ACCOUNTING AND AUDITING UPDATE

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It is not often that the world of accounting and reporting finds a mention in the Union Budget speech, but this year was different. Not only did it find mention, the implications of the Finance Minister’s announcements on convergence with IFRS are likely to be significant and far reaching. He also set out the framework and timelines within which we expect Tax Accounting Standards for the purposes of computation of taxable income to be notified.

This month, we focus on Ind AS (the Indian version of converged IFRS standards) and highlight key aspects relating to how these standards may be applied in India, what remains to be done by regulators, and what companies and preparers of financial statements should focus on as they prepare for this transition.

The transition to Ind AS will likely require a lot of effort for companies and auditors just at the time when mandatory audit firm rotation is coming into play by virtue of the provisions of the Companies Act, 2013. We examine some of the arguments for and against auditor rotation and provide some insights on this area this month. We also discuss the concept of ‘one person company’ in this issue.

In our coverage of IFRS developments, we focus this month on the final IFRS 9 standard and provide a summary of what this standard means and what changes this standard brings as compared to the earlier framework. It took six years for the standard setters to write this standard, and it will in all likelihood take some time for various constituents to absorb the full impact of the replacement to IAS 39.

We also cover this month, in addition to our monthly regulatory updates, areas of accounting policy choices that exist under Indian GAAP and attempt to provide a plain english guide for understanding the accounting implications and impact of demergers in India.

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

Happy reading!

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Background relating to the road map of Ind AS

- **April 2014**
  - The ICAI releases a revised road map and submits it to the MCA

- **October 2012**
  - The committee set up by the CBDT proposes 14 draft TAS

- **February 2011**
  - Ind AS published by the MCA, however, not made effective

- **October 2007**
  - The ICAI’s concept paper issued

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July 2014

- The finance minister’s budget speech proposes to make Ind AS mandatory from the FY 2016-2017
- Voluntary adoption of Ind AS from FY 2015-2016 permitted

In the interim, the ICAI released a number of draft Ind AS and EDs corresponding to new/revised IFRS

- Road map issued by the MCA in February and March 2010
- Clarifications issued by the MCA in May 2010
- Industry bodies called for deferral due to unresolved tax and other issues in December 2010
- CBDT sets up a committee to examine tax issues in December 2010

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1. The Budget Speech of the Finance Minister dated 10 July 2014
2. Concept Paper on Convergence with IFRSs in India released by the Institute of Chartered Accountants of India (ICAI)
3. The Ministry of Corporate Affairs website
7. The ICAI’s announcement dated 9 April 2014
A new beginning on Ind AS implementation in India

This article aims to
- Recap the Ind AS journey since 2007
- Provide an overview of the developments since the deferral of IFRS convergence in 2011
- Highlight the main differences between IFRS and the current Indian GAAP that is expected to affect corporate India
- Summary of the next steps that an entity should consider following for successful implementation of Ind AS.

Recap of the journey so far

The journey of convergence of Indian Accounting Standards with the IFRS started in 2007 with the concept paper of the Institute of Chartered Accountants of India (ICAI). This paper was issued with an intention of achieving full convergence with IFRS from 1 April 2011 by issuing IFRS-equivalent Indian AS. This plan was given further impetus by India’s commitment to converge with IFRS by April 2011 at the G20 summit held in 2009.

Continuing with the momentum, the Ministry of Corporate Affairs (MCA) released separate road maps for companies other than banking, insurance, and non-banking finance companies in January 2010, and for banking, insurance and non-banking finance companies in March 2010, with a view to achieve convergence with IFRS in a phased manner starting from April 2011.
Subsequently in February 2011, the MCA notified 35 IFRS-equivalent standards referred to as Indian Accounting Standards (Ind AS). While it was envisaged by the ICAI in its concept paper that there would be minimal differences between Ind AS and IFRS (referred to as carve outs), the notified Ind AS ended up having significant carve outs that can be categorised as follows:

- Areas where fundamental differences between the Ind AS and IFRS existed. For instance,
  - IFRS requires that when a business combination takes place, the difference between the consideration paid and fair value of the assets acquired and liabilities assumed at their acquisition date is treated as goodwill or gain on bargain purchase. If there is a gain on bargain purchase, then such a gain is recognised in the statement of profit and loss after reassessing that acquisition accounting has been applied correctly.
  - Real estate developers were allowed to recognise revenue on the basis of percentage of completion method under Ind AS, unlike IFRS which would have required a completed contract method for many such entities.
  - Equity conversion option embedded in a convertible bond denominated in foreign currency e.g., foreign currency convertible bond to acquire a fixed number of entity’s own equity instruments is considered as an equity instrument if the exercise price is fixed in any currency. Such a conversion option under IFRS would be accounted as a financial liability.
  - Areas where Ind AS provided additional exemptions and reliefs. For example,
    - A first time adopter of Ind AS has an option to use the carrying value of the property, plant and equipments as on the date of transition in accordance with the Indian GAAP.
    - A first time adopter has an option to use different accounting policies for associates while preparing consolidated financial statements if it is impracticable to align with the accounting policies of the associate.
    - Areas where Ind AS removed options or choices available in IFRS. For example,
      - Under the statement of comprehensive income, Ind AS permits only nature-wise classification of expenses, while IFRS permits either nature or function classification.
      - Ind AS allows only cost model for measurement of the investment properties.
    - Areas where Ind AS provided additional guidance. For example,
      - Business combinations under common control to be accounted using pooling of interest method.

Whereas as per Ind AS, such a gain on bargain purchase is required to be recognised in other comprehensive income and accumulated in equity as capital reserve provided, there is clear evidence that the business combination is a bargain purchase. Otherwise, the excess must be recognised directly in equity as capital reserve.

Despite the efforts made, India was unable to achieve its stated goal of converging with IFRS from 1 April 2011 possibly on account of unaddressed ambiguities with respect to impact on taxation, corporate laws, and lack of preparedness by the Indian corporate sector (which was attributed to the delayed issuance of Ind AS). Since the deferral in 2011, there has hardly been any concrete plan for Ind AS implementation in India until the most recent announcements.

**Developments since the deferral of Ind AS implementation in 2011**

While Ind AS was not implemented as planned, efforts to remove the road blocks and transition to global practices did take place. Two significant developments that happened post deferral of Ind AS implementation were issuance of draft Tax Accounting Standards and replacement of the Companies Act, 1956 with the new Companies Act, 2013.

**Tax Accounting Standards (TAS)**

With an intention to reduce the uncertainty and litigation that continues to exist on account of inconsistency in the views of the Income Tax authorities as compared to the guidance in Accounting Standards (AS) issued by the ICAI, the Central Board of Direct Taxes (CBDT) in December 2010 constituted the Accounting Standard Committee (the Committee). The Committee recommended issuance of a separate set of accounting standards that would be applied in computation of taxable income. Following this approach, the Committee issued 14 draft TAS for public comments in October 2012. Although the TAS are based on the corresponding accounting standards issued by the ICAI, there are some significant modifications which may have an impact on taxable income of several companies. The updated TAS post incorporation of public comments are expected to be finalised in the coming months and would be effective from 1 April 2015.

**Companies Act, 2013**

After several months of deliberation, in September 2013 the Companies Act, 2013 (‘the Act’) has largely replaced the Companies Act, 1956. The new Act results in a sea change of the existing legislation surrounding the governance of companies in India, and also incorporates changes that align the current accounting practices in India to the global accounting practices. Certain significant changes pertaining to accounting practices include the mandatory preparation of the consolidated financial statements, introduction of the concept of useful life, and component accounting for fixed assets and depreciation among several others.

With this development, one of the major road blocks on Ind AS implementation in 2011 is removed to a large extent and will help in making the new journey smoother.
New IFRS standards issued by the International Accounting Standards Board (IASB)

While significant progress has been made to remove the roadblocks faced in 2011, the Ind AS notified in February 2011 have to some extent become obsolete with several new IFRSs on critical topics having been issued since then, such as:

- IFRS 10, *Consolidated Financial Statements*, effective 1 January 2013
- IFRS 11, *Joint Arrangements*, effective 1 January 2013
- IFRS 12, *Disclosure of Interests in Other Entities*, effective 1 January 2013
- IFRS 13, *Fair Value Measurement*, effective 1 January 2013
- IAS 19, *Employee Benefits*, effective 1 January 2013
- IFRS 14, *Regulatory Deferral Accounts*, effective 1 January 2016
- IFRS 15, *Revenue from Contracts with Customers*, effective 1 January 2017

Revived Ind AS implementation plan

With a view to revive the Ind AS implementation plan, the ICAI in April 2014 submitted a revised road map for implementation of Ind AS in India to the MCA. The road map prescribes two separate sets of Accounting Standards: the first set comprising Ind AS applicable for the preparation of consolidated financial statements for a specified class of companies, and the second set comprising the existing notified Accounting Standards (AS) applicable for the preparation of individual financial statements of the companies preparing consolidated financial statements as per Ind AS, and for financial statements of other companies.

The road map recommends the below class of companies to apply Ind AS for the preparation of consolidated financial statements for Financial Year (FY) 2016-17, with comparatives for FY 2015-16 (i.e. transition date of 1 April 2015):

- Entities with equity or debt securities listed, or in the process of listing, in or outside India, or
- Companies having net worth in excess of INR5,000 million, or
- Holding, subsidiary, joint venture, or associate companies of the above two classes of entities.

To add further impetus to this, the Finance Minister during his budget speech in July 2014 announced the introduction of new accounting standards in line with the current IFRS mandatorily from FY 2016-17, with a voluntary option to adopt Ind AS from FY 2015-16. The MCA would have to clarify which class of companies would apply Ind AS.

With this announcement, it would be fair to say that the lost momentum on Ind AS implementation has now been re-gained and it is expected that the government will pro-actively take the required steps to help ensure Ind AS implementation becomes a reality this time.

