in prices till the time outstanding sale or purchase position is aligned on back to back basis. Some of these sale/purchase contracts for delivery at future dates and position taken on commodity exchange remain outstanding (open) as at a reporting date. Accounting for such contracts which are open as at year-end results in certain accounting issues under Indian GAAP. In this article, we are discussing accounting for scenarios in which a company has an outstanding position of open contracts under Indian GAAP.

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Accounting literature under Indian GAAP

Relevant guidance for accounting of open purchase/sale contracts is contained in AS 2, *Valuation of Inventories* and AS 30, *Financial Instruments: Recognition and Measurement*. Paragraph 23 of AS 2 (reproduced below) provides guidance for accounting of firm sale and firm purchase contracts. Contracts which are not in the nature of firm sale and firm purchase are accounted for as derivative contracts under AS 30. AS 30 requires mark to market accounting for all derivatives depending on whether they qualified or not as a hedge, with immediate recognition of the change in fair value in the statement of profit and loss.

It is relevant to note that AS 30 is currently not a notified accounting standard under the Companies Act and therefore, companies in India are not mandatorily required to follow AS 30. If a company has not early adopted AS 30, notification issued by the Institute of Chartered Accountants of India (ICAI) in March 2008 is applicable which states that *"keeping in view the principle of prudence as enunciated in AS 1, an entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet by marking them to market."*

It is important to note that AS 2 is a mandatory accounting standard while AS 30 is not mandatorily required to be followed by an entity, therefore, ICAI has not yet amended AS 2 with respect to the accounting requirements of AS 30.

For the purpose of determining applicability of relevant accounting standard, it is important to determine whether an open sale and purchase contract is in the nature of a firm sale and purchase contract. The assessment of whether a contract is in the nature of a firm sale/firm purchase contract depends upon facts of each case and requires detailed analysis to determine nature of contract and corresponding applicability of relevant accounting standard.

Factors that would be generally considered to determine the nature of a contract may include following:

- purpose of the contract,
- past history of the company to execute/ cancel similar contracts
- whether intent is to settle the contract net of cash or by actual delivery of the goods
- cancellation and net settlement clauses in the contract, etc.

Related guidance for accounting of firm sale/firm purchase contracts is contained in AS 2.

Fact pattern

Generally, a company engaged in commodity trading enters into a contract with its customer for delivery of goods at a future date, at a predetermined price. The company executes a contract by delivering goods. In order to fulfil the contract for sale of goods on its due date, the company would most likely have the following possible options:

A. Purchase the goods to be sold from the market and hold them as its inventory for the purpose of fulfilling corresponding sale contract on its due date

B. Enter into a corresponding firm purchase contract with a vendor to supply the commodity on due date in order to fulfil the firm sale contract

C. Enter into a future contract at a commodity exchange to hedge price risk of open firm sale contract till the time goods are purchased as mentioned in option A above or a firm purchase contract is entered into for supply of goods as mentioned in option B above.

A. Accounting for firm sales contracts where inventory is held

AS 2 para 23 states the following:

Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

Accounting of the open firm sale contracts where the inventory is available with the company is covered by AS 2. Accordingly, the quantity and price of the open firm sale contracts would be considered for the purpose of valuation of inventories. Following situations would arise:

- where the quantities of the inventory are in excess of the firm sales contracts, then net realisable value of the excess portion of the inventory quantities held would be recognised with reference to general market price as at a reporting date.
- where the quantities of the inventory are less than the requirement for firm sales contracts, then contingent losses on firm sales contract would be recognised in accordance with AS 4. However, if there is a gain on the firm sale contracts in excess of inventory quantities held, then the gain may not be recognised in accordance with principles enunciated in AS 4/AS 29.

B. Accounting for firm sale contracts backed by firm purchase contracts

If the company has entered into a firm sale contract and to execute the firm sale contract on its due date, the company has also entered into a corresponding firm purchase contract with a supplier then the accounting for the firm sale contract and firm purchase contract is covered under paragraph 23 of AS 2. As the company does not hold any quantity of inventory, firm sale contract and firm purchase contract outstanding as at a reporting date will be marked to market and if the net position results in a loss, the loss would be recognised as per AS 4/AS 1.

