IN THIS EDITION

Revenue recognition in the pharmaceutical sector - Key considerations p1
Potential impact of Ind AS on pharmaceutical sector p7
Survey analysis p11
Ind AS 108, Operating Segments and its impact on the pharmaceutical sector p21
Business combinations and accounting for intangibles p27
ICDS – Potential impact on the pharmaceutical sector p31
Export benefits to pharmaceutical sector p37
GST – A sweet pill for the Indian pharmaceutical sector p41
Tax deductibility of business promotion expenses p45
Regulatory updates p47

www.kpmg.com/in
Continuing with our revamped series of the Accounting and Auditing Update, we focus on the pharmaceutical sector this month.

Ind AS (Indian Accounting Standards) is bringing about a paradigm shift in financial reporting which is going to potentially affect many key metrics of performance. For the pharmaceutical sector, we highlight the impact on revenue recognition, research and development expenditure, business combinations, intangible assets and government grants in this issue of the Accounting and Auditing Update.

We also carry this month the results of a survey we ran with a number of leading pharmaceutical companies on the key regulatory changes that they face. These include Ind AS, the Companies Act, 2013, Income Computation and Disclosure Standards (ICDS) and proposed Goods and Services Tax (GST). Some of the results are of the survey provide a lot of food for thought on the level of preparedness and the extent of challenges faced by companies in this sector currently.

The standard on segment reporting under Ind AS focussed on enabling users to understand a company’s/management’s approach to the decision-making at a segment level. In this edition of the Accounting and Auditing Update, we also cast our lens on the principles of operating segments under Ind AS and their likely impact on financial reporting on pharmaceutical companies. We also highlight some of the areas in this sector which are expected to be impacted by the implementation of ICDS.

Apart from accounting and financial reporting aspects, the pharmaceutical sector faces various direct and indirect tax issues. For example, tax deductibility of business promotion expenses, various policies on export benefits and impact of the proposed GST. Our articles provide an overview on these tax issues.

Finally, our publication also includes our regular round up of regulatory updates. As always, we would be delighted to receive any kind of feedback or inputs on the topics that we have covered.
Overview

The pharmaceutical sector in India has ‘weathered quite a few storms’ in the last couple of years and has emerged stronger than before; being as a sector that has stood its ground through the recent economic turmoil. There have been significant changes affecting the industry in the recent past, mostly progressive and some arguably so. As per the India Brand Equity Foundation, India\(^1\) is expected to be one of the top three pharmaceutical markets in the world by 2020 in terms of incremental growth. India is the largest provider of generic drugs globally accounting for 20 per cent of global exports in terms of volume. India also boasts of the largest number of Food and Drug Administration (FDA) approved plants outside of the United States of America. Significant investments in the sector continue and there is also an increasing trend of consolidation in the Indian pharmaceutical market. The government of India unveiled the ‘Pharma Vision 2020’ which showcases the Government’s commitment to the sector and its aim to make India a global leader in end-to-end drug manufacturing.\(^1\)

Some of the concerns within the sector have been over the new pricing regulation that significantly affected top lines of many pharmaceutical companies, the heightened scrutiny by international regulators consequent to the increasing international footprints of Indian pharmaceutical companies and the compulsory licensing and patent related legal decisions that have triggered heated discussions across the world.

India Inc is currently bracing itself to deal with various changes in the regulatory and reporting landscape including IFRS converged standards (Ind AS), Goods and Services Tax and Income tax accounting standards among others. As India stands at the threshold of adopting IFRS converged standards, the industry has started identifying and taking stock of the key areas of financials results that these would have an impact on. We take a close look at this through a series of articles in this month’s issue of the Accounting and Auditing Update.

---

\(^1\) [http://www.ibef.org/industry/pharmaceutical-india.aspx](http://www.ibef.org/industry/pharmaceutical-india.aspx)
Revenue recognition in the pharmaceutical sector - Key considerations

This article aims to:

- Provide an overview of the relevant framework with respect to revenue recognition
- Highlight some of the key areas that require deliberations while recognising revenue
- Discuss the accounting issues and challenges and impact of transition to Ind AS on these areas.
Revenue, generally represents the largest number in the financial statements and is also amongst the most followed performance matrices in the analysis of financial statements. It is also an area where there are differing practices under different GAAPs, and there is a move towards achieving consistency in practices across the world.

As a part of India’s transition to the IFRS converged Ind AS, India was poised to be the first, globally, to adopt the new revenue recognition standard Ind AS 115, Revenue from contracts with Customers. However, the decisions of the global standard setters - International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) to defer the mandatory effective date of the equivalent revenue standard to 1 January 2018 further fuelled the discussion on whether India should take the plunge and spearhead the implementation or wait for the global standard setters to issue the proposed amendments including the additional clarifications and guidance. As a result of these deliberations, recently the National Advisory Committee on Accounting Standards (NACAS) has made recommendations to the Ministry of Corporate Affairs (MCA) to defer the implementation of Ind AS 115.

The Institute of Chartered Accountants of India (ICAI) has issued an exposure draft of changes proposed in Ind AS, as a consequence of deferment of Ind AS 115. The Exposure Draft contains Ind AS 11, Construction Contracts, along with the appendices corresponding to IFRIC 12, Service Concession Arrangements, SIC-29, Service Concession Arrangements: Disclosures, and Ind AS 18, Revenue, along with the appendices which form integral part of the standard, corresponding to IFRIC 13, Customer Loyalty Programmes, IFRIC 18, Transfers of Assets from Customers, SIC-31 Revenue - Barter Transactions Involving Advertising Services and consequential amendments to other Ind ASs, issued by the Accounting Standards Board of the ICAI, for comments. As it stands today, there does not seem to be any option for the companies required to transition as part of phase 1 to early adopt Ind AS 115 and skip the efforts on transitioning to Ind AS 18 first and then to Ind AS 115.

Broadly, AS 9, Revenue Recognition mainly focusses on the timing of recognition of revenue based on the transfer of significant risks and rewards of ownership. Uncertainties regarding the determination of the amount, or its associated costs are considered as influencer in determining the timing of revenue recognition. Ind AS 18 also echoes the same principles for timing of recognition but requires revenue to be measured at fair value of the consideration received or receivable. Ind AS 115 moves away from the concept of transfer of risk and rewards and defines a five step framework for revenue recognition based on transfer of control which requires among other things determination of mutual enforceability of a contract, identification of performance obligations of each of the parties to the contract and allocation of the transaction price to the performance obligations.

Let us look at the key areas that have been subject to diverse practices/ deliberations under the existing Indian GAAP more specific to the pharmaceutical industry and the possible impact on these areas due to the transition to IFRS converged standards.

**Gross to net adjustments - Accounting under Indian GAAP and general practices**

Revenue, under the current Indian GAAP, is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods and from the rendering of services. A company reduces the revenue to account for the impact of specific adjustments. The general gross to net adjustments made under the current Indian GAAP include sales return accrual, turnover discounts, trade discounts and volume rebates. Cash discounts, free goods offered, bundled contracts, loyalty programmes etc. are not very common deductions from gross revenue.

**Gross to net adjustments to revenue would generally include:**

1. **Provision for anticipated returns**

It is an accepted business practice for manufacturers in the pharmaceutical industry in India to accept returns of products whose shelf lives have either expired or are nearing expiry. There are two types of returns. One – where the goods cannot be resold as their shelf life has expired or are nearing expiry that may not have resale value, and two-where the goods have been returned for any other reason and can be resold.

AS 9 makes a reference to guaranteed sales i.e. where delivery is made giving the buyer an unlimited right of return wherein it may be appropriate to recognise the sale but a suitable provision for the anticipated returns should be made based on past experience. Recognition of revenue in such circumstances would depend on the substance of the agreement.

One view is that sales for the period should be adjusted for expected sales returns in the next accounting period at full sales price as per a reliable estimate based on past experience and other relevant factors and the same should be netted off against sales of the period at full sales price. Since the actual sales returns pertaining to the sales made during the period have been netted off from sales for the period, the same treatment should be given to the expected sales returns pertaining to the sales of the current period. This would also mean an adjustment of ‘cost of sale’ and ‘inventories’ against sales expected to be received back (with obsolescence/diminution in value and expected incremental cost of sale of
the returned goods being recognised by the process of valuation at lower of cost and net realisable value). Other view is based on the ICAI’s Expert Advisory Committee (EAC)’ opinion, provision is to be recognised in respect of sales returns at the best estimate of the loss expected to be incurred the entity in respect of such returns including any estimated incremental cost that would be necessary to resell those goods as per AS 29, Provisions, Contingent Liabilities and Contingent Assets. In case of non-saleable products, this would be the entire amount of the sales and in case of the saleable products, this would be the profit element included in the sales and any additional expense expected to be incurred towards resale. Consequently, under the current Indian GAAP, this provision can be presented as a separate expense item in the profit and loss account without any adjustment to sales, cost of sales and inventories.

Under Ind AS, when the buyer has a right of return and there is uncertainty about the possibility of return, revenue is not recognised until the shipment has been accepted by the customer or the goods have been delivered and the time period for rejection has elapsed.

An entity considers historical experience in assessing the possibility of return. If, based on past experience, the entity can make a reliable estimate of the amount of goods that will be returned, then it would be appropriate to recognise revenue for the amount that is expected to be received for items that are not returned (assuming that the other conditions for revenue recognition are met). Under Ind AS 18, an adjustment would be made to revenue, cost of revenue, and inventories for estimated sales return.