Benefits of Ind AS implementation in India

While several requirements need to fall in place, once implemented Ind AS could provide several benefits to companies in India such as:

- Listing on overseas stock exchanges could become easier as the financial statements would largely be in compliance with the international requirements (subject to differences which would exist between Ind AS and IFRS)
- Cost of raising capital overseas could become cheaper for Indian companies
- Improved investor confidence in Indian companies
- Better comparison of investment options
- Ease in implementing cross-border transactions.

Ind AS implementation can also be seen as a chance to make some strategic improvements to the finance systems and processes which can go a long way in providing the required information efficiently and reducing costs in the longer term.
Key differences between the current Indian GAAP and IFRS

The Ind AS which is expected to be updated to be in line with the requirements under IFRS, may have significant differences when compared to the current Indian GAAP. Some of the critical GAAP differences that most companies in India would be impacted with are as follows:

**Business combinations**

Under Indian GAAP, the term business combination is not defined and there is no comprehensive standard that addresses accounting for business combination where one entity obtains control of another entity. The accounting for such transactions is largely dependent on the form of the acquisition, for example:

- **AS 14, Accounting for Amalgamations** and certain provisions of the Indian Companies Act, 1956, address accounting for amalgamations, i.e., where an acquiree loses its existence.
- **When an entity makes an investment,** AS 21, Consolidated Financial Statements, or AS 23, Accounting for Investments in Associates in Consolidated Financial Statements or AS 27, Financial Reporting of Interests in Joint Ventures, are applied respectively, in the consolidated financial statements.
- **AS 10, Accounting for Fixed Assets** is applied when a business is acquired on a lump-sum basis.

Thus, under Indian GAAP, the accounting for a transaction is dependent on the form of the transaction and goodwill may be computed based on the book value of the assets of the acquired company or the fair value of the assets of the acquired company. Similarly, depending on the form of the arrangement, the resultant goodwill may either be amortised over a period or not amortised, but tested for impairment. In certain cases, the court-approved scheme may provide that the goodwill is adjusted against the reserves of the acquirer. Finally, Indian GAAP still permits the use of the pooling-of-interest method, whereby the entire transaction is accounted based on carrying values and no goodwill arises.

Under IFRS, all business combinations are generally accounted for using the purchase method, whereby the purchase price is compared to the fair value of all identifiable tangible assets, liabilities, contingent liabilities, and intangible assets of the acquired company, with the excess being recognised as goodwill. This goodwill is not amortised, but is assessed for impairment annually. The limited exception to this principle relates to acquisitions between entities under common control, whereby an entity can adopt an accounting policy choice of recognising the acquisition either by the purchase method discussed earlier, or by the pooling-of-interest method.

Another key area of difference relates to the date of acquisition from which the results of the acquired company are included in the consolidated financial statements. While conceptually, both Indian GAAP and IFRS prescribe consolidation from the date when control is obtained or the investment is acquired, in certain specific situations (for example, court-approved schemes), the scheme may provide for an acquisition date that precedes the date of investment or the date when control is actually obtained.

**Control**

Under IFRS, a new standard on consolidation has been issued by the IASB - IFRS 10, Consolidated Financial Statements. Under this standard, an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee, and has the ability to affect those returns through its power over the investee. To have power, the investor needs to have existing rights that give it the current ability to direct the activities that significantly affect the investee’s returns - i.e. the relevant activities. An investor can have power over an investee even if other parties have existing rights to participate in the direction of the relevant activities - e.g. significant influence over the investee. The power is assessed with the help of voting rights that are substantive, including substantive potential voting rights, rights arising from other contractual arrangements, de facto power, and through special relationships e.g., structured entities. The control model in IFRS 10 is complex and includes numerous indicators to consider; the investor would need to consider all relevant facts and circumstances in assessing whether it controls an investee and no specific hierarchy for consideration is provided.

While under Indian GAAP, AS 21, consolidation is basically based on ownership, directly or indirectly through subsidiaries, of more than one-half of the voting power or control of the composition of the Board of Directors. It is, however, important to note that the definition of subsidiary under the Companies Act, 2013 is different from what is prescribed under AS 21 or under IFRS. Under the Companies Act, 2013, it is a company where a holding company controls the composition of the Board of Directors or owns/control more than 50 per cent of the total share capital (equity and preference share capital). No guidance is available regarding potential voting rights in the case of consolidation of subsidiaries. However, AS 23 requires potential voting power to be ignored. Logically, the same position should apply in the case of subsidiaries. Further, Indian GAAP is silent on the accounting of the structured entities.

**Financial Instruments**

Financial instruments where Indian GAAP differs significantly from IFRS include financial assets such as investments, financial liabilities such as convertible debt, and preference shares and derivative instruments. Under Indian GAAP, long-term investments are generally carried at cost, less impairment; and current investments are carried at lower of cost or market value. Under IFRS 9, classification of financial assets is based on an entity’s business model for managing financial assets and the contractual cash flow characteristics of the financial asset. There are three primary measurement categories for financial assets. They are amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL). In the amortised cost category, those assets are included whose contractual terms give rise, on specified dates, to cash flows that are solely payments of principal and interest (the ‘SPPI criterion’); and they are held within a business model whose objective is to hold financial assets in order to collect contractual cash flows. In the FVOCI category, those assets are included that meet the SPPI criterion and are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
This category also includes non-trading equity instruments for which fair value changes are irrevocably elected to be presented in OCI. In FVTPL category includes assets irrevocably designated as at FVTPL to reduce accounting mismatches and all other financial assets.

IFRS require that a financial instrument should be classified in accordance with the substance of the contractual agreement, rather than its legal form (substance over form). Thus, redeemable preference share would be a financial liability and dividends on redeemable preference shares are recognised as interest expense under IFRS, and can impact the statement of profit and loss for the year. This is different from the Indian GAAP classification of redeemable preference shares as equity and the related presentation of dividends on such preference shares as appropriation of profits. This would impact financial structures and debt-equity ratios.

Similarly, under IFRS, convertible debt is split into a liability and equity portion whereby, the proceeds from the issuance of the debt are allocated to the two components. The liability component is recognised at fair value by discounting at a market rate for non-convertible debt, while the balance proceeds are allocated to the equity component and recorded directly in equity. This results in recognising effective interest expense using rates applicable to non-convertible debt. Under Indian GAAP, there is no specific accounting guidance for convertible debt, and interest expense is generally recognised based on the stated rate of interest. Thus, if the stated rate of interest is lower than the market rate on non-convertible debt (due to the presence of the conversion feature), adoption of IFRS can result in additional interest expense based on this split-allocation approach.

Under IFRS, an entity must recognise all derivative instruments at fair value on the balance sheet. Unless certain specific rules for hedge accounting are met, all changes in fair value are recorded through the income statement. Indian GAAP currently provides limited guidance on accounting for derivatives. Thus, except for certain specific forward exchange contracts, many derivative instruments are currently not recorded on the balance sheet and do not affect the financial statements until realised/settled. Adopting these standards in relation to derivative instruments and hedge accounting can be a monumental shift in accounting for a large number of items on the balance sheet which can lead to recognition of many financial instruments which are currently kept off-balance sheet. Additionally, unless specific hedge accounting requirements are met, applying these standards can result in significant income statement volatility impacted by changes in fair value of the derivative instruments.

Revenue

The IFRS revenue standard, a very recent and significant change under IFRS has been the new standard on revenue recognition applicable from 1 January 2017 (IFRS 15, Revenue from Contracts with Customers).

The new standard provides two approaches for recognising revenue, reflecting the principle that revenue is recognised when (or as) an entity transfers goods or services to customers. Revenue is recognised in either of two ways: (a) over time, similar to the current stage-of-completion or proportional performance methods; or (b) at a point in time, similar to the current sales of goods accounting.

If a licence of intellectual property is assessed as being distinct from other promises in the contract, specific criteria are provided to determine whether the licence provides:

- a right to access the entity’s intellectual property as it exists throughout the licence period (over time) or
- a right to use the entity’s intellectual property as it exists at the point in time at which the licence is granted (point in time).

The revenue model features a contract-based five-step analysis of transactions, focussing on transfer of control, to determine whether, how much and when revenue is recognised. Entities will have to disclose more information about contracts with customers under the new standard than under the current requirements. At a high level, the objective of the disclosure requirements in the new standard is to enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from the contracts with customers. The revenue standard is expected to affect different companies in different ways, especially companies that sell products/services in a bundle (such as telecom, software) or those engaged in major projects (construction, real estate).

The current Indian GAAP guidance is on transfer of risk and rewards, and also permits revenue recognition when the seller has transferred to the buyer the property in the goods. Revenue from rendering of services is recognised using percentage of completion method or completed contract method, whichever relates the revenue to work accomplished. The selection of the revenue recognition method is based on the nature of services rather than on the degree of reliability of the outcome.

Restatement of comparative financial statements for changes in accounting policies and correction of errors

Unlike Indian standards, where prior period items that represent correction of errors; and cumulative impact of change in accounting policies, are recorded as an adjustment in the current period, IFRS generally require accounting policy changes and correction of prior period errors to be made by adjusting opening retained earnings and restating comparatives.

In addition to the above, there are several other GAAP differences between Indian GAAP and IFRS which may have a significant impact on transition such as the concept of embedded leases, mandatory use of fair value accounting for share based payment transactions, segment reporting disclosures, etc.
Status of IFRS convergence process of other countries

European Union (EU) - The countries that are part of the European Union (EU) and the European Economic Area (EEA) have adopted IFRS from 1 April 2005 for the consolidated financial statements of all European companies whose debt or equity securities trade in a regulated market in Europe through a process of endorsement of IFRS. IFRS as adopted by the EU are IFRS as issued by the IASB with some limited modifications. Some of the foreign companies (third country issuers) whose securities trade in a public market in the EU are currently, permitted to apply Japanese GAAP, U.S. GAAP, Chinese GAAP, Korean GAAP, Canadian GAAP and, until at least 31 December 2014, Indian GAAP. Third country issuers are also permitted to apply IFRS as issued by the IASB.