If net position of mark to market results in a net gain, the same would not be recognised being contingent in nature as per AS 4/AS 1.

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C. Accounting for firm sales contract hedged by corresponding position on a commodity exchange

If the company has entered into a firm sale contract but does not have either the underlying inventory or corresponding firm purchase contract to execute the contract on its due date, the company may take a position on a commodity exchange to hedge from the commodity price movement.

When an entity enters into commodity exchange contracts, it is necessary to consider the intent and substance of those contracts in order to evaluate such contracts. If the contract is in the nature of firm sales/firm purchase contract, it should be accounted for as a firm purchase/sale contract as per para 23 of AS 2.

However, a company may enter into a commodity exchange contract to hedge price risk and not for the purpose of taking delivery of goods. In those situations, such contracts are accounted for as derivative contracts under AS 30 if the company has adopted AS 30. If the company has not adopted AS 30, the same would be accounted in accordance with notification issued by the ICAI in March 2008 to account for such contracts under AS 1. Accordingly, the firm sale contract and commodity exchange contract will be accounted for as two separate accounting contracts and hedge accounting will not be applied.

The company enters into a firm sale contract on 31 January 20X1 to sell 100 MT of commodity X at INR50 per MT for delivery on 30 June 20X1. However, the company does not have quantity of inventory to fulfil the contract. To hedge loss from any price risk movement, the company enters into a contract on a commodity exchange on the same day (day it enters into firm sale contract) to buy 100 MT of commodity X at INR50 per MT.

So the company would have to account for loss/gain on the two separate contracts:

a. firm sale contract for selling 100MT of commodity at INR50 per MT on 30 June 20X1

b. contract entered on commodity exchange to buy 100MT of commodity at INR50 per MT.

Assuming that the market price of commodity X is INR60 per MT on reporting date, i.e., 31 March 20X1, following transactions would arise:

a. loss on firm sale contract of INR1,000 would be accounted for in accordance with paragraph 23 of AS 2.

b. gain on commodity exchange contract of INR1,000, the same would be recognised only if the company has adopted AS 30.

Assuming that the market price of commodity X is INR40 per MT as at a reporting date following transactions would arise:

a. gain on firm sale contract would not be recognised since being contingent in nature.

b. loss on commodity exchange would be recognised irrespective of whether the company has adopted AS 30 or not.

A lot of the complications in this area, as has been described above, exist because AS 30 is presently not a mandatory accounting standard and AS 2 has not been amended to incorporate changes required corresponding to AS 30. Accordingly, there may be situations where the recording of positions of all open sale and open purchase contracts is not reflected on a symmetrical basis in the financial statements on a reporting date.

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Review of guidelines governing stock related employee benefit schemes

The Securities and Exchange Board of India (SEBI) in its Board meeting on 19 June 2014 reviewed its regulatory framework in the primary market and took decisions about a number of reforms including review of SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 (ESOP guidelines).

This article aims to

- Summarise the changes to the employee benefit schemes approved by the SEBI

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Review of ESOP guidelines

SEBI guidelines prescribe the accounting requirements relating to rewards given by the listed entities to their employees through stock option schemes and stock purchase schemes. These schemes could either be administered by the company itself or through a trust.

Under the ESOP guidelines, an employee stock option scheme (ESOS)/employee stock purchase scheme (ESPS) trust can only distribute options/shares to its employees issued by the company. The ESOP guidelines, when framed, did not contain any express provision regarding purchase and sale of shares in the secondary market through ESOS and ESPS trusts. The SEBI had observed that some entities may frame such schemes with the purpose of dealing in their own securities with the object of inflating, depressing, maintaining or causing fluctuation in the price of the securities by engaging in fraudulent and unfair trade practices.

In order to address the concerns over acquisition of shares by employee welfare trusts from the secondary market, the SEBI decided to prohibit listed companies from framing any employee benefit scheme involving acquisition of own securities from the secondary market. Accordingly, pursuant to the approval of SEBI Board, the SEBI issued a circular dated 17 January 2013, prohibiting secondary market acquisitions by employee welfare trusts and requiring existing employee welfare schemes to align themselves with the SEBI guidelines by 30 June 2013.