Ind AS 115 has more specific guidance on recording sales with a right to return.

As per Ind AS 115, in case of transfer of products with a right of return, an entity would recognise all of the following:

a. revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognised for the products expected to be returned)

b. a refund liability and

c. an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

In a nutshell, revenue is to be recognised only to the extent the entity expects to receive the consideration i.e. net of expected sales returns. A liability is to be recognised for the amount expected to be refunded to the customers at the time of the returns and a corresponding asset is to be created for the right to recover products from the customer on settling the refund liability. Replacements of similar products are not considered as returns.

II. Turnover discounts, trade discounts and volume rebates

It is a usual practice to provide discounts to customers based on volume of sales commonly known as trade discount, volume rebates, etc. and for promptness of payment commonly known as cash discount, etc. In practice, divergent practices are followed by companies in accounting for such discounts. Under the current Indian GAAP, an EAC issued by ICAI has clarified that trade discount is not encompassed within the definition of revenue since it represents a reduction of cost. Accordingly, trade discounts and volume rebates given should be deducted in determining revenue. Incentives/discounts based on achievement of a certain turnover such as foreign travel, gifts, etc. are usually provided for and disclosed as an expense as part of sales promotion expenses. In current practice several of such rebates, promotion scheme expenditure etc. is presented as part of sales promotion expenses.

As per Ind AS 18, “Revenue is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.” Accordingly, all discounts and incentives expected to be offered on the sales made during the year should be estimated and reduced from revenue.

As per Ind AS 115 paragraph 50 and 51, “if the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.” Accordingly, the variable consideration is to be allocated to the entire contract or to any specific obligation based on the facts and circumstances of the contract and revenue from each performance obligation is recognised net of the discounts, rebates, etc.

Each customer contract would require careful evaluation as accounting would differ based on the facts and circumstances of each contract.

III. Cash discounts

Companies offer discounts for a certain percentage of the sales price, as an incentive for prompt payment. Under the current Indian GAAP, these discounts are shown as a separate expense in the statement of profit and loss.

Under Ind AS, companies would be required to estimate the total cash discount expected to be offered to customers and reduce this from revenues.

IV. Patient programmes

Patient programs are run by pharmaceutical companies mainly for oncology related drugs which are high-priced and need to be consumed over a longer period of time. Typically, these programmes comprise providing free drugs to the patient on purchase of certain quantity of these drugs. There is no specific guidance on accounting for such programmes under the current Indian GAAP. Under Indian GAAP guidance is available under a technical guide on Accounting Issues in the Retail Sector (guide) relating to customer loyalty programmes. It mentions that currently in India, deferral model and provision model are prevalent.
Timing of revenue recognition is one of the most critical factors governing revenue recognition. Under the current Indian GAAP, revenue is to be recognised at the time of transfer of significant risk and rewards of ownership to the buyer.

As per AS 9, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

i. the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

ii. no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

In many cases of export sales on Customs, Insurance and Freight (CIF) basis, we would need to evaluate whether significant risk and rewards of ownership have been considered to be transferred when the goods are handed over to the transporter based on the contractual terms and after considering facts and circumstances of each case.

Ind AS 18, however, has specific guidance on customer loyalty programs. Though the patient programmes may not entirely be comparable to these loyalty programs, one can draw inference from this guidance. Accordingly, the entity should allocate the fair value of the consideration received or receivable in respect of the initial sale between the free drugs and the other components of the sale. The consideration allocated to the free drugs should be measured by reference to their fair value, i.e. the amount for which these drugs could be sold separately.

Under Ind AS 115, the transaction price is to be allocated to the goods promised to be supplied free of cost and deferred to the period in which such goods are provided.

Timing of recognition – exports

Timing of revenue recognition is one of the most critical factors governing revenue recognition.

Under the current Indian GAAP, revenue is to be recognised at the time of transfer of significant risk and rewards of ownership to the buyer.

As per AS 9, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been satisfied:

i. the entity has transferred to the buyer the significant risks and rewards of ownership of the goods

ii. the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold

iii. the amount of revenue can be measured reliably

iv. it is probable that the economic benefits associated with the transaction will flow to the entity, and

v. the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Consequently, in case of CIF export sales, the above criteria should be evaluated to analyse whether the risk and rewards of ownership of the goods passes only on delivery at the port and the seller has continuing managerial involvement till the time the goods reach the destination port. Companies would need to understand contractual terms and exercise significant judgement while recognising revenue.

Ind AS 115 requires evaluation through a five step model to determine recognition of revenue:

1. Identify the contract.
2. Identify the performance obligations. An asset is transferred when (or as) the customer obtains control of that asset.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations and
5. Recognise revenue.

Under Ind AS 115, the timing of revenue recognition is focussed on transfer of control rather than transfer of risks and rewards. Consequently, the terms of the contracts with customers will need careful evaluation as to when the control of the goods transfers to the customer.
Many Indian pharmaceutical companies enter into out licensing agreements for the purpose of selling their products in other jurisdictions. A typical agreement consists of two deliverables i.e. preparation and sale of dossier based on which the customer obtains ‘market authorisation’ and commitment to supply the products for sale in the specific jurisdiction. In practice, a variety of such kind of arrangements exit, for example, in some cases, the dossier are to be returned on completion of the arrangement whereas in other the customer is free to retain the same. Some agreements could stipulate refund of the upfront fees paid for dossier in case the marketing authorisation is not granted. Sometimes the contracting parties are free to procure the products from other manufacturers whereas in many cases, there is a commitment to procure from the company preparing the dossier. The process of seeking approval, typically, for change of the manufacturing facility would involve as much efforts as required for obtaining a fresh approval. This would hold true even for cases when the dossier related information is retained by customer on termination.

Presently, under Indian GAAP, revenue from sale of dossiers is recognised based on the contractual milestones while revenue from sale of goods is recognised separately on supply of goods when risks and rewards of ownership are transferred for those goods.

Under IAS 18, ‘it is necessary to apply the revenue recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole’.

Under Ind AS 115, factors that indicate that an entity’s promise to transfer a good or service to a customer is separately identifiable (in accordance with paragraph 27(b)) include, but are not limited to, the following:

a. the entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.

b. the good or service does not significantly modify or customize another good or service promised in the contract.

c. the good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

Ind AS 115 requires the revenue from a contract to be allocated to each distinct good or service provided on a relative standalone selling price basis, though a ‘residual’ approach is permitted in limited circumstances.

Based on the discussion above, it seems that the intention of such contracts is to sell the products in the defined jurisdiction and the dossier by itself may not represent separate standalone value to the customer. Accordingly, the amount attributed to such sale of dossier would need to be amortised with reference to the expected pattern of sale of products over the contractual period (five to 10 years) which represents the sole performance obligation relating to the arrangement discussed above.

However, considering the practical difficulty in anticipating revenues for the future, another approach that can be considered is amortising the dossier income over the contractual period on a straight line basis provided the impact of such straight line approach is not expected to be materially different from the approach referred to above.

While the guidance under Ind AS 115 is more detailed, the requirements under Ind AS 18 are primarily the same. Consequently, pharmaceutical companies would now need to evaluate each contract carefully to determine the performance obligations and allocation of the transaction price to the performance obligations.

The conversion from the current Indian GAAP to Ind AS 18 to Ind AS 115 would entail a lot of changes not only in accounting but in other areas such as contract management, IT systems, tax compliance, etc. The pharmaceutical industry in particular, would have to be geared to be able to meet the measurement, recognition and disclosure requirements especially with respect to the areas discussed above. Further, as companies prepare themselves for Ind AS, it would also be required that they keep investors, analysts and other stake holders updated on the required changes and the anticipated impact on the financial results.
Potential impact of Ind AS on pharmaceutical sector

This article aims to:

– Summarise the impact of the adoption of Ind AS on the pharmaceutical sector.

Financial reporting and accounting in pharmaceutical companies can be fairly complex and companies in the sector routinely deal with accounting nuances which may call for significant judgement and careful evaluation of contractual terms of arrangements.

The introduction of Ind AS brings forth more guidance on areas such as revenue recognition, accounting for sales returns, recognition of revenue from sale of licenses or marketing dossiers, intangible assets, government grants, segment reporting and also introduces new concepts such as embedded leases and business combination transactions which may have an impact on the pharmaceutical industry.
Some of the key impacts are as under:

**A | Revenue recognition**

Revenue recognition under Indian GAAP for this sector is primarily governed by principles contained in Accounting Standard (AS) 9, Revenue Recognition. There are a few areas of revenue recognition that will have an impact on transition to Ind AS. This topic is covered in detail in a separate section in this publication.

**B | Research and Development (R&D) expenditure and recognition of intangible assets**

Pharmaceutical companies typically invest heavily on R&D activity to develop novel drugs or to develop more cost effective methods to produce existing drugs.

Ind AS 38, Intangible Assets, is similar to the AS 26, Intangible Assets. The existing Indian GAAP requires any research expenditure to be expensed as incurred and any development costs to be capitalised if they meet certain specified criteria such as technical feasibility, ability and intention of developer to complete the asset, availability of adequate technical, financial and other resources to complete the development, and the asset is expected to generate future economic benefits and expenditure can be reliably measured.