Australia - Australia has adopted IFRS for all companies (for-profit entities) that are ‘reporting entities’ since 1 January 2005. A reporting entity is ‘an entity in respect of which it is reasonable to expect the existence of users who rely on the entity’s general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries. Australian Accounting Standards Board (AASB) policy is that standards and amendments are adopted/endorsed as and when issued by the IASB.

Canada - Canada adopted IFRS for most ‘publicly accountable enterprises’ for financial years beginning on or after 1 January 2011. ‘Publicly accountable enterprises’ are entities, other than not-for-profit organisations, that have issued, or are in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market or hold assets in a fiduciary capacity for a broad group of outsiders as one of their primary businesses. Mandatory adoption of IFRSs has been deferred for investment companies and segregated accounts of life insurance enterprises until 2014 and for entities with rate-regulated activities until 2015. Deferral dates may be extended if completion of the IASB projects is delayed. Some publicly accountable entities whose securities are not traded in the United States have permission from the Canadian Securities Administrators to use US GAAP until 1 January 2015.

Brazil - Since 2010, Brazil has adopted IFRSs for all companies whose securities are publicly traded and for most financial institutions whose securities are not publicly traded, for both consolidated and separate (individual) company financial statements. In adopting IFRSs, Brazil has made several modifications to IFRSs. Some options have been eliminated, for example, the revaluation of property, plant and equipment under IAS 16 Property, Plant and Equipment and revaluation of intangible assets under IAS 38 Intangible Assets. Nonetheless, the resulting consolidated financial statements can still be in full compliance with IFRSs as issued by the IASB.

Korea (South) - Korea (South) made IFRS application mandatory for all listed companies in Korea and for some unlisted companies effective from 2011. Further, IFRS are required for financial institutions whether or not their securities are publicly traded and state-owned companies. However, application of IFRS to mutual savings banks has been deferred until annual periods beginning on or after 1 January 2016. The IFRS that Korea has adopted are referred to as IFRS since there is no carve-out or modifications. Foreign companies must use one of IFRSs, K-IFRSs, or U.S. GAAP.

Malaysia - In November 2011, the Malaysian Accounting Standards Board (MASB) issued the Malaysian Financial Reporting Standards (MFRSs) that are word-for-word in agreement with all IFRS in effect as of 1 January 2012. Non-private entities are mandated by law to apply the MFRS Framework (i.e. IFRS) for annual periods beginning on or after 1 January 2012, with the exception of ‘transitioning entities’ (TE). Financial statements that have been prepared in accordance with the MFRSs are required to include an explicit and unreserved statement of compliance with IFRS. Private entities are permitted to use the MFRS Framework (identical to IFRSs) or they may use the Private Entity Reporting Standard (PERS) issued by the MASB.

United States of America (USA) - With an intention to converge with IFRS, the Securities and Exchange Commission (SEC) staff in July 2012 published a report on its work plan. However, the report did not make a recommendation on whether, how, or when IFRS should be incorporated into the U.S. financial reporting system for domestic issuers. While the Financial Accounting Standards Board (FASB) and the IASB continue to work together on many aspects of the remaining joint convergence projects such as leases, and insurance contracts, the future of further convergence remains uncertain. At present, the SEC permits but does not require IFRS reporting for its foreign private issuers, however, the domestic issuers are permitted to only follow U.S. GAAP.

Japan - Voluntary application of IFRS for consolidated financial statements by companies that meet certain criteria has been permitted since March 2010 by the Japanese regulators. In October 2013, the number of companies eligible to apply IFRS increased from 621 to 4,061, covering virtually all listed companies and unlisted companies preparing consolidated financial statements for listing purposes.

China - Since 2007, all listed companies in China have adopted the Chinese Accounting Standards (CAS) which are substantially converged with IFRS and are being updated to be in line with the developments in IFRS. CAS will also be made mandatory for other companies and enterprises in a phased manner.

Way forward for the regulators to help ensure smooth implementation

a. Clarity on applicability of Ind AS - To give adequate time for preparation, the MCA should at the earliest finalise the classes of companies (including banking and insurance companies) to which Ind AS would apply by confirming/modifying the road map issued by the ICAI in April 2014. It would be ideal that the implementation is carried out in a phased manner, as planned earlier.

d. Acceptance of Ind AS - To help ensure a smooth implementation of the Ind AS, it is imperative that corporate India is both willing and ready. While getting resources trained would be a pre-requisite, it also calls for a change in the mindset of corporate India, regulators, accountants, and other key stakeholders to accept the radical changes proposed by Ind AS such as moving away from the conventional basis of accounting followed for decades i.e. historical cost to fair value accounting which is the crux of IFRS.

Way forward for corporate India

a. Planning and gap assessment - With less than 10 months for the proposed transition date i.e. 1 April 2015, companies should proactively assess the impact of Ind AS on their business, financial statements, processes, IT systems, etc.

b. Communicate the impact on key metrics to the key stakeholders - An impact on financial statements on transition would imply a change in the key metrics. Therefore, early communication to stakeholders on how the key metrics would change (both positive and negative) would assist in taking adequate measures in time.

c. Build capacity and align systems to achieve business as usual - As mentioned earlier, implementation of Ind AS would in many ways significantly change the way accounting has been done so far in India. Hence, it is essential that the resources are trained and systems are aligned to absorb this additional work-load to help ensure the routine business activities are not disrupted.

Conclusion

Despite the work that is left to be done in a relatively short timeframe, the basic framework and ingredients for India to make a transition to IFRS converged standards exists. It is now up to the government and corporate India to make Ind AS implementation a reality.
In recent years, with the auditing fraternity coming under a cloud after a spate of accounting scandals, auditor rotation or ‘Mandatory Firm Rotation’ (MFR) has become a global phenomenon. In India, the government has mandated MFR which has been effected through the Companies Act, 2013.

Auditor rotation is expected to have far reaching impact in India, around 8,000 listed companies and an even larger number of unlisted companies that meet the criteria will have to comply with the newly enacted legislature.

India Inc. has got three years from 1 April 2014 to implement the new regime.

In this article, we aim to summarise the key requirements of the Companies Act, 2013 regarding MFR, and set out a roadmap towards transition.
Key elements of MFR

The key elements of the MFR rules are as follows:

- Instead of the present provision of appointment of auditors from one ‘Annual General Meeting’ to the next, an individual or a firm would be appointed for a five-year term, and the appointment is to be ratified annually by an ordinary resolution.

- Listed companies and certain prescribed companies cannot appoint or re-appoint an audit firm for more than two consecutive terms of five years each. Term prior to 1 April 2014 will be retrospectively reckoned for computing the five to ten years validity. Therefore, on initial appointment under the Companies Act, 2013, the period of appointment could be less than five years as it depends on the transition requirements and the remaining tenure.

- Prescribed class of companies to include:
  a. All unlisted public companies with a paid up share capital of INR100 million or more
  b. All private limited companies with a paid up share capital of INR200 million or more
  c. All companies with paid up share capital below the threshold limit mentioned in points a) and b) above, but with public borrowings from financial institutions, banks, or public deposits of INR500 million or more.

- A cooling-off period of five years is required for individual auditors and audit firms.

- In determining the tenure of the audit firm prior to 1 April 2014, the tenure of the ‘other firms’ operating under the same network of audit firms would also be considered. The same network includes the firms operating or functioning, hitherto or in the future, under the same brand, trade name, or common control.

What are the challenges that MFR can create for companies?

Some of the challenges that companies are expected to face due to MFR implementation are discussed below:

- A major concern surrounding MFR is a substantial quantum of time that managements of the companies, at periodic intervals of five to ten years, will have to spend to get the incoming auditors acquainted with the company’s operations, systems, business strategies, and goals. The management of a company will have to work with auditors and invest significant resources to help ensure a smooth transition with minimal conflicts.

- The periodic rotation of auditors could lead to a loss of collective knowledge built within the audit teams over the years.

- Significant costs would have to be incurred in identifying auditors that possess the necessary sector expertise and are in a position to identify risks/potential issues, and provide the management of a company with insights on such issues.

- MFR could raise additional concerns for organisations that have a global presence. Multi-national companies (MNCs) would prefer to appoint a global auditor, thereby attempting to ensure consistency in audit procedures and methodologies. MFR could mandate the appointment of a different audit firm in India resulting in loss of audit synergies.

In what way could MFR benefit companies?

Some of the benefits that companies are expected to derive from MFR are as follows:

- MFR could go a long way in helping to ensure greater auditor independence and professional skepticism, thereby boosting confidence among investors and audit committees.

- It can also provide an opportunity to obtain a fresh look at a company’s financial statements, providing additional insight on accounting issues and raising the standards of financial reporting.

How can your company ensure a smooth audit transition?

The imposition of MFR might prompt certain pre-emptive company specific measures to avoid any conflicts. A smooth transition can be brought about only if the company has geared itself for a change in auditor well in time.

Though auditor transition could severely strain an organisation’s resources, the challenges it poses are not insurmountable. A well-defined plan can certainly ease the process. A mechanism needs to be put in place for all the procedural requirements of transition.

Some of the measures that can help a smooth transition are as follows:

- Start early – A most critical step in the process of transition is selecting an auditor that best matches the company’s profile. Taking the time to find the right audit firm that will best serve the company in the long run and can significantly ease the transition process. Request for proposals and presentations on the business should be planned with enough time to spare for analysis and selection.

In case of a conglomerate/a large group, timeline for MFR compliance should be created for each entity within the group. This can help streamline the process of transition across entities, especially if all entities voluntarily opt to appoint the same auditor. Utilising the three years transition window provided by the regulation effectively, will help ensure that the audit firm you select is the suitable fit for your company.

- Selecting the right firm- Based on past experiences, the management of a company should develop a basic idea of what they look for in an audit firm, which can help streamline the selection process. Criteria such as audit credentials in the relevant industry, local, as well as, global network and resources available with the audit firm could be key factors.
• Identify independence threats – The Companies Act, 2013 has elaborate rules regarding the independence requirement of the auditors. Therefore, issues pertaining to such independence requirements call for significant attention. It is of utmost importance to devote significant time and resources to appoint an auditor who can stand the test of independence and regulatory compliance. Given the importance of auditor independence and the likelihood that the prospective auditors may have previously worked on non-audit assignments with the company, it is important to establish clarity over auditor independence requirements right at the onset.