Post this, the SEBI received representations from various industry bodies and companies citing difficulties in ensuring compliance with the provisions of the circular dated 17 January 2013. In order to address these concerns, the timelines were extended for alignment of employee benefit schemes with SEBI guidelines three times, first upto 31 December 2013, then upto 30 June 2014 and now till the time new regulations are notified[1]. The SEBI also initiated a consultative process for reviewing the existing SEBI guidelines and issued a discussion paper on 20 November 2013.

Why SEBI relooked at this?

The SEBI relooked at the ESOP guidelines and the circulars issued in this regard due to the following reasons:

- Secondary market acquisitions by trusts is an internationally accepted practice and therefore, should be considered subject to necessary safeguards to prevent misuse.
- Secondary market acquisitions allow companies to grant options to employees without having to dilute their existing share capital.
- Many kinds of employee benefits schemes involving own securities being outside the purview of extant ESOS Guidelines were unregulated.
- There was also a need to provide for a suitable regulatory framework for such kind of schemes.
- Further, considering the provisions in the section 11A of the SEBI Act 1992, the Board felt it would be appropriate to convert the ESOP guidelines into 'Regulations'.

Recent decisions

In its Board meeting on 19 June 2014, the SEBI approved the proposals to review the existing regulatory framework on ESOP guidelines and frame regulations for employee benefit schemes involving shares of the company. These proposals would eventually replace the existing ESOP guidelines.

These proposals are expected to address following topics:

- composition of trusts
- secondary market acquisitions
- enhancement of disclosures and enforceability.

The proposed regulation also covers employee benefits schemes dealing in shares of the company, in addition to ESOS and ESPS. These employee benefit schemes, ESOS and ESPS would also be permitted to acquire shares from the secondary market under certain conditions so as to avoid forced dilution of capital and to be in line with the international practice. Certain safeguards proposed are as follows:

- mandatory shareholders' approval through special resolution will be required for undertaking secondary market acquisitions
- secondary market acquisitions should not exceed certain limits
- general employee benefit schemes other than ESOS type schemes are permitted to own shares of the company/listed holding company to the extent of 10 per cent of its assets.
- trusts shall undertake only delivery based transactions and not deal in derivatives
- restrictions proposed on sale of shares by the trusts
- shares acquired from secondary market should be held for a minimum of six months
- shareholding of the trusts would be classified separately from promoter and public category in the balance sheet
- stricter disclosures and other regulatory obligations.

In order to ensure a smooth implementation of the proposed regulatory framework transition period has been proposed as follows:

- Existing employee benefit schemes to comply within a period of one year from the date of notification of the regulatory framework
- Transition period of five years for:
  - re-classifying shareholding of existing employee benefit schemes separately from promoter and public category
  - reducing the level of shares acquired from the secondary market within the permissible limits
  - reducing own share component to 10 per cent of the total assets of general employee benefit schemes.

The SEBI has issued another circular date 27 June 2014 in which it has reiterated that prohibition on acquiring securities from the secondary market shall continue till the existing schemes are aligned with the new regulations to be notified.

1. SEBI circular dated 27 June 2014

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Regulatory **updates**

MCA's clarifications on rules related to independent directors

With a view to facilitate the implementation of the Companies Act, 2013 (the 2013 Act), and to address the representations received from various stakeholders, the Ministry of Corporate Affairs (MCA) has provided clarifications with regard to pecuniary relationships, appointment and tenure of independent directors.

Pecuniary relationship

The 2013 Act requires that an independent director should not have any pecuniary relationship with the company or any of its holding, subsidiary or associate company, or their promoters, or directors, during the current year and two preceding financial years.

In this regard, the MCA has clarified that transactions entered with independent directors which are in the ordinary course of business and at an arm's length price should not be considered for assessing the pecuniary relationship criteria for independent directors. Similarly, fees and reimbursement of expenses for participating in board and other meetings are also not considered for assessing pecuniary relationship of independent directors.