While the differences on transition to Ind AS are not expected to represent a significant departure from existing GAAP, companies may need to consider the following:

- In India many pharmaceutical companies manufacture generic drugs. These are those drugs which have already been approved by regulatory authorities and whose technical feasibility is established. Based on the other criteria for capitalisation, companies may require to exercise judgement to determine the start point of capitalisation of development expenses in relation to such drugs.

- Ind AS 38 requires amortisation of intangibles based on useful lives as estimated by the management, unlike in the current Indian GAAP where companies generally amortise intangibles over 10 years.

- Ind AS 38 also allows recognition of intangibles with indefinite lives, which are not amortised but are instead tested for impairment at each reporting date. Thus, acquired brands or drugs in the generic space may require evaluation whether they can be carried out for an indefinite period. Where such intangibles are carried out for an indefinite period, some pertinent factors to consider which may result in impairment include, drop in market share, availability of new or cheaper replacement drugs, government bans or restrictions on sales of such drugs, litigation, etc.

- As per Ind AS 38, companies have an option to measure the intangible asset under revaluation model if there is an active market for the intangible asset. Whereas under AS 26 the intangibles are not allowed to be revalued.

**C | In-licensing and acquired ‘in process R&D’ in case of business combinations**

- Under in-licensing arrangements, the licensor provides a licence to the in-licensee to use the research findings of the licensor to develop a new product range. The payment consideration given to the licensor is linked with the milestones as per the arrangement subject to regulatory approvals. In-licensing arrangement agreement may also require payment of an upfront fee.

While the current practice under the Indian GAAP is mixed, as per Ind AS 38, the upfront and milestone payments may be capitalised as in-process R&D.

As per Ind AS 38 para 5, the price an entity pays to acquire an intangible asset separately will reflect expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is an uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion is always considered to be satisfied for separately acquired intangible assets.

However, internal costs of the acquirer must the acquisition cannot be capitalised unless they meet the development expenditure criteria as laid out under Ind AS 38.

An entity may also recognise as a separate intangible, costs of any ‘in-process R&D’ on acquisition of an entity accounted for using the business combinations guidance included in Ind AS 103, even if the acquired entity itself had not recognised an intangible asset in its own separate financial statements.

Research costs paid by an entity to get research done by a contract research organisation, however has to be distinguished from the above situations. Such expenditure represents research cost and should not be capitalised as an intangible. Any upfront payments made, however, could be carried as prepaid costs. An assessment may be required in group situations wherein a subsidiary performs research for a parent whether at group level the activities performed represent research or development activities.
**Government grants**

The government provides incentives to pharmaceutical companies to promote R&D activity or to set up manufacturing facilities in backward areas. These incentives can take the form of interest free or concessional rate loans, excise, sales tax or custom duty benefits, grants akin to promoters' contribution, grants for purchase of assets etc. The relevant standard is Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance.*

**Interest free or concessional rate loans or sales tax deferrals**

Under Ind AS 109, *Financial Instruments,* all financial instruments (including below market borrowings from the government) are initially recognised at fair value with reference to the market rate of interest for a borrowing with similar terms (currency, tenure, etc.).

The difference between the initial carrying amount of the borrowing determined in accordance with Ind AS 109 and the present value of future cash inflows and outflows discounted using the market rate of interest would be accounted for as a government grant. This government grant would be recognised as income over the period of the loan.

Similar accounting is done for sales tax deferral schemes, which are treated as borrowings from the government.

Under current Indian GAAP above accounting practices are not followed.

**Excise sales tax or customs duty benefits, subsidies**

In some cases instead of providing a cash grant, a government may waive amounts payable by the entity e.g. a liability for taxes (excise duty, sales tax, customs duty, subsidies). Under Ind AS, these amounts would qualify as government grants because in substance there is a transfer of resources, although it is in the form of a waiver of expenses.

**Grants akin to promoter’s contribution**

In Indian GAAP, grants in the nature of a promoter’s contribution are normally shown as capital reserves or recognised as income on satisfaction of the conditions of the grant. In Ind AS, such grants are not treated as part of equity and instead are set up as a liability in the form of deferred income which is recognised on completion of the conditions of the grant.

**Grants for purchase of fixed assets**

Where grants are given for purchase of fixed assets, under the current Indian GAAP guidance, an entity can reduce the amount of such grant from the cost of the fixed assets. This treatment is available in IFRS as well. However, in Ind AS, grants cannot be reduced from the cost of assets capitalised and should be set up as a deferred income liability, which is recognised as income over the useful lives of the assets purchased.

**Contract manufacturing**

Pharmaceutical companies often enter into exclusive ‘contract manufacturing’ arrangements, whereby the contract manufacturer produces specified products for the pharmaceutical company with use of specific machinery/assets.

Guidance in Appendix C to Ind AS 17 Leases, Determining whether an arrangement contains a Lease, requires a careful analysis, to identify any embedded lease component, included as part of the underlying product supply transaction where there are specific identified assets and conditions as to ‘right to use’ of the identified asset/group of assets are satisfied.

To apply this guidance an entity while obtaining more than an insignificant amount of output, either control the use of the asset or have ability to restrict physical access to the asset or the purchase price of goods is neither fixed per unit nor is it the market price.

There is no equivalent guidance in the Indian GAAP and companies may face challenges in applying the said guidance. Once a determination of a lease component is made, a further assessment would be required to ascertain whether the lease is a finance or an operating lease. In case of finance lease the assets used for production, would need to be recognised as part of the lessee entity’s balance sheet.

**Segment reporting**

Several pharmaceutical companies currently disclose a single ‘pharmaceutical’ segment. Under Ind AS, additional segments may have to be identified and disclosed based on the manner in which the Chief Operating Decision Maker (CODM) reviews information to take decisions on resources to be allocated to certain segments and to assess performance. This topic is covered in detail in a separate section in this publication.

**Business combinations**

Presently companies account for acquisition of the subsidiary in the consolidated financial statements based on the guidance outlined under AS 21, *Consolidated Financial Statements.* In case of acquisition of specific assets such as intangibles, plant and machinery etc., AS 10, *Accounting for Fixed Assets,* or AS 26 apply. Any excess of consideration paid over the assets acquired is recognised as goodwill.

Under Ind AS, there is specific guidance on ‘business combinations’ which is defined as a transaction or other event in which an acquirer obtains control of one or more businesses. Accordingly, while under Indian GAAP, goodwill is required to be recognised on acquisition of a subsidiary (without any further evaluation), under Ind AS, a further evaluation may be required as to whether the acquisition of a group of assets, represents a business combination, even though a separate legal entity may not be acquired. This topic is covered in detail in a separate section in this publication. This topic is covered in detail in a separate section in this publication.
In addition to the above, there are several other differences between Indian GAAP and Ind AS which may have an impact on the pharmaceutical sector after the transition. Some of these impact areas are:

- Component accounting for property, plant and equipment
- Debt equity classifications for any financial instruments issued such as redeemable preference shares which are considered as debt instruments under Ind AS, while in Indian GAAP these are disclosed as equity
- Investments under Ind AS 109, which are to be carried at amortised cost or at fair value through profit and loss account or at fair value through equity
- Accounting for share based payment transactions
- Timing of recognition of proposed dividend
- Discounting of long-term provisions
- Taxes (component of taxes, tax rate reconciliation)
- Restatement of financial statements for prior period errors.
Survey analysis
India is at the cusp of a series of changes that are influencing the agenda of companies. First and foremost, whilst companies are still coming to terms with the requirements of the Companies Act, 2013 which was made largely effective last year, the government announced convergence with IFRS equivalent standards (IND AS) and introduced standards for computing taxable income – referred to as Income Computation and Disclosure Standards (ICDS). With changes like introduction of the new Goods and Services Tax (GST) regime as well as Base Erosion and Profit Shifting (BEPS) guidelines announced by the Organisation for Economic Co-operation and Development (OECD) lurking in the background, the changes that the CFOs have to embrace are comprehensive and many-fold.

The pharmaceutical sector, like many other sectors is also deeply impacted by these changes. With this in mind, we interviewed CFOs of a wide variety of companies in the pharmaceutical sector to find out what they think about these changes – its impact not just on finance but on business as a whole, relevance and their overall preparedness to tackle them.

In this article, we present our impression from the survey conducted which we hope will help you as you plan for the transition to these new requirements.

**Ind AS/IFRS**

On IFRS convergence we asked companies whether this is the right time to transition and whether they believe that the transition will be disruptive. Although 59 per cent of the companies surveyed do not have any previous experience in IFRS financial statements, nearly half of the companies surveyed do not expect Ind AS to change the way business is conducted even though most people unanimously feel that Ind AS is expected to provide more insights in terms of enhanced disclosures and is expected to provide a more realistic depiction of the state of affairs of a company. While some feel that this is unlikely to change the way business is conducted in spite of enhanced credibility and transparency, others feel that Ind AS would have an overarching impact on the business beyond just financial reporting. Amongst others, it will have an impact on the way management information is reported, the way data is managed and information systems are structured, tax management and internal control environment. Some of the respondents have brought out that this will also bring financial reporting to a comparable platform where divergence in accounting practices will be bridged.

Quite surprisingly while a majority of the industry do not expect Ind AS changes to have a significant impact, most of the corporates whom we interviewed were still in the process of evaluating the impact of Ind AS on the profits. Those who have prior experience with IFRS have identified revenue recognition as the area that will have the most significant impact. Most respondents expect a reduction in revenue as a result of implementation of Ind AS. Segment reporting is another area identified to have a significant impact followed by share based payment accounting and changes in accounting policies. Most respondents agree that there will be a substantial change to presentation of financial statements.