• Have clear ownership for transition in a senior position on both sides – Transition to MFR is expected to pose a challenge for both the company and the auditor. Therefore, it is important to clearly identify and allocate responsibility areas among senior positions on both sides, for e.g. the company CFO and Audit Lead Partner could be designated to lead the transition process. Such an initiative can guarantee accountability while easing out the process of dealing with the complications of transition.

• Communication is key – Communication both within the organisation and with the prospective auditors has to be effectively managed to streamline the transition. It is critical that members of the Board of Directors and audit committee are actively involved in meetings with the representatives of the prospective audit firms. These meetings can provide an opportunity to discuss matters and issues which are critical to the company.

• Avoid surprises – Preliminary review of financial statements and accounting policies by the prospective audit firm is expected to troubleshoot any contentious areas as early as possible. Two-way communication of timelines and compliance requirements needs to be addressed well in advance to keep conflicts and risks at bay.

• Work with your former audit team – The company should facilitate contact between the two audit firms (outgoing and incoming). Communication with incumbent auditors may be required to gather their approach on reporting issues, accounting judgements, and company specific financial concerns. A new auditor is expected to take some time to settle in, however, by getting on board a firm that knows your industry and understands your company, the lag time could be lessened. Well planned decision making and coordinated execution can help you achieve a smooth transition and a successful relationship with your auditor.
On 24 July 2014, the International Accounting Standards Board (IASB) issued the completed version of IFRS 9, Financial Instruments (IFRS 9(2014)/the new standard), which substantially concluded the challenging project launched in 2008 to replace IAS 39, Financial Instruments: Recognition and Measurement.

The IASB had divided the project to replace IAS 39 into three main phases namely a) Phase I: classification and measurement of financial assets and financial liabilities b) Phase II: impairment methodology, and c) Phase III: hedge accounting. To implement each of these phases, the IASB has issued various versions of IFRS 9 in 2009, 2010, and 2013. However, the final version i.e. IFRS 9 (2014) consolidates the previous three versions of IFRS 9 to replace IAS 39 in entirety.

IFRS 9 (2014), the complete standard
• Replaces the earlier versions of IFRS 9
• Includes:
  – Amendments to classification and measurement requirements in the previous versions of IFRS 9
  – A new impairment model
• Retains from IAS 39
  – Scope of the standard and recognition and de-recognition requirements with minor amendments.
• Amends IFRS 7, Financial Instruments: Disclosures and introduces new or amended disclosures.
In this article, we aim to provide an overview of the key requirements of the new standard regarding:

- classification and measurement approach
- impairment
- hedge accounting.

In this article, we have also highlighted significant differences from the current practice under IAS 39 and some of the key sectors that are getting impacted.

**Classification and measurement of financial assets**

IFRS 9 (2014) applies one classification approach for all types of financial assets, including those that contain embedded derivative features. The financial assets would be classified in their entirety rather than being subject to complex bifurcation requirements.

Financial asset classification is based on the following criteria:

- objective of business model in which assets are managed
- contractual cash flow characteristics.

**Business model**

An entity’s business model refers to how an entity manages its financial assets in order to generate cash flows i.e., by collecting cash flows, selling financial assets, or both.

The business model is determined on a level that reflects how financial assets are managed to achieve a particular business objective, i.e. not at the individual instrument level.

Judgement is required to determine the business model which warrants consideration of multiple factors such as how the performance of financial assets held within that business model is evaluated and reported to the entity’s key management personnel, trend of sales activity of the financial assets within that business model, etc.

**Contractual cash flow characteristics**

One of the criteria for determining the classification of a financial asset is whether the contractual cash flows are Solely Payments of Principal and Interest (SPPI). Only financial assets with such cash flows are eligible for amortised cost or FVOCI measurement dependent on the business model in which the asset is held.

‘Principal’ is the fair value of the financial asset at initial recognition and ‘interest’ consists of consideration for the time value of money, credit risk, other basic lending risks (e.g. liquidity risk), and costs (e.g. administrative costs), as well as a profit margin. For example, A Ltd issued debentures to B Ltd. If the contractual terms of the debentures permits A Ltd to prepay the debentures or permits B Ltd. to put the debentures back to A Ltd. before maturity, and the prepayment amount substantially represents unpaid amounts of principal and interest, it would represent that such contractual cash flows represent SPPI.

Once the above two criteria are determined, the classification and measurement of financial assets as per IFRS 9 (2014) (along with comparison with IAS 39) can be summarised in the diagram below:
IFRS 9 has three primary measurement categories for financial assets. They are as follows:

- Amortised cost
- Fair value through other comprehensive income (FVOCI)
- Fair value through profit or loss (FVTPL).

The above categories are similar to the ones contained in IAS 39, however, the criteria for classification into the appropriate measurement categories are significantly different. The table below summarises the key characteristics of the three categories:

<table>
<thead>
<tr>
<th>Amortised cost</th>
<th>FVOCI</th>
<th>FVTPL</th>
</tr>
</thead>
<tbody>
<tr>
<td>In this category, the assets meet the following criteria:</td>
<td>In this category, the assets meet the following criteria:</td>
<td>In this category, the assets meet the following criteria:</td>
</tr>
<tr>
<td>• contractual terms give rise, on specified dates, to cash flows that are SPPI</td>
<td>• Assets that meet the SPPI criterion and are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.</td>
<td>• Assets irrevocably designated as at FVTPL to reduce accounting mismatches.</td>
</tr>
<tr>
<td>• they are held in a business model whose objective is to hold them in order to collect contractual cash flows.</td>
<td>• Non-trading equity instruments for which fair value changes are irrevocably elected to be presented in OCI.</td>
<td>• All other financial assets.</td>
</tr>
</tbody>
</table>

**Classification and measurement of financial liabilities**

For the classification and measurement of financial liabilities, the new standard retains almost all of the existing requirements from IAS 39. Under IFRS 9, financial liabilities are measured at amortised cost with some exceptions that include liabilities held for trading or designated at FVTPL. The standard does not permit reclassifications between categories.

Under IFRS 9, the gain or loss on a financial liability designated at FVTPL that is attributable to changes in its credit risk is usually presented in OCI; the remaining amount of change in fair value is presented in profit or loss.

Recognition of gain or loss in OCI, owing to changes in credit risk addresses the long pending so called ‘own credit issue’ where entities could book a gain in the profit or loss under IAS 39 due to fall in the fair value of its financial liabilities measured at FVTPL owing to worsening of its own credit rating.

**Differences from the current practice**

- Financial assets: although categories are similar, basis of classification significantly different
- Financial liabilities: substantially all requirements from IAS 39 on classification and measurement retained.

**Possible impact on sectors**

- The new standard may have a significant impact on the classification and measurement of:
  - Financial assets held by banks e.g. those held to meet various liquidity needs
  - Financial assets held by insurance companies to fund their insurance liabilities or to match the duration of their longer-term insurance liabilities.
- The impact on corporates will often be limited, although investment portfolios will be affected.
Impairment

IFRS 9 moves away from the ‘incurred loss’ model to the ‘expected credit loss’ model for providing impairment. The new model does not require occurrence of the loss event to recognise an allowance for impairment loss. The standard follows a dual measurement approach requiring recognition of either:
- 12-month expected credit losses or
- Lifetime expected credit losses.

If the credit risk of a financial asset has not increased significantly since its initial recognition, the financial asset will attract a loss allowance equal to 12-month expected credit losses. If its credit risk has increased significantly, it will attract an allowance equal to lifetime expected credit losses, thereby increasing the amount of impairment recognised. However, the standard does not define what is meant by ‘significant’ – so judgement will be needed to determine whether an asset should be transferred between these categories.

The new impairment model will apply to financial assets that are:
- Debt instruments recognised on-balance sheet, such as loans and bonds
- Classified as measured at amortised cost or at FVOCI.

It will also apply to certain loan commitments and financial guarantees. This model will not be applicable to equity instruments.

A simplified approach will be available for certain trade and lease receivables and for contract assets. Special rules will apply for assets that are credit-impaired on initial recognition.

Differences from the current practice
- Impairment allowance will cover both incurred credit losses and (some) expected future credit losses
- Impairment trigger no longer required before impairment allowance is recognised
- Model will apply to debt assets measured at amortised cost or FVOCI, certain guarantees and loan commitment, lease and trade receivables – but not equity instruments.

Possible impact on sectors
- Banks are likely to see a significant impact; - far-reaching implications are expected for credit systems and processes
- Insurance companies can expect a substantial impact; there is no simplification for debt instruments measured at FVOCI
- For leasing companies, the extent of the impact will likely depend on the type of leases and the impairment approach elected
- Corporates will likely see a limited impact for trade receivables
- All sectors are expected to be affected by extensive new disclosures requirements.

Hedge accounting

The new hedge accounting requirements seek to deliver a more principles-based approach that aligns hedge accounting more closely with risk management. The new requirements were first published in November 2013 and are unchanged in the IFRS 9 (2014), except to reflect the addition of the FVOCI measurement category to IFRS 9.

One of the major changes that the new standard has brought about is that now the components of the non-financial items may also be hedged. Previously, an entity could designate the non-financial assets’ liabilities as hedged item only for foreign currency risks or in its entirety for all risks. Similarly net positions, layer components of items, and equity investments at FVOCI may be designated as hedged items. By this change more entities can apply hedge accounting that reflects their risk management activities.

Another major change is the elimination of bright lines to assess hedge effectiveness. Hitherto, hedge was considered to be highly effective if the changes in the fair value or cash flow of the hedging instrument and the hedged item are within the range of 80 to 125 per cent. However, the new standard has replaced such rule based approach with more qualitative, forward-looking hedge effectiveness assessments.

Apart from the above, the new hedge accounting model contains several other changes from the current practice under IAS 39, such as new fair value option model for managing credit risk. Similarly, time value of purchased options, forward element of forward contracts, and foreign currency basis spreads may be deferred or amortised.