Appointment and tenure

Regarding the appointment and tenure of independent directors, the MCA has clarified that any remaining term of independent directors as on 1 April 2014, who were appointed under the Companies Act, 1956 (1956 Act), should not be considered for appointment under the 2013 Act. The MCA has also emphasised that the transition period of one year provided under the 2013 Act for appointment of independent directors needs to be strictly adhered to and the appointment needs to be formalised through a letter of appointment.

Further, as per the 2013 Act, independent directors may be appointed for two consecutive terms of five years each. The MCA has clarified that independent directors may be appointed for a term of less than five years, however, in such a case, such a person shall have to demit office after two consecutive terms even if the total number of years of his appointment in such two consecutive terms is less than ten years.

For a detailed discussion on these clarifications please refer to KPMG's First Notes dated 12 June 2014.

[Source: General Circular No. 14/2014, No. 1/22/2013-CL-V, Ministry of Corporate Affairs, dated 9 June 2014]

MCA amends rules relating to acceptance of deposits[1]

The MCA has notified Companies (Acceptance of Deposits) Amendment Rules, 2014, according to which companies are allowed to accept deposits without deposit insurance till 31 March 2015. The amended rules come into force from 6 June 2014.

Additionally, the MCA has notified sections 74(2) and (3) of the 2013 Act relating to 'power of the Tribunal to extend time period for companies for repayment of deposits accepted under the 1956 Act' with an effective date of 6 June 2014. The MCA has also notified that until the National Company Law Tribunal is constituted under the 2013 Act, the Board of Company Law Administration shall continue to exercise powers in this regard.

[Source: Notification published in the Gazette of India dated 6 June 2014]

1. For more details and KPMG in India's comments, please refer to KPMG's First Notes dated 18 June 2014.

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Board of Company Law Administration[1]

The 2013 Act requires companies to follow financial year ending 31 March for preparation of its financial statements. The MCA has released an order specifying that until the National Company Law Tribunal is constituted under the 2013 Act, the Board of Company Law Administration shall continue to exercise powers to allow certain companies to follow a different accounting year other than the 31 March ending financial year. The effective date of this order is 2 June 2014.

[Source: Notification published in the Gazette of India dated 2 June 2014]

Amendment related to appointment of a company secretary[1]

The MCA notified the Companies (Appointment and Remuneration of Managerial Personnel) Amendment Rules, 2014. The amended rules now require companies having a paid up share capital of INR50 million or more should also have a whole-time company secretary. Hitherto, the 2013 Act required listed companies and other public companies having a paid-up share capital of INR100 million or more to have a company secretary. The amended rules are effective from 9 June 2014.

[Source: Notification published in the Gazette of India dated 9 June 2014]

Clarifications related to constitution of audit committee[1]

The 2013 Act requires public companies:

- with a paid up capital of INR100 million or more, or
- having a turnover of INR1,000 million or more, or
- having an aggregate, outstanding loans or borrowings or debentures or deposits exceeding INR500 million or more to constitute an audit committee.

The 2013 Act gave a transition period of one year to companies to re-constitute audit committees which were existing under the 1956 Act. However, the 2013 Act granted no such transition period to those public companies that need to constitute an audit committee for the first time under the 2013 Act.

As such, the MCA notified Companies (Meetings and Powers of Board) Amendment Rules, 2014 according to which a transition period of one year has also been granted to companies which were not required to constitute an audit committee under the 1956 Act. Such companies will also have a transition period of one year for constitution of their nomination and remuneration committee.

One year transition period will begin from date of publication of the amended rules in the Official Gazette i.e. 12 June 2014 or the date of appointment of independent directors by such companies, whichever is earlier.

[Source: Notification by Ministry of Corporate Affairs, dated 12 June 2014]

MCA's clarifications on share transfers[1]

Clarification had been sought by various stakeholders with regard to share transfer forms executed before 1 April 2014 as per the forms prescribed under the 1956 Act and which are yet to be accepted/ registered by the companies.

In this regard the MCA has notified that share transfer forms executed before 1 April 2014 which are duly submitted to the company within the period prescribed under the 1956 Act should be accepted by the company for registration of transfer.