CFOs, quite understandably have identified the following as the critical challenges in implementation/transition:

- Lack of trained and experienced resources
- Regulatory environment and regulatory clarity in India
- Educating investors, Board of Directors and other significant stakeholders.

India’s pharmaceutical sector believes that starting early with access to knowledgeable advisors along with sponsorship from the leadership are the top three critical success factors for a smooth transition.

In order to take care of these critical factors, most organisations (that have been surveyed) are in the process of imparting training to their resources. Most respondents believe that awareness about the differences that Ind AS implementation will bring should be spread to the analyst, investors, bankers, rating agencies, other providers of finance so as to make the information more meaningful for them. People who believe that Ind AS will impact the way business is conducted also believe that this change will require active involvement of top management.

Majority of the others believe that some of the areas that involve policy decisions that would impact top-line or bottom-line would require the involvement of top management while other regular matters can be managed by the finance and accounts teams.

About half of the responding companies have set up a structured oversight mechanism like a committee to ensure smooth convergence and identification of the key impact areas is in progress. While about most of the respondents do foresee a change required in the Accounting Information System to give effect to the transition, about 50 per cent respondents are yet to initiate the required changes.

Irrespective of the status of their transition projects, majority of the respondents, however, feel confident that their companies are ready for adoption of Ind AS by 1 April 2016 with prior year comparatives though majority of the respondents have not factored the impact of Ind AS into their budgeting process. It is expected that sales targets may continue to be set in the same manner as in the past without considering the impact of any revenue deferrals.
Q1
Does your company have any previous experience in IFRS financial statements, for example through a group reporting pack, listing abroad, etc.?

No, 55%  Yes, 41%

Q2
Do you consider adoption of Ind AS would be just a technical accounting exercise or will change the way business/transactions are currently conducted?

Both, 53%  Accounting change 47%  Change the way business is managed, 0%

Q3
What do you believe adoption of Ind AS will provide in terms of disclosure, true financial performance and comparability?

More insight 76%  Less insight 0%  Don’t know 6%
Convergence to Ind AS is expected to impact financial position and financial performance of Indian entities. In your assessment, will the adoption of Ind AS in the following areas, lead to an increase or reduction in profits of the Company?

Acquisitions and consolidation

Don’t know 50%
Reduce 14%
No impact 14%
Increase 21%

Financial instruments accounting

Don’t know 44%
Reduce 19%
No impact 19%
Increase 19%

Revenue recognition

Don’t know 0%
No impact 25%
Increase 13%
Reduce 63%

Debt equity presentation

Don’t know 36%
Increase 21%
Reduce 0%
No impact 43%

Share-based payments

Don’t know 40%
Reduce 27%
Increase 7%

Segment reporting

Don’t know 20%
Increase 33%
Reduce 0%
No impact 47%
Q5
Which one of the following do you think is/are the critical challenge(s) for transition?

- Regulatory environment and regulatory clarity in India
- Lack of trained and experienced resources
- Educating investors, Board of Directors and other significant stakeholders
- Significant one-time costs
- Technology costs

Q6
What in your assessment are the critical success factors to a smooth transition?

- Leadership of the project
- Communication with internal stakeholders and investors/analysts
- Sufficient resources
- Access to knowledgeable advisors
- Starting early
Q7
In your opinion, is it required to train the investors, bankers, rating agencies, other providers of finance and analysts so as to make the information more meaningful for them?

No 24%
Yes 76%

Q8
Has a structured oversight mechanism/committee, entrusted with convergence responsibility, been set in the organisation to ensure smooth convergence?

Not required 18%
No 25%
Yes 53%

Q9
Do you foresee a change in the Accounting Information Systems (AIS) to bring out desired information per Ind AS? If yes, have you started the process of enabling changes in the same?

Yes, still need to start the process of upgradation of AIS 58%
Yes, we have started the process of upgradation of AIS 19%
No, NA 31%

Q10
Is your company ready for adoption of Ind AS by 1 April 2016 with prior year comparatives, including training of staff, having understood the implications of adoption, taking care of interests of investors, bankers and others?

Can’t say 6%
No 25%
Yes 68%
The ICDS have been notified and are applicable from Assessment Year 2016-17 onwards. The adoption of ICDS is expected to significantly alter the way companies compute their taxable income, as many of the concepts from existing Indian GAAP have been modified. This may also require changes to existing processes and systems. What are the key implementation challenges of ICDS that you foresee? Do you believe that adequate implementation time and guidance has been provided by the Government for ICDS?

A
Do you agree that ICDS would require changes to existing processes and systems?

No 31%  
Yes 69%

B
Do you agree you have adequate implementation time?

No 44%  
Yes 56%
What are the key implementation challenges of ICDS that you foresee?

- Borrowing costs
- Revenue recognition
- Government grants
- Financial instruments
- Foreign exchange differences capitalisation
The Companies Act, 2013 (2013 Act)

We had sought the views of the respondents on impact of the 2013 Act and the implementation challenges faced by the industry. The emerging viewpoints and key messages include:

What’s gone well?
- The 2013 Act has places increased responsibilities on the shoulders of Key Management Personnels (KMPs) who are ideally responsible for the functioning of the company
- There is a welcome emphasis on governance and transparency
- Is timed well in terms of transition to IFRS converged standards.

What could have been better?
- Privately held companies should not be subject to the same rigor as publicly held companies.
- Industry representations have not been well considered. Further, the multiple clarifications and subsequent amendments indicate the haste with which the 2013 Act was enacted. There is a lot of scope for improvement with respect to implementation.

Q12

The 2013 Act has introduced Section 134(5)(e) which requires the directors’ responsibility statement to state that the directors, in the case of listed company, have laid down IFC to be followed by the company and that such internal controls are adequate and were operating effectively. How have you approached this areas and what have been the key considerations relating to the implementation of reporting on IFC?

Additionally, in your view whether IFC would improve or enhance internal processes and whether it would be time consuming and would it provide benefits as compared to costs incurred to implement it?

Does your company have a similar process e.g. as per group guidelines?

What is the status of preparedness of your company on this front:
GST

GST has been in the offing for quite some time. While everyone is waiting with bated breath, we pre-empted a view from the CFOs on this significant paradigm shift. While a lot of the CFOs believed it’s too early to comment, most of the pharmaceutical sector CFOs are expecting a consolidation in the distribution model from one Carrying and Forwarding Agent at each state level to a central hub model and major impact in the IT infrastructure. They expect both the companies as well as the consumers to benefit from GST. Only about 38 per cent of the respondents have indicated preparedness for implementation of GST. A significant majority have also raised that sufficient time should be given for implementation from the date the GST Act is finalised. Most of the companies have either done or are in the process performing impact assessment.

Q13

GST is a path breaking business reform, and not just a tax reform for India. It is likely to trigger a major ‘business transformation’. Despite the setback of the monsoon session of the parliament which ended on 13 August 2015, the general view is that GST will soon become a reality.

Are you prepared for this area?

No 62%
Yes 38%
Ind AS 108, Operating Segments and its impact on the pharmaceutical sector

This article aims to:

– Explain the key principles of Ind AS 108, Operating Segments as compared to Accounting Standard (AS) 17, Segment Reporting and the related impact on the pharmaceutical sector.
The basic composition of pharmaceutical industry can be categorised into two components i.e. the branded players (the holders of the original patent) or a generic players i.e. who monetises the generic version of the original branded drug post expiry of the related patents. However, if we take a closer look we would find that there are certain key activities around which the business activities of a company in this sector may be carried out. Some of these activities are:

- Research and development activities
- Manufacturing of ‘Active Pharmaceutical Ingredients’ (API)
- Manufacture of ‘Dosage Formulations/Injectable’
- Sale of manufactured products
- Ancillary services around or in connection with any of the above mentioned or any other activities.

Few companies may be carrying out all these activities while others may not be doing so as they may have outsourced a particular activity in full or part.

The business community around the world seems to be moving towards specialisation to maximise economic and social impact of their activities and pharmaceutical industry is not left behind in this aspect. Therefore, some companies may be positioning themselves as specialised beyond branded/generic either on the basis of therapeutic treatment or on the basis of activity. These by category/area specialisation adopted by a company along with associated risks and rewards may influence the decision to allocate available resources and regular monitoring of performance (for example, inconsequential category performance may not be evaluated in detail by the decision makers).

The general purpose financial statements presents to the stakeholders a view of the overall performance, but a company may have multiple sub category/area and their performance indicators may provide useful information to stakeholders to better appreciate the risk and returns associated with these different sub category/areas instead of only evaluating overall company’s performance.

From an accounting perspective, these sub categories/areas, if meets certain conditions may become segment and thus segment reporting would be required to be made in the financial statements in the manner required by the applicable accounting standard. The core principle of segment reporting is that an entity should disclose information to enable users of its financial statements to:

- Evaluate the nature and financial effects of different types of business activities in which it engages, and
- The economic environments in which it operates.

The concept of segment reporting is not new in the financial reporting world both in India as well as outside India. However, there is significant difference between the approach and requirements of the current AS 17 and of the IFRS 8, Operating Segments.

The recently notified Ind AS, which are converged with IFRS, it is important to note that there is no material difference between Ind AS 108 and IFRS 8.