Considering that the new hedge accounting model is aimed to reflect the entity’s underlying risk management framework, the new standard contains additional disclosure requirements regarding an entity’s risk management and hedging activities.

Differences from the current practice
- New fair value option model for managing credit risk
- Alternative fair value option model for certain own-use contracts
- Time value for purchased options, forward element of forward contracts, and foreign currency basis spreads may be deferred or amortised
- Additional disclosure requirements regarding an entity’s risk management and hedging activities.
Effective date
The new standard is applicable from annual periods beginning on or after 1 January 2018. Early application is permitted. The standard applies retrospectively with some exceptions. Restatement of prior periods is generally not required, and is permitted only if information is available without the use of hindsight.

No convergence with the U.S. GAAP
The project to revise accounting for financial instruments although started as a joint project of the IASB and FASB, but ultimately the convergence efforts have been unsuccessful. Thus, the companies applying both U.S. GAAP and IFRS will be required to apply different guidance as contained in the respective GAAPs.

Next steps
The new standard is different in some fundamental ways from the erstwhile IAS 39. Be it the classification and measurement model or the new impairment model, the entities need to re-look at the entire range of financial instruments that they may be holding. The task of determining the business model as a first step is challenging in itself. All agreements, be it simple ones relating to trade receivables or the complex ones relating to derivatives and borrowings would need a re-assessment. The new valuation model may have an impact on the key performance indicators (KPI), and certain loan covenants which need to be timely assessed to mitigate any adverse consequences. Additionally companies may also have to design and implement new systems and processes to address the new requirements. Considering the above, although the effective date of the standard looks far away from now, work needs to be started at the earliest to minimise implementation issues later.
This article aims to:

- Summarise some of the common accounting policy choices available with the reporting entities under Indian GAAP
- Highlight the potential impact of the accounting policy choices on the financial reporting.

Policy choices

The framework of financial reporting, nationally and globally endeavours to help ensure comparability of financial information across reporting entities. Frameworks including both rule-based and principle-based aim to achieve this objective. However, considering the myriad business scenarios, ‘one size fits all’ approach will likely not stand the test of fair financial reporting. Balance is often struck between prescriptive rules and flexibility based on principles in the framework. Indian Generally Accepted Accounting Practices (IGAAP) recognises that enterprises operate in a situation of diverse and complex economic activity which makes alternative accounting principles and methods of applying those principles acceptable. The alternative should, however, be in compliance with the overall framework of the GAAP.

Selection and application of the correct accounting policy is an important judgement an enterprise has to make. The enterprise makes an accounting policy choice considering circumstances under which the enterprise operates, its economic activity, etc. There are certain accounting standards which provide alternative treatment for the same transactions or items. However, in the recent years, the Institute of Chartered Accountants of India (ICAI) along with the government agencies and other regulatory agencies have reduced the number of acceptable alternatives for the same transactions or items.

AS 1, Disclosure of Accounting Policies, has highlighted some of the areas where companies can follow different accounting policies. However, since the accounting policies followed vary from enterprise to enterprise, there is a need to make adequate disclosures of the accounting policies adopted by an enterprise so that the user of the financial statements is able to compare the information with other enterprises. Though in some cases accounting policy choice has been given to the enterprises, it is expected that the accounting policy once chosen will be followed consistently.

This article summarises some of the common accounting policy choices available with the reporting entities and its potential impact on the financial reporting.
Depreciation/amortisation

There are several methods of allocating depreciation over the useful life of the assets. Commonly adopted methods of charging depreciation is either straight line method or a reducing balance method (also known as written down value method). The management of a company selects the most appropriate method(s) based on various important factors e.g. (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. The depreciation method selected should be applied consistently from period to period.

Similar choice exists with regard to intangible asset, where the amortisation method used should reflect the pattern in which the asset’s economic benefits are consumed by the company and is consistently applied from period to period.

The choice of the method can have a potential impact on the earnings of the company which in turn may impact its key financial and operating ratios. The choice of the depreciation method may impact the deferred tax carried in the financial statement since only the written down value method of depreciation is to be used in tax computation as prescribed by the Income Tax Act, 1961 and results in the timing difference.

Inventory valuation

A variety of cost formulas are used to determine the cost of those inventories for which specific identification of individual costs is not appropriate. The formula used in determining the cost of an item should be such that it provides the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. Accordingly, enterprises are permitted to use the cost formula such as first-in-first out (FIFO) or weighted average. The usage of FIFO method results in the year-end inventory reflecting the units purchased/produced most recently and consequently the items remaining in inventory at the end of the period are those most recently purchased/produced. While under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. Further, the GAAP also allow the calculation of the average on a periodic basis or on any other factor depending on the circumstances. Selection of the method to be used by enterprise should be based on type of the product, seasonality of industry, physical movement of the inventory, etc.

All the enterprises are expected to follow the method of valuation of inventory consistently.

Hedge accounting

The accounting for derivatives and hedge accounting is governed by AS 30, Financial instruments: Recognition and Measurement. However, AS 30 has not been notified under the Companies Act, 1956 nor the Companies Act, 2013 and hence, may be applied only to the extent that it does not conflict with the guidance in the notified accounting standards.

AS 11, The Effects of Changes in Foreign Exchange Rates is an accounting standard notified under the Act which provides guidance on accounting for forward exchange contracts. However, the guidance provided under AS 11 applies only to forward exchange contracts entered to hedge recognised assets or liabilities. Forward contracts not covered by AS 11 and other derivative contracts (also outside the scope of AS 11) are accounted for by companies based on an announcement made by the Institute of Chartered Accountants of India (ICAI) in March 2008 wherein companies only recognise mark to market losses on such derivatives based on the principle of prudence.

Hedge accounting is permitted only when strict documentation and effectiveness requirements, as stated in AS 30 are met. The application of the hedge accounting principles will have significantly different reporting results in comparison to application of AS 11 or AS 1 (i.e., accounting of losses).

Accounting for effects of changes in foreign exchanges rates

The Ministry of Corporate Affairs (MCA) has provided companies with an option in accounting for exchange differences arising on reporting of long-term foreign currency monetary items (assets as well as liabilities) other than those which form part of the company’s net investment in a non-integral foreign operation. As per that option, such exchange differences are allowed to be:

a. adjusted to the cost of the asset, where the long-term foreign currency monetary items relate to the acquisition of a depreciable capital asset (whether purchased within or outside India), and consequently depreciated over such asset's balance life.

b. accumulated in ‘Foreign Currency Monetary Item Translation Difference Account’ (FCMITDA) and amortised over the balance period of long-term monetary asset/liability but not beyond 31 March 2020, in cases other than those falling under (a) above.

Additionally, on 29 December 2011, the MCA has provided an irrevocable option to all entities (including those which did not avail the option given in 2009) to follow option (a) or (b) stated above without any sunset clause (i.e., it is unlike paragraph AS 11 para 46 option (b) as this option has a sunset clause of 2020). Therefore, exchange differences arising on reporting of long-term foreign currency monetary items (assets and liabilities) arising in respect of accounting periods commencing on or after 1 April 2011 can be amortised over the tenure of the underlying long-term monetary item. The financial statements should disclose this policy election and provide the details of the unamortised foreign exchange differences.

Thus, the choice with reporting entities results in diversity in accounting practices across industry segments and the amounts involved. Companies that have chosen to capitalise these foreign exchange differences to the cost of assets may face challenges with respect to testing these assets for impairment, since these exchange differences would be included in the carrying value of assets without any corresponding change in the value in use of the assets.
Conclusion

Understanding and interpreting financial statements is not merely an exercise that involves analysing numbers and different financial ratios but also requires a careful reading of the accounting policies based on which the underlying financial numbers are generated and presented. Some of the above choices aggravate the differences between Indian GAAP and international GAAP, e.g., policies relating to accounting for exchange differences, accounting for employee share based payments, etc.

While the policy choices may not be completely eliminated considering the varying business scenarios in an evolving economy, the reporters should exercise judgement while selection to depict the actual business reality in the financial statements. Further, the users of the financial statements should exercise caution and keep an eye on the explanatory notes to the financial statements for their analysis and decision making.

Accounting for goodwill under AS 10, Accounting for Fixed Assets

As per AS 10, goodwill should be recorded in the financial statements only when some consideration in money or money’s worth has been paid for it. One of the situations highlighted in the standard is the case of acquisition of a business where the acquisition price exceeds the value of the net assets taken over. No specific guidance exists in AS 10 on the subsequent accounting/amortisation of the goodwill recognised. In this situation an enterprise can either amortise goodwill over a period or may retain goodwill as an asset and test the same for impairment.

Accounting for goodwill under AS 21, Consolidated Financial Statements

The goodwill arising on preparation of consolidated financial statements is the excess of the parent’s cost of investment in subsidiary over the parent’s portion of the equity of the subsidiary as on the date when the investment is made.

While AS 21 does not specifically require amortisation of goodwill, the background material to this standard does indicate that an impairment test should be carried out to determine the recoverability of recorded goodwill annually or when there is a trigger of impairment. Accordingly, there is diversity in practice followed by companies.

Accounting for ancillary cost in connection with the arrangement of borrowings

Companies often need to pay loan processing fees or commitment charges to banks at the time of availing loans. There is no specific guidance in accounting standards that deals with accounting of such ancillary costs related to borrowings. Certain companies treat these costs as payments for completed services and recognise them as expenses in the statement of profit and loss. However, since AS 16, Borrowing Costs specifies that the amortisation of ancillary costs incurred can be included as borrowing costs, it appears that amortisation of such costs is permissible.

Valuation of employee stock options

The Guidance Note on ‘Employee Share-Based Payments’ issued by the ICAI permits accounting for share based options valued either at intrinsic value or at fair value on the date of the grant. Intrinsic value and the fair value are different conceptually and may result in different values being assigned to the options resulting in a significant variation between the two values in most cases. In case a company follows the intrinsic value method, then additional disclosures are required in respect of effect on Earnings per share had the fair value method been followed.
Background

The new Act has introduced a distinctive and advanced concept of OPC which is expected to encourage individual entrepreneurs to form their own undertakings which have a distinct structured platform and separate legal identity.