However, the MCA has allowed companies to exercise discretion whether or not to accept share transfer forms where there has been a delay in their submission to the company. In case the companies do not accept these forms, the companies need to convey the reason for such non-acceptance.

Further, the MCA has clarified that a committee of directors may exercise powers of the Board with regard to issue of duplicate share certificates subject to any regulations imposed by the Board in this regard.

[Source: MCA, General Circular No. 19/2014 dated 12 June 2014]

Amendment to rules relating to payment of dividend[1]

According to the Companies (Declaration and Payment of Dividend) Rules, 2014, released on 31 March 2014, companies were not permitted to declare dividend unless the lower of carried over previous year losses or the depreciation not provided in the previous year is set off against the profit of the company for the year for which the dividend is to be declared or paid.

However, on 12 June, the MCA amended these rules to provide that the companies are now required to set off both the carried over previous losses and also the depreciation against the profit of the current year, in order to declare dividend.

The amended rules will be effective from the date of publication of these amended rules in the Official Gazette.

[Source: MCA notification dated 12 June 2014]

MCA's clarification with regard to voting through electronic means[1]

Based on practical difficulties observed by stakeholders in respect of voting by electronic means (e-means) at general meetings, the MCA has deferred the mandatory effective date of the provisions relating to voting through e-means till 31 December 2014.

Additionally, the MCA has also provided clarifications on certain e-voting procedures such as those relating to show of hands, postal ballot, demand of poll, one-share one-vote, etc.

Recently, the MCA has amended the Companies (Management and Administration) Rules, 2014 in order to remove the inconsistency between Rule 20(3) and Rule 20(1) which deals with class of companies that are required to follow voting through e-means.

[Source: MCA, General Circular No. 20/2014 dated 17 June 2014 and MCA notification dated 23 June 2014]

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MCA amends rules relating to issue of shares and debentures

The MCA has notified that till the time a registered valuer is appointed under the 2013 act, companies may obtain a valuation report for the purpose of issuing shares on preferential basis either from:

- Independent merchant banker registered with the SEBI, or
- An independent chartered accountant in practice having experience of 10 years or more.

The MCA has additionally also provided that the price of the securities to be issued on preferential basis should not be less than the price determined as per the valuation report.

The MCA has also prescribed following class of companies which may issue secured debentures for a period exceeding 10 years but not exceeding 30 years:

- Companies engaged in setting up of infrastructure projects
- Infrastructure finance companies and
- Infrastructure Debt Fund NBFCs

The amendments come into force from the date of these getting published in the Official Gazette.

[Source: MCA notification dated 18 June 2014]

MCA issues clarifications regarding provisions relating to corporate social responsibility (CSR)

The MCA has provided clarifications with regard to provisions dealing with CSR under the 2013 Act. The clarification illustrates the activities which capture the essence of items included in schedule VII of the Act. In this regard, the MCA also provided that the CSR activities should be undertaken by a company as a project/programme in accordance with its approved CSR policy. One-off events such as marathons/ awards/ charitable contribution/ advertisement/ sponsorships of TV programmes, etc. would not qualify as an expenditure on CSR activities.

For a detailed discussion on the clarifications, please refer to KPMG's First Notes dated 23 June 2014.

[Source: Ministry of Corporate Affairs, General Circular No. 21/2014 dated 18 June 2014]

ICAI's announcement relating to reporting of adequacy of internal financial control systems and frauds by the auditors

Section 143(3)(i) of the 2013 Act requires the auditors of the companies to report as whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. Similarly, section 143(12) of the Companies Act 2013 requires the auditors of the companies to report to the Central Government on the frauds committed or being committed against the company.

In this regard, the Institute of Chartered Accountants of India (ICAI) has clarified that the requirements of these sections and related rules would not apply to audits of financial statements of the periods beginning on or before 31 March 2014, even if the audits for such periods were actually carried out and auditor's report thereon issued on or after 1 April 2014. Such audits would continue to be governed by the requirements of the 1956 Act.

Additionally, the ICAI has clarified that the provisions of the section 143(12) would prima facie become applicable only for the financial year (and not for a period) 2014-2015, and onwards. That is, the statutory auditor would not be required to report pursuant to section 143(12) while carrying out audits of financial statements for the interim periods, such as quarterly or half yearly audits. The Council is, however, in the process of communicating with the Ministry of Corporate Affairs in this regard.