Through this article we are discussing key differences between Ind AS 108 and AS 17 in the context of pharmaceutical companies.
The existing standard - AS 17

The existing standard on segment reporting i.e. AS 17, requires identification of two sets of segments, one that is based on related products and services and the other based on geographical areas, as depicted below:

**Business segments**
A distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.

**Geographical segments**
A distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

**Rule based approach based on the principles of ‘risks and returns’**
The above segments are classified as primary segment and secondary segment depending on the dominant source, nature of risks and returns, internal organisation and management structure of a company and its system of internal financial reporting to the Board and CEO. Disclosure of segment assets, segment revenue and capital employed is made after applying the definitions and the rules of aggregation for business/geographical segment as the case may be as well as ensuring that these are reconciled to the financial statements.

Source: KPMG in India Analysis

In our experience many of the pharmaceutical companies are currently considering pharmaceutical as the only primary reportable business segment and give secondary geographical segment disclosures in their annual accounts prepared under Indian generally accepted accounting principles.
Key aspects of the reporting requirements under Ind AS 108

In contrast, Ind AS 108 ushers in a fundamental change as it is based on a management approach wherein operating segments are identified based on internal reports regularly reviewed by the entity’s chief operating decision maker (CODM).

The new standard explains that an operating segment is a component of an entity:
- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
- whose operating results are regularly reviewed by the entity’s CODM to make decisions about resources to be allocated to the segment and assess its performance, and
- for which discrete financial information is available.

Thus the concept of primary and secondary segment classification would no longer be applicable. Similarly, there are no specific definitions of segment revenue/assets in the new standard although a reconciliation of the reporting with financial statements continues to be a requirement.

The standard further clarifies that an operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues. Additionally, if activities conducted through joint ventures or associates are reviewed separately by the CODM for taking decisions about the group and the criteria for identifying operating segments are met, the joint venture operations or associates may qualify as operating segments for the purpose of consolidated financial statements.

There are no major technical differences between Ind AS 108 and IFRS 8. Due to the management approach under IFRS 8, we have observed that pharmaceutical companies organise the segments based on the structure of the entity's internal organisation and information reported internally to the CODM. Examples of segments are:
- Separate operating segments for branded drugs, generics, vaccines, consumer healthcare and research and development activities
- Identification of operating segments only by regions
- Identification of operating segment by therapeutic area

Concept of CODM

Ind AS 108 explains that the term CODM identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the CODM of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.

The standard also emphasises that generally, an operating segment has a segment manager who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment.

The term ‘segment manager’ identifies a function, not necessarily a manager with a specific title. The CODM also may be the segment manager for some operating segments. A single manager may be the segment manager for more than one operating segment. If the characteristics as envisaged in the definition of operating segment, apply to more than one set of components of an organisation but there is only one set for which segment managers are held responsible, that set of components constitutes an operating segment.

The above characteristics may apply to two or more overlapping sets of components for which managers are held responsible. That structure is sometimes referred to as a matrix form of organisation. For example, in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. The CODM regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity should determine which set of components constitute the operating segments by reference to the core principle.
The task of identifying a CODM can be complex. In our experience, globally, it is the managing director, CEO, COO, executive directors or the Board or a sub group of the Board which has been identified as a CODM in the financial statements prepared under IFRS. It is pertinent to note that while lower level management may make decisions about resource allocation that relate to less than the whole entity (i.e. allocation decisions are not made across the entire organisation), these lower levels of management cannot be the CODM.

Other key aspects

Measurement principles
The AS 17 requires segment information to be prepared in accordance with the accounting policies adopted for preparing and presenting the financial statements. The existing standard defines segment revenue, segment expense, segment result, segment assets and segment liabilities.

Correspondingly, Ind AS108 states that segment information is to be prepared on the same basis that is used by the CODM for the purposes of making decisions about allocating resources to the segment and assessing its performance. Where the CODM uses more than one measure of an operating segment’s profit or loss, the segment’s assets or the segment’s liabilities, the reported measures are those that management believes are determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the entity’s financial statements.

Ind AS 108 does not specifically define what are segment revenue, segment expense, segment result, segment assets and segment liabilities. The standard required that an entity should report a measure of profit or loss for each reportable segment and should report a measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to the CODM. It further states that a reconciliation between the segment information and the financial statements would be required. All material reconciling items should be separately identified and described e.g. reconciliation of reportable segment profit or loss to the entity’s profit or loss arising from different accounting policies.

Single segment companies
Another key change is the disclosure requirements for a one segment company. Currently, no segment information is required to be disclosed in case a company neither has more than one business segment nor has more than one geographical segment and if a note to this effect is given in the notes to the financial statements. However, under Ind AS 108, certain specific ‘entity wide disclosures’ would be required to be made by all entities. These are broadly categorised as follows:

- Information about product and services
- Revenue from external customers for products and services
- Information about geographical areas
- Revenue from external customers by geographical areas
- Geographical information about non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising from insurance contracts
- Information about major customers
- Revenues from an individual external customer that represent 10 per cent or more of an entity’s total revenue.

Consistent with the earlier requirements, if a financial statement contains both the consolidated financial statements of a parent that is within the scope of Ind AS 108 as well as the parent’s separate financial statements, segment information is required only in the consolidated financial statements.

Interest expense/revenue
Under the existing standard, interest expense/income is not included as part of segment expense/income even if it relates to overdrafts/other operating liabilities relating to a particular segment except that interest expense is disclosed as a segment expense when the interest is included as a part of the cost of inventories and those inventories are a part of segment assets. This is also consistent with the definition of segment expense/income which excludes interest. Interest expense/income (except in case of inventories as stated above), is disclosed as an unallocated expense in the segment information.

Under Ind AS 108, interest income and expense is required to be disclosed separately for each reportable segment if regularly reviewed by/provided to the CODM. Interest revenue and interest expense are presented separately. However, interest revenue (net of interest expense) may be reported in some cases.

Enhanced disclosure requirements
In addition to the above, an entity should be required to disclose the factors used to identify the entity’s reportable segments, including the basis of organisation (for example, whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated), and the types of products and services from which each reportable segment derives its revenues.

In addition, an entity would now be required to report the revenues from external customers for each product and service, or each group of similar products and services as well as certain information about geographical areas, unless the necessary information is not available and the cost to develop it would be excessive, a fact that will also be required to be stated. Similarly specific information would be required to be disclosed about major customers.
Conclusion

The fundamental change in using a management approach under Ind AS 108 vis-à-vis the risk and reward approach under AS 17 warrants a concerted relook at the segment reporting required to be made by pharmaceutical companies.

Several of pharmaceutical companies operate with diversified product portfolios along with operations in both domestic and international markets. With the concept of CODM now firmly in place, a careful assessment would be required to be made by the management to ascertain the level of operating segment which could be at a product level (API, dosage formulations or life science ingredients) and at a geographical level (domestic and overseas). A key aspect which needs consideration is the level of information provided to the CODM which enables a decision to allocate resources to and assess the performance of the operating segments of an entity.

The fundamental changes in Ind AS 108 should enable the companies to be able to gather information in a relatively easier manner considering the management approach wherein the information should ideally be available internally. While the reporting under Ind AS 108 is expected to create diversity in reporting considering that there are no definitions of segment revenue, segment expense, segment assets and segment liabilities which are included in the standard, it will also give the user of financial statements a perspective of the operating segment as viewed by the eyes of the management.
Business combinations and accounting for intangibles

This article aims to:
- Provide an overview of the business combination standard and intangible assets under Ind AS.
- Provide examples of intangibles that are recognised by pharmaceutical companies when business combinations occurs.

Currently, Indian GAAP does not mandatorily require fair valuation of assets and liabilities acquired on amalgamation/acquisition. However, with the introduction of Ind AS, fair valuation of all assets and liabilities would be mandatory, except for common control transactions. It is expected that accounting for amalgamation/acquisition transactions specially for pharmaceutical sector under Ind AS would lead to recognition of several intangible assets by the acquirer/transferee companies.
Under the current Indian GAAP, amalgamations means under which two companies merge to form a new company or merge one company into another and are accounted under the Accounting Standard (AS) 14, Accounting for Amalgamations. Separate guidance is available for acquisition of a group of assets under AS 10, Accounting for Fixed Assets, and for acquisition of a subsidiary under AS 13, Accounting for Investments. The accounting for such transactions would change significantly under Ind AS.

Ind AS 103, Business Combinations, covers all transactions or events in which an acquirer obtains control of one or more businesses. Business combinations would therefore cover mergers, acquisitions and controlling equity stake. Ind AS 103 defines business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants. Therefore, a business would generally include three elements:

i. Inputs (for example, plant and machinery, inventory),

ii. Processes applied to those inputs (for example, employees, operational processes, distribution network) and

iii. The ability to create output (products manufactured or services rendered).

If any of these three elements are missing, the transaction may not constitute a business.

For example, company X purchases company Y which holds land. Apart from the ownership of the land, Y does not have any other assets nor does it carry out any operations. Under the current accounting principles, it is possible to record goodwill in the consolidated financial statements of the acquirer. Under Ind AS a careful analysis of what is acquired is often needed to determine whether the purchase constitutes a business, and frequently involves exercise of judgement. In this case, though X has purchased a legal company, this purchase would not meet the definition of a business under Ind AS if the purchase lacks processes and would be considered as an asset acquisition. Thus, the entire purchase consideration would be allocated to the underlying land and no goodwill would be recorded.