The concept of OPC was initially recommended by an expert committee in the year 2005. It has now been introduced through section 2(62) of the 2013 Act. With the upsurge in use of information technology and growth in the service sector, the committee was of the opinion that every individual should be provided with an opportunity to develop his ideas independently. On account of all these developments, a need for creation of a law that recognised the formation of a single person economic entity in the form of OPC was considered necessary. Such an entity could be provided with a simpler arrangement through exemptions so that the sole entrepreneur is not bound to exhaust away his valuable time, energy, and resources on procedural matters.

Although this concept is new in India, it is already a part of legislation in many other countries like China, Australia, Pakistan, and U.K.

Key provisions

Definition

According to section 2(62), ‘One Person Company’ means a company which has only one person as a member.
Incorporation of OPC

An individual intending to incorporate OPC has to provide the following information:

- Name of the OPC
- Nature of the activities of OPC
- A nominee to take place of the single member.

The member of an OPC has to nominate a nominee with the nominee’s written consent, and file the nomination with the Registrar of Companies (ROC). This nominee in the event of death or in event of any other incapacity of the member shall become a member of the OPC. The member of an OPC at any time can change the name of the nominee merely by providing a notice to the ROC in such manner as prescribed by the rules.

On account of death of a member, the nominee is automatically entitled to all shares and net assets of OPC.

Similar to the naming of a private limited company which is required to have ‘Private Limited’ as suffix in its name, likewise an OPC shall add ‘One Person Company’ at the end of its registered name.

OPC can be formed as a company limited by shares, company limited by guarantee or an unlimited company. If limited by shares, it has to comply with the following requirements:

- Shall have minimum paid up capital of INR100,000
- Restricts the right to transfer its shares
- Prohibits any invitation to the public to subscribe for the securities of the company.

Privileges and exemptions for an OPC

It is important to note that the 2013 Act classifies OPC as a private company for all legal purposes; therefore, all the provisions relating to a private company are applicable to an OPC unless otherwise expressly excluded. The following privileges and exemptions are applicable to an OPC:

- **Annual return (section 92)**: The annual return shall be signed by the company secretary, or where there is no company secretary, by the director of an OPC.

- **Annual general meeting (section 96)**: An OPC is not required to hold annual general meeting.

- **Applicability of chapter VII ‘Management and Administration’ (section 122)**: The provisions of section 98 and sections 100 to 111 pertaining to general meetings namely, notice of meeting, quorum for meetings, chairman, voting through e-means, postal ballot, proxies, extra-ordinary general meeting, etc. are not applicable to OPC.

- **Ordinary and special resolutions (section 114 and section 122(3))**: Any business which is required to be transacted at an AGM or other general meeting of a company by means of an ordinary or special resolution, may be done by the individual by mere communication to the company and entering the details of the transactions in the minutes book required to be maintained under section 118 of the 2013 Act.

- **Board of directors and board meetings (Section 149, 152 and 173)**
  1. OPC can have minimum one director and a maximum of 15 directors
  2. In case of an OPC, an individual being member shall be deemed to be its first director until the director or directors are duly appointed by the member if no provision has been made in the articles of the company for the appointment of the first director. The sole member can himself continue to be a sole director of an OPC.
  3. At least one meeting of the Board of Directors should be conducted in each half of a calendar year and the gap between the two meetings should not be less than 90 days.

- **Financial statements (Section 134 and 137)**
  1. The financial statements shall be signed by only one director
  2. The report of the Board of Directors to be attached to the financial statement, in case of an OPC, shall mean a report containing explanations or comments by the Board on every qualification, reservation, adverse remark, or disclaimer made by the auditor in his report.

3. OPC is not required to present a cash flow statement as a part of the financial statements.

- **Appointment of key committees and directors**: Since an OPC is classified as a private company from a legal perspective, provisions relating to appointment of audit committee, nomination and remuneration committee, women director, key managerial personnel, and independent director are not applicable.

- **Conversion of OPC to private limited company**: When the paid up capital of any OPC exceeds INR5 million and/or its annual turnover during any period crosses INR20 million, within six months of such event, the OPC shall convert itself either to a private limited company or a public limited company.

Compliances

**Contract by OPC (Section 193)**: If a contract is not in writing, an OPC shall ensure that terms of the contract entered into with the member who is also a director shall be recorded in the minutes book of the first meeting of the Board of Directors of the company held next after entering into the contract, provided that contract entered is not in the ordinary course of business. The company shall inform the Registrar about every contract entered into by the company and recorded in the minutes.
Snapshot of comparative analysis between sole proprietorship, OPC, and private company

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Sole Proprietor</th>
<th>OPC</th>
<th>Private Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited liability</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Compliances</td>
<td>No</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Perpetual succession</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Separation of ownership and management</td>
<td>No</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>No</td>
<td>Low</td>
<td>Medium</td>
</tr>
<tr>
<td>Benefit of tax slabs</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Minimum Alternate Tax (MAT) applicability</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: KPMG in India analysis

The biggest difference between a sole proprietor and OPC would be that in case of an OPC, the liability is limited to only the business assets in case of losses in the business. This characteristic is beneficial for individuals who wish to distinguish personal assets from business related assets. However, one can debate over the purpose and credibility of such entities as the decision making will be concentrated in a single authority.

Conclusion

The concept of OPC can certainly foster the growth of individual entrepreneurs, and thereby the Indian economy. A separate oversight body to review and resolve contentious matters applicable to formation and management of OPC’s will help encourage the option of conducting business through the OPC model. Similarly, the direct and indirect tax laws applicable to OPCs should be reconsidered and certain exemptions may be granted to promote their formation.
Demystifying the demerger

This article aims to
• Explain accounting implications of demerger accounting under Indian GAAP and IFRS.

Background

Demerger, as a terminology, is not defined under Indian accounting standards or under corporate laws in India. However, as the name suggests, demerger involves separation of a part/undertaking of one company into one or more companies. Internationally, it is commonly known as ‘spin-off’. It is a converse of a merger or acquisition.

In practice, a demerger would be undertaken primarily (a) as an exercise of corporate restructuring and (b) to give effect to a family partition in case of a family owned undertaking or (c) to enhance shareholder values.

Generally, spin-off transactions result in non-cash distributions to the owners of an entity (these may also be referred to as dividends, but we will use the term ‘distributions’ for the purposes of this article). In a demerger transaction, a division of a company or a segment becomes an independent legal entity. The new company takes assets, intellectual property, technology, personnel, and/or existing products from the existing organisation. Shareholders of the existing company receive shares in the new company. Therefore, on the date of demerger, the ownership of the existing and new companies is expected to be identical.
In order to appreciate the accounting implications of demerger, it is important to understand the key terminologies used in a demerger transaction:

**a. Demerged company and resulting company**

It is important to understand the terminologies - demerged company and resulting company, as the accounting for demerged company is different from the resulting company.

A ‘demerged company’ connotes a company whose undertaking is transferred, pursuant to the demerger, to the resulting company. A ‘resulting company’ means one or more companies (including wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger. The resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company.

The key aspects of the aforesaid definition of ‘resulting company’ are as follows:

- The consideration for transfer of undertaking would be generally by issue of shares by the resulting company
- Such consideration would be paid to the shareholders of the demerged company
- The resulting company can also take the form of a subsidiary of the demerged company.

**b. The concept of ‘appointed date and effective date’ in demerger**

It is important to understand the terms – ‘appointed date’ and ‘effective date’, primarily because these dates have accounting and disclosure implications under the Indian GAAP and International Financial Reporting Standards (IFRS).

Under the Indian regulatory framework, the appointed date of a demerger is of significance because the Indian courts generally approve the demerger schemes which are effective from an appointed date. The appointed date connotes the date from which the assets and liabilities of a demerged company vest in a resulting company.

The ‘effective date’ signifies the completion of all the regulatory requirements/ formalities of the demerger.

The accounting for demerger under Indian GAAP is given effect on the appointed date as per the schemes approved by the courts. Unlike Indian GAAP, under IFRS, appointed date does not have any relevance. The accounting under IFRS is given effect on the date when the demerged company loses control of the transferred business.

**c. Share-swap ratio**

A share-swap ratio in a demerger signifies the exchange ratio that the resulting company offers to the demerged company. This ratio defines the number of shares of the resulting company that is offered to the shareholders of the demerged company for shares held by them in the demerged company. Generally, the share-swap ratio is specified in the demerger scheme. In practice, for listed companies the swap ratio is established on the basis of the quoted prices of the instruments. In case of unlisted undertakings, the share-swap ratio is based on the valuation of the companies.

While evaluating demerger, one needs to keep in mind several regulatory aspects and laws of the land as the accounting and disclosures in the financial statements under different GAAPs could vary and also depends upon the facts and circumstances of each case. The following chart showcases various regulatory bodies that are involved in a demerger transaction in India:
In India, generally, a demerger is approved by the high court of the respective State in which a company is registered. A company (specially a listed undertaking) when evaluating demerger has to consider the implications under each of the aforesaid regulations, to the extent applicable.

Typically, in the case of a demerger of a listed undertaking, the following activities are undertaken:

1. **Valuation exercise**
2. **Board meeting to consider the proposal for demerger**
3. **Approval of the scheme by the SEBI**
4. **Approval of the scheme by the stock exchange**
5. **Approval of the scheme by the court**
6. **Hold shareholders and creditors meeting to approve the scheme**
7. **Seek approvals from other regulators such as FIPB, RBI, etc.**
8. **Filing the scheme with the court**
9. **Filing of the court approved scheme with the ROC**
10. **Record date for issuance of shares of the resulting company**
11. **Issuance of shares of the resulting company to the shareholders**

Source: KPMG in India analysis

1. **SEBI**: Securities and Exchange Board of India
2. **FIPB**: Foreign Investment Promotion Board
3. **RBI**: Reserve Bank of India
4. **ROC**: Registrar of Companies
Accounting literature

Under Indian GAAP, there is no specific guidance on demerger accounting. AS 24, Discounting Operations, provides guidance from the demerged entity perspective for disclosures when a demerger meets the definition of a ‘discounting operation’. Similarly, under IFRS, IFRS 10, Consolidated Financial Statements, deals with the loss of control in general, it does not deal with the loss of control through a demerger. Such non-reciprocal distributions of assets are dealt under IFRIC 17, Distribution of Non-cash Assets to Owners. IFRS 5, Non-current Assets Held for Sale and Discontinued Operations, covers the classification and presentation requirements relating to all recognised non-current assets and to all disposal groups of a company. IFRS 5 also applies to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners (held for distribution to owners).