[Source: ICAI's announcements dated 20 June 2014]

Disclosure of sector-wise advances by banks

In order to encourage banks to actively manage their exposures in various sectors including priority sectors, the Reserve Bank of India (RBI) now require banks to disclose sector-wise advances in the notes to the financial statements for financial years beginning 1 April 2014 onwards. The RBI has also provided the disclosure format along with this announcement.

[Source: RBI/2013-2014/647 dated 18 June 2014]

Key SEBI's announcements

Expanding the framework for offer for sale (OFS) shares through the stock exchange mechanism

In order to encourage retail participation in OFS, and to enable all large shareholders including non-promoter shareholders to use the OFS mechanism, the Securities and Exchange Board of India (SEBI) has approved the following modifications to the existing OFS mechanism:

- Reservation for retail individual investors
  - Minimum 10 per cent of the issue size should be reserved for retail investors i.e. for the investors bidding for amounts less than INR 0.2 Million. In case this percentage is not fully utilised, the unutilised portion may be offered to other investors.
  - Seller of shares may offer a discount to retail investors in accordance with the framework specified from time to time.
- Allowing non-promoter shareholders to offer shares through OFS
  - Non-promoter shareholders having shareholding more than ten per cent or such percentage as specified by the SEBI from time to time will also be eligible to use OFS.
- Expanding the list of eligible companies
  - OFS mechanism will be made available for shareholders of top two-hundred companies by market capitalisation.

The above modifications will also expand the universe of companies to whom OFS mechanism is available, which is presently 100 top companies.

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Minimum public shareholding for PSUs under Securities Contracts (Regulation) Rules, 1957 (SCRR)

In order to achieve uniformity in the applicability of the SCRR amongst companies, the SEBI has recommended to the Ministry of Finance to amend SCRR such that all listed companies including Public Sector Undertakings (PSUs) should be required to achieve and maintain minimum public shareholding of twenty-five per cent of the total number of issued shares, within a time period of three years. Currently the PSUs are only required to have a minimum public shareholding of ten per cent.

[Source – SEBI's PR No. 63/2014 dated 19 June 2014]

SEBI releases new norms for public issue of debt securities

The Securities and Exchange Board of India (SEBI) issued new norms for public issue of debt securities. Following are the key highlights:

1. **Minimum subscription**

- Minimum subscription for public issue of debt securities has been specified as 75 per cent of the issue size
- If the issuer does not receive minimum subscription, then the entire application money received should be refunded within 12 days from the date of the closure of the issue
- Any delay in such refund will carry an interest of 15 per cent per annum for the delayed period.

2. **Issue size**

- The issue size should be a minimum of INR1,000 million or more.

3. **Retention of over-subscription limit**

- Issuers would generally be allowed to retain the over-subscription money up to the maximum of 100 per cent of the base issue size or any lower limit as specified in the offer document
- However, issuers filing a shelf prospectus can retain over subscription up to the rated size as specified in their shelf prospectus.

4. **Detailed disclosures in prospectus**

- Objects of the issue, detailed disclosures such as percentage of the issue proceeds earmarked for each object. Further, amount earmarked for 'general corporate purposes' should not exceed 25 per cent of the amount raised by the issuer in the proposed issue.
- Since NBFCs generally utilise their proceeds for onward lending, their offer document should also disclose details such as lending policy, top 10 borrowers, etc.
- Utilisation details regarding the previous Issues of the issuer as well as group companies
- Provisions relating to fictitious applications.

Rules for issuers issuing tax free bonds have also been prescribed.

The provisions of this circular are applicable for the draft offer documents for issuance of debt securities filed with the designated stock exchange on or after 16 July 2014.