Ind AS 103 requires every entity to account for the business combination by applying the acquisition method. The acquisition method comprises of following steps:

i. Identify the acquirer – Generally, the entity that obtains control of another entity is the acquirer.

ii. Determine the acquisition date – It is generally the date on which the acquirer obtains control of the acquiree which is evidenced by the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree.

iii. Identify and measure consideration transferred – The consideration transferred is measured at fair value at the acquisition date and includes assets transferred, liabilities incurred to previous owners and equity instruments issued.

iv. Identify and measure the identifiable net assets acquired – The assets and liabilities acquired should meet the definition of asset and liability at the acquisition date and are measured at fair values. This can result in recognition of those assets and liabilities which were not previously recognised as assets and liabilities in the acquiree’s financial statements.

v. Measure Non-Controlling Interest (NCI) in the acquiree – NCI is measured at fair value or their proportionate interests in fair value of identifiable net assets.

vi. Recognise and measure goodwill or a gain from a bargain purchase – Goodwill is the excess of consideration transferred and NCI over the fair value of net identifiable assets. Any shortfall arising from the above, is considered as a gain on bargain purchase to be recognised in the equity as capital reserve in the balance sheet.

vii. Recognise any measurement period adjustments – Measurement period is the period after acquisition date when an entity may adjust provisional amounts recognised for a business combination. During this period an entity may obtain new information about facts and circumstances which existed at the acquisition date, and if known, would have impacted the measurement of the amounts of assets and liabilities recognised as of the acquisition date. The period ends, when the information an entity is seeking to obtain for the facts and circumstances existing at the acquisition, is obtained or determined to be not available and cannot exceed one year from the acquisition date.

Under current Indian GAAP, there is no requirement to identify assets separately and hence many intangibles assets may be currently subsumed under goodwill.

Under Ind AS 103, one of the complex areas in the above steps is the identification of the acquired assets and liabilities assumed to be recognised. Generally, in the books of the acquiree, tangible assets and certain intangible assets are recorded in the financial statements and therefore, by involving experts, one would be able to arrive at the fair value of such recognised assets. However, a large number of intangible assets may not be reflected in the acquiree’s balance sheet since these may be internally generated and the recognition criteria of AS 26, Intangible Assets (Ind AS 38, Intangible Assets) were not met. Therefore, in a pharmaceutical company, such internally generated intangibles may not have been recorded in the balance sheet of the acquiree. Therefore, recognition of intangibles would be a significant area in any business combination for the acquirer.
In a pharmaceutical company, when a business combination takes place some of the examples of intangibles which could be recognised are as follows:

- **Trade names/brands** – Many of the pharmaceutical companies would recognise brands as intangible asset in a business combination.
- **Distribution network** – These can cover exclusive tie-ups/arrangements with Carrying and Forwarding Agents (CFA) who may have relationships directly with customers, and such relationships cannot, with or without significant effort, be replicated.
- **Customer relationships/customer lists** – These can cover information/database of customers such as their name, address and other contact information and would be valuable to any business.
- **Know how/formulations** – These can be recognised if these are specific and not generic formulations and which would be difficult for any market participant to replicate.
- **In process Research and Development (R&D)** – Ind AS 38 specifically recognises that an acquirer can recognise the in-process R&D project of the acquiree if the project meets the definition of an intangible asset.
- **Vendor relationships** – These can be recognised as an asset if the terms and conditions which the acquiree has negotiated with its vendors are specific to it and would not be generally available to other market participants.
- **Favourable lease agreements** – They are recognised when the rates associated with the lease are below the prevailing market rates.

In general, an intangible assets is recognised only if it meets the asset recognition criteria i.e. it is probable that the expected future economic benefits attributable to the asset will flow to the entity and its cost can be measured reliably. For identifiable intangible assets acquired in a business combination, these recognition criteria are always considered to be satisfied. Therefore, all identifiable intangible assets acquired in a business combination are recognised separately from goodwill.

Having recognised an intangible asset, the next step is to determine the amortisation period over which these intangible assets would be amortised.

Under the current Indian GAAP, there is a rebuttable presumption that the useful life of the intangible would not exceed 10 years from the date the intangible asset is available for use. Under Ind AS 38, the useful life of an intangible asset would be assessed as finite or indefinite. Where the useful life is assessed as finite, such useful life is determined based on management’s estimate which is to be reviewed at least annually. Under Ind AS, an intangible can be assessed to have an indefinite useful life if there is no foreseeable limit over which it is expected to generate economic benefits for the company.

Factors that are considered in determining whether an intangible asset such as a brand has an indefinite useful life include the period of existence of the brand, growth projections, positioning of the company in the market and margins earned by the brand. Such intangibles do not have to be periodically amortised but are tested for impairment, at least annually or when there is a trigger for impairment.

Under Ind AS 103, companies are also mandated to disclose qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors. This would enable the reader of the financial statements to appreciate the management rationale for paying a higher considerations than the net assets which have been acquired in the business combination.

Accounting under Ind AS 103 is likely to result in a significant change in the way companies account for the business combinations. It is expected to highlight to the reader of the financial statements the substance of the transaction and the way the management looked at the transaction by reflecting appropriate value of the assets it acquired through the business combination. Going forward, management would need to consider various aspects discussed above while accounting for the business combinations.
ICDS – Potential impact on the pharmaceutical sector

This article aims to:
- Highlight some of the areas in the pharmaceutical sector which are expected to be impacted by the implementation of Income Computation and Disclosure Standards (ICDS).
Taxable income in India is computed based on the books of accounts after taking into consideration the adjustments specifically laid out in the Income Tax Act, 1961 (the IT Act). Over the years, inconsistency in accounting treatment for similar transactions in the same industry has posed a challenge to authorities, and impacted tax outflows of various entities. Another important aspect emerged with the announcement of a road map for converging Indian Financial Reporting with International financial reporting Standards (IFRS) i.e. taxable income and book income would be different for companies reporting under Ind AS vis-à-vis companies under current Indian GAAP. 

With the objective to address various issues including those highlighted above, the Central Board of Direct Taxes (CBDT) has prescribed a separate framework for the computation of taxable income. This new tax framework is independent from the financial reporting framework followed by companies.

Providing a tax neutral framework for transition to Indian Accounting Standards (Ind AS) was a pre-requisite for the smooth implementation of Ind AS from 2015-2016. Therefore, the notification of these ICDS is quite timely and important. Any change in the existing regime of taxation is expected to provide a resolution/path to overcome certain existing challenges but concurrently has directly/indirectly given birth to various new challenges. The change may challenge the existing positions taken on the basis of interpretations/prevalent practises including administrative procedures.

The introduction of ICDS is expected to impact the way taxable income is computed by companies across sectors; however, the areas of differences and the degree of impact may be different. These changes are also important since some of them may result in an entity becoming a taxable loss entity, and thus triggering application of virtual certainty principles instead of the currently applied reasonable certainty for recognition of deferred tax asset as (prescribed in AS 22, Accounting for Taxes on Income).

The peculiarity of the pharmaceutical industry in India is that on one hand it provides a huge market for global and domestic companies but on the other hand it also provides cost arbitrage for manufacturing and Research and Development (R&D) activities.

Consequently, the industry has significant commercial transactions such as building manufacturing facilities, success fee/milestone based collaborative arrangements, contract providing or hedging exposure to currency risk, structured funding arrangements, etc.

Some of the important aspects of ICDS at a glance

- Effective from financial year beginning on or after 1 April 2015
- Meant for computation of taxable income; taxpayers not required to maintain separate books of accounts
- In case of conflict between the provisions of the IT Act and ICDS, the provisions of the IT Act shall prevail
- Transitional provisions provided in each standard to facilitate first time adoption and consideration of the resultant impact
- Certain differences exist between the principles used in ICDS (which are currently based on existing Accounting Standards (AS)), and the impact of Ind AS would require separate evaluation
- Standards on ‘Leases’ and ‘Intangible assets’ are currently being developed
- ICDS should not have an impact on Minimum Alternate Tax (MAT) computation
- Tax audit and tax return related forms would require modifications.

After a lot of preparatory work and deliberation, the Ministry of Finance vide Notification No. 33/2015 dated 31 March 2015 issued 10 ICDS operationalising a framework for computation of taxable income under the head ‘Profits and gains from Business and Profession’ and ‘Income from Other Sources’. The ICDS are applicable to assesses following the mercantile system of accounting.
Basis our understanding of the pharmaceutical industry and depending upon the nature of operations of companies, we believe that the probable impact of each ICDS on the industry may be summarised as below:

**High**
- ICDS IV Revenue recognition
- ICDS IX Borrowing costs
- ICDS VI The effects of changes in foreign exchange rates

**Medium**
- ICDS I Accounting policies
- ICDS II Valuation of inventories
- ICDS X Provisions, contingent liabilities and contingent assets

**Low**
- ICDS VII Government grants
- ICDS V Tangible fixed assets

**Not applicable**
- ICDS III Construction contracts
- ICDS VIII Securities

Source: KPMG in India Analysis
In this article, we have discussed ICDS on revenue recognition, ICDS on the effects of changes in foreign exchange rates and ICDS on borrowing costs and summarised certain key impacts of other ICDS.