Accounting implications

a. Evaluation of common control transaction

Demergers would generally involve distribution of non-cash assets to owners. Typically, a demerger would be a common control transaction in which the resulting company and the demerged undertaking are controlled by the same party or parties before or after the demerger and the said control is not expected to be transitory. Generally, a group of individuals would control an entity when, as a result of contractual arrangements, they collectively have the power to control and derive benefits from its activities.

Under Indian GAAP, there is no guidance relating to common control transactions. However, practically, most demergers are accounted for using book value of assets and liabilities of the demerged company.

Under IFRS, IFRIC 17 provides guidance on non-reciprocal distributions of assets. However, a demerger that is a common control transaction is outside the scope of IFRIC 17. Therefore, demergers that are outside the scope of IFRIC 17 may be accounted for using either book value or fair values under IFRS.

b. Evaluation of whether the regulatory approvals are substantive

A demerger is a long drawn process which requires approvals from various stakeholders and regulatory bodies. Depending upon the jurisdiction where demerger takes place, regulatory approvals generally play a vital role in the consummation of a demerger. A company should evaluate whether the various regulatory approvals are substantive i.e., determining the accounting period in which demerger would be accounted or disclosure of initial disclosure event would take place in the financial statements of the demerged entity.

For example, a company should evaluate the requirements under section 391-394 of the Companies Act, 1956 in respect of conducting meetings of shareholders/creditors, meeting the quorum requirements to pass the resolution and the procedures prescribed under Rules 67-87 of the Companies (Court) Rules, 1959 (Rules). Similarly, regulatory approvals by the RBI, the SEBI and the high court are generally considered substantive for determining when the disclosures relating to commitment to discontinue the operations crystallises for the demerged company. This evaluation is even more important for listed companies during the interim financial reporting period when the regulatory approvals are progressing and are at various stages of evaluation by the regulatory authorities.

Under IFRS, the accounting for held for distribution is determined based on the assessment of whether the asset or disposal group meets the conditions of held for distribution i.e. the assets are available for immediate distribution in their present condition, distribution is highly probable and the distribution will be made. Accordingly, it is extremely critical to evaluate whether the regulatory approvals in the process of demerger are substantive or not.

c. Accounting for employee stock options issued to the employees as part of the demerger

Demerged company may have given its employees stock option awards. Under the scheme of demerger, a resulting company may decide to issue additional stock options to the existing employee option-holders to compensate for the reduction of the value of the resulting company upon demerger. The stock option scheme under which the stock options were originally granted to the employees may or may not envisage the situation for granting additional stock options. If the original stock option scheme did not envisage such a situation, it could result into a modification of the original award. There is no specific guidance under Indian GAAP under such modifications. Therefore, both the resulting company and the demerged company should evaluate the change in the terms of the stock option scheme due to demerger carefully. The accounting of the incremental cost, if any, of such additional stock options will depend on the facts and circumstances of each case.

d. Evaluation of accounting for the foreign currency translation gain/loss in respect of foreign subsidiaries

In the consolidated financial statements of a company, the financial statements of a non-integral foreign operation are translated into the group presentation currency. After following the principles of translation, the resulting exchange differences are recognised in the ‘foreign currency translation reserve’ within equity. In case of a demerger which is a common control transaction and accounted based on book value accounting policy, generally, the net assets transferred to the resulting company by the demerged company are accounted for within equity (as a distribution to shareholders). A question, therefore, arises on whether book value of net assets transferred includes the cumulative effect of foreign currency translated balances of such subsidiaries or not. There is no specific guidance on this matter and diversity exists in practice internationally on inclusion of FCTR as part of net assets transferred.
e. Valuation methodologies

Generally, there is diversity in practice to apply the valuation techniques to determine the value of shares in case of a demerger. In case, the resulting company is a listed company, generally the market price of the shares will reflect the fair value. However, for unlisted companies, the following valuation techniques are generally applied by the valuers:

**Intrinsic value or book value**
Assets and liabilities are valued on the ‘going concern’ basis.

**Yield method**
Rate or amount of dividend is compared to the industry rate of return to arrive at the value of shares.

**Earnings per share (EPS)**
Price per share is determined by multiplying the EPS with the price-earnings ratio.

**Earnings method**
Average return of the company is compared with average return in the industry to arrive at the value of shares.

Different valuation techniques are applied in different scenarios and hence, there is no one-size-fits-all formula for all situations. One needs to carefully evaluate which measure will be an appropriate indicator of the fair value of the shares of the resulting company.

f. Presentation and disclosure

Under Indian GAAP, AS 24 deals with the presentation and disclosure requirements in case of a discontinuing operation. IFRS 5 describes the accounting and disclosure requirements in case of assets held for distribution in the form of a demerger. The disclosure requirements under Indian GAAP and IFRS are different. The disclosure requirements would depend on the facts and circumstances of each case e.g. whether the effective date of the demerger is the balance sheet date or is a date after the balance sheet date but before the adoption of financial statements by the Board of Directors.

Therefore, a company should evaluate for the requirements of the presentation and disclosures in the statement of financial position, statement of profit and loss, statement of stockholders’ equity, statement of cash flows and related schedules/notes. Additionally, the requirements of restatement of comparative periods is different in the Indian GAAP from IFRS.

g. Other matters

**Overseas listing:** In cases where the resulting company is listed in an overseas stock exchange, additional complications may arise in respect of compliance relating to furnishing information or seeking approvals for demergers. For example, informing the American Depository Shareholders (ADS) about the scheme, registering the additional securities granted under the demerger scheme with the overseas exchange, etc. are critical matters that should be evaluated.

**Related party:** If the demerged company and the resulting company have common directors, the transactions between the two entities need to be evaluated from the related party transactions perspective. This would imply additional related parties being identified and disclosed in the financial statements.

**Taxes:** While a demerger may be non-cash transfer of assets, some jurisdictions may impose direct tax on such transactions. Similarly, the implications of deferred taxes need to be evaluated.

**Segment disclosures:** Generally, if a demerger involves disposal of a significant component within a reportable segment, management of the company may restructure their operating segments as well. In such a situation, one needs to evaluate the disclosure implications under ‘segment reporting’.

**Conclusion**
A demerger transaction has far reaching consequences even from the perspective of the health of financial statements, various financial ratios that banks refer to for evaluation of companies, etc. There are several laws and regulations that one needs to keep in mind to make an overall determination of applicability and compliance with such laws and regulations. Considering the significance of such transactions and complexities involved, a thorough understanding of the demerger scheme, secretarial related matters, accounting and disclosure requirements, etc. is required. While international GAAPs have specific and detailed guidance around demerger, generally the practices vary in accounting and disclosures under Indian GAAP due to lack of accounting literature in this area.
Ministry of Corporate Affairs (MCA) clarification on requirement of resident director under the Companies Act, 2013

Section 149 (3) of the Companies Act, 2013 provides that there should be at least one director who should have stayed in India for a period of not less than 182 days during the previous calendar year. Various stakeholders had approached the MCA for clarifications regarding applicability of these provisions in the current calendar/financial year. The MCA vide general circular dated 26 June 2014 has issued the following clarifications on the requirement of resident director under the Companies Act, 2013:

- ‘Residency requirements’ would be reckoned from the date of commencement of section 149 of the Companies Act, 2013 i.e. 1 April 2014. The first ‘previous calendar year’ for compliance with these provisions would, therefore, be calendar year 2014.
- The period to be taken into account for compliance with these provisions will be the remaining period of the calendar year 2014 (i.e. 1 April to 31 December). Therefore, on a proportionate basis, the number of days for which a director would need to be resident in India during calendar year 2014 shall exceed 136 days.
- Regarding newly incorporated companies, it is clarified that companies incorporated between 1 April 2014 to 30 September 2014 should have a resident director either at the incorporation stage itself or within six months of their incorporation.
- Companies incorporated after 30 September 2014 need to have the resident director from the date of incorporation itself.

(Source: General circular no. 25/2014, No. 1/22/13-CL-V, Ministry of Corporate Affairs, dated 26 June 2014)

Minimum Assets Under Management (AUM) of debt oriented schemes

The Securities and Exchange Board of India (SEBI) has issued new directions relating to the SEBI (Mutual Funds) Regulations, 1996 vide circular dated 20 June 2014, which inter-alia, include the following:

- Minimum subscription amount of debt oriented and balanced schemes at the time of new fund offer shall be at least INR200 million, and that of other schemes shall be at least INR100 million.
- An average AUM of INR200 million on half yearly rolling basis shall be maintained for open ended debt oriented schemes; existing open ended debt oriented schemes shall comply with this requirement within one year from the date of issue of this circular.
- Confirmation on compliance of the above requirements shall be reported to SEBI in the half yearly trustee reports.

(Source: SEBI Cir/ IMD/ DF/ 15/2014 dated 20 June 2014)

Companies (Prospectus and Allotment of Securities) Amendment Rules, 2014

The Companies Act, 2013 provides that issuance of non-convertible debentures through private placement requires a prior special resolution. The MCA vide circular dated 30 June 2014 has issued amendment to the Companies (Prospectus and Allotment of Securities) Amendment Rules, 2014. As per the amendment, it is clarified that for non-convertible debentures that are issued through private placement within six months of the Rules coming into effect, then the special resolution should be passed within six months from the date the Rules have come into effect i.e. from 30 June 2014.