[Source: SEBI's circular CIR/IMD/DF/ 12 /2014 dated 17 June 2014]

MCA's clarifications – the Companies Act, 2013(2013 Act)

The MCA has issued following clarifications in relation to the 2013 Act:

- **Shares held in fiduciary capacity** Similar to the clarification received from the MCA in December 2013 to disregard shares held in fiduciary capacity to determine holding subsidiary relationship between two companies, the MCA has now clarified that shares held in fiduciary capacity will not be counted for the purpose of determining the relationship of associate company as well.
- **Subsidiaries of companies incorporated outside India -** Government has received references seeking clarity about the status of subsidiaries incorporated/to be incorporated by companies incorporated outside India. Various clarifications were also sought specially in the light of absence of provisions corresponding to section 4(7) of the 1956 Act relating to deemed public companies. In this regard the MCA has clarified that, there is no bar in the new Act for a company incorporated outside India to incorporate a subsidiary either as a public company or a private company in India. Further, an existing company, being a subsidiary of a company incorporated outside India, registered under the 1956 Act, either as private company or a public company by virtue of section 4(7) of the 1956 Act, will continue as a private company or public company, as the case may be, without any change in the incorporation status of such company.
- **Annual Return -** The MCA has clarified that Form MGT-7 applicable for filing of annual returns under the 2013 Act is not applicable for annual returns for financial years ended on or before 1 April 2014. Annual returns for financial years ended on or before 1 April 2014 shall continue to be filed per forms applicable under the 1956 Act.

[Source: MCA's General circular No. 24/2014 dated 25 June 2014; MCA's General circular No. 23/2014 dated 25 June 2014; MCA's General circular No. 22/2014 dated 25 June 2014]

MCA proposes to ease certain norms for private companies

In exercise of powers conferred under section 462(1) of the 2013 Act, the MCA in public interest has issued a draft notification to provide a number of modifications with respect to certain sections of the Act that would apply to a private company. Some significant modifications include:

- Exempting all private companies from the provisions relating to related party transactions
- Exempting private companies having 50 or less number of members from the provisions relating to section 180 dealing with 'restrictions on the powers of the board'
- Allowing whole time directors to be appointed as such in more than one company.

For a detailed discussion on the draft notification please refer to KPMG's First Notes dated 27 June 2014.

[Source: MCA's draft notification dated 24 June 2014]

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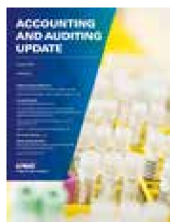
Introducing Voices on Reporting

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

On 28 May 2014, the International Accounting Standards Board and the U.S. Financial Accounting Standards Board issued IFRS 15/ASC 606 Revenue from Contracts with Customers – a new standard that will apply to every entity reporting under IFRS and U.S. GAAP. In our call this month, we discussed the main aspects of IFRS 15.

The Companies Act, 2013 (the Act) was largely operationalised with effect from 1 April 2014. However, there are a number of implementation issues on which various stakeholders have sought clarifications from the Ministry of Corporate Affairs (MCA). Recently, the MCA has issued various clarifications to the Act and amendments to the Rules relating to various chapters of the Companies Act, 2013. In our call, we discussed the MCA clarifications and amendments.

Missed an issue of Accounting and Auditing Update or First Notes?



The June 2014 edition of the Accounting and Auditing Update focusses on the pharmaceutical sector and provides insights into accounting issues faced by the sector through a series of articles.

We highlight diversity that exists in practice for the capitalisation of R&D costs and provide a perspective on the intent of standard setters in this area. We also highlight the history and evolution of price control in India for pharmaceuticals and provide some perspective into the accounting and reporting challenges arising out of the Supreme Court decision on how price control guidelines should operate. We also examine some of the reporting challenges and considerations associated with product recalls.

Apart from the pharmaceutical sector, we also cover this month one of the single largest policy shifts that have taken place internationally with regard to audits and auditors through an article focusing on the key aspects of the EU audit reforms, the impact of which on Indian companies could also be significant.

The MCA proposes to ease certain norms for private companies

In exercise of powers conferred under section 462(1) of the Companies Act, 2013 (the Act), the Ministry of Corporate Affairs (MCA) in public interest has issued a draft notification to provide a number of modifications with respect to certain sections of the Act that would apply to a private company. The MCA has invited public comments on this draft notification by 1 July 2014. Our First Notes provides an overview of this draft notification.

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