ICDS IV – Revenue recognition

This ICDS deals with the basis for recognition of revenue arising in the course of the ordinary activities of a person from the sale of goods, from the rendering of services, or from the use by others of the person’s resources yielding interest, royalties or dividends.

As per ICDS IV, revenue from sale of goods should be recognised upon transfer of significant risks and rewards of ownership, and when there is reasonable certainty of its ultimate collection. It appears that to the extent of revenue from sale of goods, ICDS is not materially different from the current AS.

With respect to revenue from rendering of services, ICDS IV states that revenue should be recognised by using the percentage completion method, whereas AS 9, Revenue Recognition permits recognition of revenue from service transactions either by the proportionate completion method (percentage completion method) or by the completed service contract method. It is clear that ICDS IV does not permit adoption of any method for revenue recognition other than the percentage completion method. Further, the transitional provisions of ICDS IV requires the management to consider cumulative catch-up of revenue after the date of transition for all contracts undertaken on or before 31 March 2015, but not completed by the said date.

The activities of the pharmaceutical industry include rendering of various services including R&D services. Considering the varied and distinctive nature of service agreements involving product development, etc. the pharmaceutical companies opt to recognise revenue for accounting purposes based on milestones achieved (percentage completion method) or completed service contract method for certain type of contracts, since it may not be reasonably possible to assess the stage of completion for such contracts. Introduction of ICDS IV is likely to pose a challenge for such companies that are using completed service contract method as they would have to assess the stage of completion with reference to percentage of completion to recognise revenue for income tax purposes.
**ICDS VI – The effects of changes in foreign exchange rates**

Foreign exchange fluctuation could significantly impact the bottom line financial performance of pharmaceutical companies owing to substantial import/export transactions.

This ICDS deals with the treatment of transactions in foreign currencies, translating the financial statements of foreign operations and treatment of foreign currency transactions in the nature of forward exchange contracts (including foreign currency option contracts or other similar financial instruments). However, this ICDS does not deal with hybrid derivative instruments such as currency/interest rate swaps.

There appears to be no apparent difference in the treatment of transactions in foreign currencies, classification, translation and recognition of exchange differences of foreign operations between ICDS VI and AS 11, The Effects of Changes in Foreign Exchange Rates, except that as per ICDS VI, exchange differences arising on translation of non-integral foreign operations should be recognised as income or expense in that year, whereas as per AS 11, the same should be accumulated in a foreign currency translation reserve until the disposal of the net investment. The treatment prescribed under ICDS in relation to recognition of exchange differences and translation of non-integral foreign operations has been made subject to Section 43A of the IT Act and Rule 115 of the Income tax Rules.

On certain occasions, pharmaceutical companies have branches and it would have to evaluated whether or not they function on an independent basis i.e. qualify as non-integral foreign operations or integral foreign operations. Thus, an assessee would need to make a careful assessment of classification of foreign operations which may accordingly require adjustments in the computation of its taxable income.

ICDS VI further states that any premium or discount arising at the inception of forward exchange contracts entered into to hedge the foreign currency risk of existing assets and liabilities should be amortised as an expense or an income over the life of the contract and exchange differences/differences on renewal or cancellation should be recognised as income or expense for the year. This is in line with the requirements of AS 11. However, with regards to all other forward contracts including those intended for trading or speculation purposes, hedging the foreign currency risk of a firm commitment or a highly probable forecast transaction (which are not governed by AS 11), ICDS VI states that premium/discount and exchange differences relating to the same should be recognised at the time of settlement. Further ICDS prescribes that accounting for foreign currency option contracts and other similar contracts should be similar to forward exchange contracts. On the other hand an announcement of the Institute of Chartered Accountants of India in this regard requires the same to be marked-to-market and the resultant exchange losses to be recognised in the statement of profit and loss for the period and gains should be ignored, keeping in view the principle of prudence as enunciated in AS 1, Disclosure of Accounting Policies.

Pursuant to the fact that inbound and outbound foreign currency transactions constitute a substantial portion in the pharmaceutical industry, generally companies enter into numerous long-term and short-term forward contracts to hedge the risk of foreign exchange fluctuations. As summarised above, this may lead to dissimilar treatment of premium or discount arising at the inception of forward exchange contracts in accounting books and tax books.

**ICDS IX – Borrowing costs**

Typically, the capital structure of pharmaceutical companies in India is highly leveraged by borrowings which constitute a significant portion for financing their business. This is often driven by huge capital expenditure requirements which form one of the integral parts of the pharmaceutical industry. ICDS IX eliminates the minimum period criterion for classification as a qualifying asset except for inventories. Capitalisation of borrowing cost under ICDS may increase as larger number of assets would now come under the ambit of qualifying assets.

ICDS IX also requires commencement of capitalisation of borrowing cost to be earlier than that stated in AS 16, Borrowing costs and would cease only when the asset is put to use, resulting in higher capitalisation of borrowing cost. Also, ICDS IX has introduced a new formula for capitalisation of borrowing cost on general borrowings which involves allocating the total general borrowing cost incurred in the ratio of average cost of qualifying assets on the first day and last day of the previous year and the average cost of total assets on the first and last day of the previous year.

Under ICDS, income from temporary deployment of unutilised borrowed funds would not be deducted from the borrowing cost to be capitalised. Rather, these will be treated as income. Further, AS 16 requires that capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted. However, this requirement has not been carried over under ICDS.

Accordingly, deduction of borrowing costs as expense for computation of taxable income may reduce as higher amount of borrowing costs would get capitalised which could result in significant difference between accounting income and taxable income for the year.

**Other impact areas**

- Standard cost method for the measurement of cost of the inventories is not permitted
- Fair value of a tangible fixed assets acquired in exchange would be the actual cost of assets received
- ICDS does not permit the capital approach for treatment of government grants
- Mandatory ‘bucket’ approach (i.e. to be assessed category wise and not for each individual security) for valuation of securities held as stock-in-trade at lower of cost or net realisable value (NRV).
- Recognition of contingent assets to be done when the inflow of economic benefit is reasonably certain
- Provisions to be recognised as per the yardstick of ‘reasonable certainty’ of outflow of economic resources as against ‘probable’ outflow of resources as prescribed under AS 29, Provision, Contingent Liabilities and Contingent Assets. Provision for losses on onerous contracts are disallowed.
Conclusion

Considering the nature of transactions in the pharmaceutical industry, ICDS are expected to result in numerous adjustments to accounting income to compute the taxable income, which may warrant the need to maintain additional set of records. Further, the taxable income of a pharmaceutical company may be visibly delinked from its accounting income.

Recently on 26 November 2015, the CBDT has requested the stakeholders as well as the general public to share the issues and challenges they face while implementing the ICDS. The period for inviting these suggestions/comments ends on 15 December 2015.

This is a welcome step by the CBDT as the adoption of ICDS has raised many implementation challenges for companies. Therefore, all stakeholders should consider providing their inputs to the CBDT, so that the required changes and clarifications are incorporated in an efficient and timely manner.
Export benefits to pharmaceutical sector

This article aims to:
- Provide an overview of the various regulations affecting the export benefits to pharmaceutical sector.
India has carved a niche for itself in the pharmaceutical space, being one of the top generics pharmaceutical player in the world with significant exports. India offers excellent quality at competitive prices, making it a preferred choice for sourcing pharmaceutical products.

The pricing of export oriented products depends on the taxes which form part of the cost structure. While the export transactions per se do not bear indirect taxes, the procurement of goods and services for the manufacturing activity or the Research and Development (R&D) activity is subject to various taxes that has a bearing on the price of the goods and services exported. The present indirect tax structure in the country has its inherent inefficiencies which adversely impacts the price of the final product manufactured and exported. For example: no credit is available on the goods procured on an interstate basis, inverting the duty structure for pharmaceutical products leading to accumulation of credits.

The government over a period of time has introduced various benefits to incentivise exporters of pharmaceutical products, which has had helped in reducing costs on account of the indirect taxes involved. These benefits are typically provided through the Foreign Trade Policy (the FTP) issued by the Ministry of Commerce and Industry or through various notifications issued by the Ministry of Finance.

The FTP lays down various policies and schemes for the import and export of goods, which is renewed every five years. The schemes laid down by the FTP are in the nature of duty remission or duty exemption schemes that allow an exporter of goods to procure goods duty free subject to the fulfillment of export obligations prescribed.

This has a significant impact on reducing the cost of manufacture as the basic customs duty applicable on import of goods always forms part of the cost. Similarly, the additional duties payable on the import of goods as well as the excise duty on local procurement of goods, though available as credit to the manufacturer, impacts the cash flow, till the credit is utilised against the tax payable.

The FTP 2009-14 which was in force up to 31 March 2015 laid down a host of schemes for exporters of goods and services. These rewards were offered in terms of a duty credit scrip which can be used by the exporter (including its group company) for payment of duties on procurements. Some of these schemes were:

**Served From India Scheme (SFIS)**

The objective of SFIS was to accelerate growth of services so as to create a powerful and distinctive 'Served From India' brand, recognised world over. Benefits under this scheme was available to service providers located in India, who were providing notified services at the rate of 10 per cent of the net foreign exchange earned.