(Source: Notification by MCA dated 30 June 2014)
MCA’s clarification regarding filing of Form DPT-4 under the Companies (Acceptance of Deposits) Rules, 2014

It was specified under section 74(1) (a) of the Companies Act, 2013 and the Companies (Acceptance of Deposits) Rules, 2014 that companies are required to file a statement regarding deposits existing as on the date of commencement of the Companies Act, 2013 within a period of three months from such commencement. Such time period expired on 30 June 2014. The MCA vide general circular dated 30 June 2014 has extended the time limit for filing of Form DPT-4, ‘Statement regarding deposits existing on the commencement of the Act’ under the Companies (Acceptance of Deposits) Rules, 2014, from 30 June 2014 to 31 August 2014 without additional fee.

(Source: General circular no. 27/2014, Ministry of Corporate Affairs, dated 30 June 2014)

The Government proposes to make Ind AS mandatory from the financial year 2016-17 as per Union Budget speech

The Finance Minister on 10 July 2014, in his budget speech, has proposed to make Indian Accounting Standards (Ind AS), converged with International Financial Reporting Standards, mandatory for Indian companies from the financial year 2016-17. It also mentions that the companies could opt to adopt Ind AS voluntarily from the financial year 2015-16. The date of implementation of Ind AS for banks and insurance companies will be notified separately by the respective regulators. Similarly, the budget speech also states that standards for computation of tax will be notified separately.

For more details on this, please refer to our publication ‘First Notes: Related party transactions – certain clarifications by the MCA released on 18 July 2014.

(Source: General circular no. 30/2014, Ministry of Corporate Affairs, dated 17 July 2014)

Clarifications on matters relating to related party transactions under the Companies Act, 2013

With respect to related party transactions covered under section 188 of the Companies Act, 2013, the Government had received representations from stakeholders seeking certain clarifications. The Ministry of Corporate Affairs (MCA), vide general circular no. 30/2014, dated 17 July 2014, has provided the following clarifications:-

• Related party not to vote for approval of contract entered by the company- Second proviso to subsection (1) of section 188 requires that no member of the company shall vote on a special resolution to approve the contract or arrangement (referred to in the first proviso), if such a member is a related party. It was unclear whether such a member would be required to abstain from voting on every contract/arrangement entered into by the company. It is clarified by the MCA that the term ‘related party’ in the above context refers only to such related party as may be a related party in the context of the contract or arrangement for which the said special resolution is being passed.

• Transactions arising out of compromises, arrangements, and amalgamations whether covered under section 188 - It was earlier unclear whether transactions arising out of compromises, arrangements and amalgamations dealt with under specific provisions of the Companies Act, 1956/Companies Act, 2013 are covered under section 188. The MCA has clarified that such transactions will not will not attract the requirements of section 188 of the Companies Act, 2013.

• Requirement of fresh approvals required for transactions under section 297 of Companies Act, 1956- It was clarified by the MCA that for contracts entered into by companies which came into effect before the commencement of Section 188 of the Companies Act, 2013 will not require fresh approval under the said section 188 till the expiry of the original term of such contracts. If any modification is made in such contracts on or after 1 April 2014, then the requirements under section 188 of the Act would have to be complied with.

Preparatory activities for enhancement in wage limit for contributing to employee’s provident fund

In the Budget speech, the Finance Minister has announced enhancement in the statutory wage ceiling for enrolment in the Employee Provident Fund and Miscellaneous Provisions Act, 1952 from INR6,500 to INR15,000 per month.

Accordingly, vide its notification dated 14 July 2014, the Employee Provident Fund Organisation (EPFO) has advised certain preparatory activities to be initiated by the regional provident fund commissioners e.g. to visit establishments to check the total number of employees drawing salary beyond INR6,500 and up to INR15,000 who are not enrolled as members.

Enforcement officers are required to specifically target visits to establishment having large concentration of workers such as building and construction industries, placement agencies, etc. Enforcement officers are also directed to meet representatives of the worker’s union and apprise them of the intent.
of the notification and assist them in implementing the same once it is issued.
(Source: Coord/316/2011/Amendment Scheme/6235; Employees Provident Fund Organisation, dated 14 July 2014)

Prudential norms on income recognition, asset classification, and provisioning pertaining to advances - Projects under implementation

The Reserve Bank of India (RBI) has issued instructions clarifying that project loans under implementation will not be treated as restructuring in case there is a shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) due to revisions of the date of commencement of commercial operations (DCCO) provided:

- The revised DCCO falls within the period of two years and one year from the original DCCO stipulated at the time of financial closure for infrastructure projects and non-infrastructure projects respectively
- All other terms and conditions of the loan remain unchanged.

The RBI has clarified that banks may restructure such loans subject to

- revision of DCCO beyond the time limits quoted above
- retain ‘standard’ asset classification so long as they adhere to the prudential norms on restructuring of advances issued by the RBI
- the account continues to be serviced as per restructured terms and a fresh DCCO is fixed within the prescribed limit in the circular.

Multiple revisions of the DCCO and consequential shift in repayment schedule will be treated as a single event of restructuring, provided that the revised DCCO is fixed within the respective time limits as quoted above and all other terms and conditions remain unchanged. If deemed fit, banks may extend DCCO beyond the above time limits; however, in that case, banks will not be able to retain the ‘standard’ asset classification status of such loan accounts.
(Source: RBI/ 2013-14/664 dated 26 June 2014)

Financial inclusion by extension of banking services- Use of business correspondents

Taking into account the recommendations of the Mor Committee, the RBI vide notification dated 24 June 2014 has revised the existing guidelines on appointment of business correspondents (BCs). It has been decided that the services of non-deposit taking NBFCs (ND-NBFC) can be engaged by banks as business correspondents subject to the conditions as notified in the circular. It was also decided to remove the stipulation regarding the distance criteria which RBI had notified vide circular dated 28 September 2010. The RBI has left it to the discretion of the banks to modify extant distance criteria while formulating the board-approved policy for engaging BCs, keeping in mind the objectives of adequate oversight of the BCs as well as provision of services to the customers. The notification also advises that banks may continue to take measures to address possible reputational risks arising out of appointment and functioning of business correspondents.
(Source: RBI/ 2013-14/653 dated 24 June 2014)

MCA notification on appointment of key managerial personnel

The Companies Act, 2013 under section 203(1), inter alia, does not allow a company to appoint an individual as the chairperson of the company as well as the managing director or Chief Executive Officer of the company at the same time. The section also allows the Central government to exempt certain class of companies from this requirement.

The MCA vide notification dated 25 July 2014 has prescribed a class of companies which are permitted to appoint/reappoint an individual as the chairperson of the company as well as the managing director or Chief Executive Officer of the company at the same time as per section 203 of the Companies Act, 2013. The class of companies would be ‘public companies, having paid-up share capital of INR1,000 million or more and annual turnover of INR10,000 million or more, as per last audited balance sheet engaged in multiple businesses and which have appointed Chief Executive Officer for each such business’.
(Source: MCA notification dated 25 July 2014, File No. 1/5/2013-CL(V)

MCA’s clarification on transitional period for resolutions passed under the Companies Act, 1956

The MCA vide circular dated 23 July 2014 has clarified that resolutions approved or passed by companies under the Companies Act, 1956 (1956 Act) between 1 September 2013 to 31 March 2014, can be implemented in accordance with provisions of the 1956 Act, notwithstanding the repeal of the relevant provisions, if the implementation of the resolution actually commenced before 1 April 2014.

This transitional arrangement will be available up to expiry of one year from the passing of the resolution or six months from the commencement of the corresponding provision in Companies Act, 2013 (2013 Act), whichever is later.

Further, it is also clarified that any amendment to the resolution must be in accordance with the relevant provision of the 2013 Act.
(Source: MCA General Circular No. 32/2014 dated 23 July 2014)

Tax audit report requirements amended

The Central Board of Direct Taxes vide the Income-tax (7th Amendment) Rules, 2014 dated 25 July 2014 has amended Appendix II (i.e. Form No. 3CA, Form No. 3CB and Form No. 3CD) of the Income-tax Rules, 1962.

The amended Form No. 3CA and 3CB now requires explicit mention of the observations/qualifications, if any, by the auditors while issuing the true and correct audit report in addition to several other amendments to the Form no. 3CD.

The amendment Rule shall come into force on the date of their publication in the Official Gazette.

For an overview of these amendments, please refer to KPMG’s First Notes dated 1 August 2014.
(Source: Ministry of Finance notification dated 25 July 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 10 July 2014, the Finance Minister of India announced a roadmap and definite dates for convergence with the International Financial Reporting Standards (IFRS) for Indian companies as part of his Union Budget speech. The Finance Minister proposed to make Indian Accounting Standards (Ind AS) converged with IFRS mandatory for Indian companies from the financial year 2016-17. He also stated that ‘income computation and disclosure standards’ (tax accounting standards) would be notified separately. TAS are expected to take effect from 1 April 2015 and in relation to the assessment year 2015-16 and subsequent years.

This is a significant development and will most likely apply to several companies. We discussed the implementation challenges put forth by the convergence with IFRS and use of tax accounting standards for the corporate India.

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

The July 2014 edition of the Accounting and Auditing Update focuses on the aviation sector and provides insights into accounting issues faced by the sector. We also cover some significant recent developments in international accounting under IFRS where we highlight salient features of the new revenue recognition standard and the discussion paper on dynamic risk management activities (macro-hedge accounting).

This month, we also examine the complexity and diversity in practice in the areas of borrowing costs and accounting of open contracts. Finally, in addition to our round up on key regulatory developments during the recent past, this issue also highlights an article on SEBI’s review of guidelines governing stock related employee benefit schemes.

Tax audit report requirements amended

The Central Board of Direct Taxes vide the Income-tax (7th Amendment) Rules, 2014 dated 25 July 2014 has amended Appendix II (i.e. Form No. 3CA, Form No. 3CB and Form No. 3CD) of the Income-tax Rules, 1962. The amendment Rule shall come into force on the date of their publication in the Official Gazette. Our First Notes provides an overview of these amendments.

Feedback/Queries can be sent to aaupdate@kpmg.com

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