The SFIS has been a matter of litigation, with the Bombay High Court recently holding in his ruling in case of Shri Naman Hotels Pvt Ltd vs The Union of India and Others dated 17 August 2015 that the purpose and intent of granting a SFIS license was for promoting an Indian Brand projecting a Unique Indian Identity and commanding respect and recognition world over. Thus, the SFIS benefit is sought to be denied for an established foreign brand. As a result of this, the authorities are in the process of issuing notices to companies promoting a foreign brand and availing the benefits of SFIS for its imports.

**Focus Market Scheme/Focus Product Scheme/Market Linked Focus Product Scheme**

Various schemes were prescribed for exporters of goods either on the basis of export of specified goods or export to specified markets or export of specified goods to specified markets. The benefits available ranged from 2 to 5 per cent of FOB value of exports.

These scrips (other than SFIS) were allowed to be sold in the market and the duty debited to the scrip was adjustable as CENVAT Credit or as drawback.

Besides the above, a Market Access Initiative scheme was also prevalent that allowed exporters of pharmaceutical products to claim reimbursement of expenses/charges for fulfilling statutory requirements in the buyers’ country, which includes registration charges, clinical trials, data validation, etc.

Under this scheme benefit was available for upto 50 per cent of the charges/ expenses subject to a total ceiling for each exporter upto INR50 lakhs per annum.

The above mentioned schemes available to the exporter of goods and services under the FTP 2009-14 was revamped with the issuance of the new FTP 2015-20 applicable for exports from 1 April 2015. Scrips issued prior to commencement of FTP 2015-20, i.e. prior to 1 April, 2015 continue to be valid for the purpose and duration for which such scrip was issued.

Accordingly, SFIS was converted into the Service Exports From India Scheme (SEIS) and the above mentioned schemes related to goods were converted into the Merchandise Exports from India Scheme (‘MEIS’).

**SEIS**

Under the SEIS, benefits in the range of 3 to 5 per cent of the net foreign exchange earned from notified services are available as a duty credit scrip. The net foreign exchange earned is net off of total expenses/payments/remittances of foreign exchange relating to the service sector. As per this definition, it can be inferred that even if there is no actual outflow of foreign exchange the same can be considered for the computing the net foreign exchange.

Also, as against FTP 2009-14, the scope of the definition of service providers has been widened to include Indian Service Providers (ISP) supplying:

a. Service from India to other country (Cross Border Trade)

b. Service from India to consumer of any other country (Consumption abroad)

c. Service through commercial/ physical presence in other country (Commercial presence)

d. Service from India through the presence of natural persons in any other country (presence of natural persons).

---

Further, as in case of the current litigation pertaining to SFIS as mentioned above, there is no requirement under the new FTP 2015-20 to promote Indian brands only.

Majorly pharmaceutical companies are engaged in the export of technical testing and R&D services which are covered in the list of notified services. Further, a detailed description of the services eligible for benefit under SEIS is provided in the Central Product Classification (CPC) Code.

MEIS

Under MEIS, duty credit scrips are granted to exporters of notified goods to notified markets (countries are categorised into three groups i.e. A, B and C in Appendix 3B of MEIS schedule). The rate of reward for export of pharmaceutical products ranges from 2 percent to 5 per cent of the FOB (free on board) value of exports (as per shipping bills) or FOB value of exports realised in free foreign exchange, whichever is lower.

The list of counties eligible for benefit under MEIS extended to developed countries such as U.S., U.K., Canada, France, Germany, Finland, Denmark, Spain, Egypt, China, Hong Kong, etc. which were not eligible under the erstwhile FMS and MLFPS schemes. This MEIS benefit is not available for certain categories of exports/sectors, such as:

- Supplies made from DTA units to SEZ units
- Deemed exports or exports through trans-shipment
- Products of SEZ/EOU/EHTP etc. exported through DTA
- EOU/STP/EHTP/BTP who are availing direct tax benefits / exemptions
- Exports made by units in FTWZ.

With the boom in the e-commerce business, the FTP has extended the MEIS benefit to exports through courier or foreign post office using e-commerce upto FOB value of INR 25,000 per consignment.

The said duty credit scrips can be used for:

- Payment of customs duty on import of inputs/goods excluding specified goods available in case of import of capital goods under lease financing
- Payment of excise duty on domestic procurement of inputs and capital goods
- Payment of service tax on procurement of local services
- Payment of custom duty in case of default in fulfillment of ‘export obligations’ (EO) under the Advance Authorization and Export Promotion Capital Goods schemes
- Payment of composition fee, application fee, etc.

Such taxes paid by debiting the duty credit scrips can be adjusted as CENVAT credit or Duty drawback. Also, as against the provisions under FTP 2009-14, wherein SFIS was not transferrable, under FTP 2015-20 duty credit scrips under SEIS and MEIS are freely transferrable.

The applications for the above benefits if made after the expiry of last date for submission, can be made upto two years from the last date prescribed subject to the late cut fees as stipulated.

Besides the above, there are schemes which allow duty free procurement of goods subject to fulfillment of export obligations. This includes the Advance Authorization (AA) and the Export Promotion Capital Goods (EPCG) schemes.

Under the AA scheme, duty free import of inputs is allowed with a pre-condition attached of physically incorporating the said inputs in the export product with a minimum value addition prescribed. The export obligation under the said license is to be fulfilled within 18 months from the date of issue. The holder of AA can also procure inputs from an indigenous supplier in lieu of direct import.

For obtaining AA in relation to pharmaceutical products, for which the import of certain raw-materials are subject to non-infringing process, the regional authority may be referred to approve the input combination permitted for export of the said pharmaceutical products based on the certificate provided by the Chartered Engineer (Chemical). For such imports and exports of drugs Standard Input-Output Norms (SION) should not apply. Further, the DGFT may impose pre-import conditions for import of drugs from un-registered sources.

Under the EPCG scheme, capital goods (other than second hand capital goods) is allowed to be imported duty free, subject to an export obligation equivalent to six times of duty saved to be fulfilled in six years reckoned from the authorisation issue-date.

Exporters of goods can also claim a duty drawback wherein the taxes paid on inputs and input services can be claimed by the exporter subject to fulfillment of conditions prescribed by the customs authorities.

STPs/EOUs/SEZs

The Ministry of Commerce also allows companies to set up units in STPs/EOUs/SEZs, for which duty free procurement of goods is allowed. While no service tax is applicable on services rendered to SEZs (subject to issuance of prescribed Form A2), STPs/EOUs are eligible to claim refund of service tax paid on services procured.

Lastly, to promote free global trade of goods and services government of India has entered into Free Trade Agreements (FTA) with various countries like China, Malaysia, Thailand, etc. The FTAs opened markets for the trade of pharmaceutical products by reducing the trade tariffs thereby imposing concessional import duties.

Though there are certain practical difficulties in obtaining the scrips and refunds, they are mostly at an administrative level; the incentives offered to the exporters of pharmaceutical products does assist in reducing the cost of manufacture. Further, the ‘Make in India’ initiative of the Prime Minister has given an added boost for the manufacturing sector in India, which further gives an impetus to the export market in the country.
Accounting treatment

While there are a host of benefits available to pharmaceutical companies, in addition to the administrative prerequisites, there are various aspects that may need deliberation while accounting for export incentives including:

- What should be the timing of recognition – at the time of export of services, receipt of license or at the time of actual utilisation of credit
- How should unutilised/unrealised credits be treated
- What should be the treatment of these credits at the time of utilisation against purchase of capital goods or materials, etc.

These matters were also considered by the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI). The EAC noted that even though the entitlement received under many of the schemes do not strictly fall within the definition of the term ‘revenue’, as defined under Accounting Standard (AS) 9, Revenue Recognition, issued by ICAI, such duty credit entitlement is of the nature of revenue and accordingly, it should be recognised as ‘other income’ in the books of account provided the conditions for recognition of revenue are satisfied (other operating income in line with Schedule III of the Companies Act, 2013).

According to AS 9, ’9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.’

Keeping in view the above mentioned revenue recognition principle of AS 9, the EAC is of the view that the credit under the Scheme should be recognised only at the time when and to the extent there is no significant uncertainty as to its measurability and ultimate realisation, i.e., utilisation of the credit under the scheme. The assessment of the level of uncertainty is a matter of judgement based on the facts and circumstances of each case on considering factors, such as, utilisation of duty credit within the specified period as evidenced by the existence of a binding contract for purchase of allowable specified goods against which the duty credit can be utilised; the expected cost of purchase of the imported allowable specified goods vis-à-vis the cost thereof in the domestic market; etc. Events occurring between the balance sheet date and the date on which the financial statements are approved by the governing authority may also remove the uncertainty about the utilisation of the duty credit, e.g., imports are made after the balance sheet date but before the approval of the financial statements by the governing authority, against which the duty credit has been utilised. It is not necessary that uncertainty regarding measurement and utilisation of duty credit is removed only on actual utilisation of the credit, i.e., at the time when the import of specified goods is made. Thus, in the view of the EAC, the entity should recognise the duty credit entitlement in the statement of profit and loss as its ‘other income’ on the above basis, by debiting the ‘duty credit entitlement account’ and crediting the statement of profit and loss.

At the time of purchase of fixed asset or spares, etc. such credit entitlement should be adjusted against the duty payable on the import of these items. The capital items/stores and spared procured should be recorded at the value inclusive of the customs duty payable thereon whether by way of cash or by way of adjustment of the duty credit entitlement.

1. EAC Opinion, Volume no. XXVI, Query no. 1.25 Recognition of duty credit entitlement under ‘Served from India Scheme’ and Query No. 1.32 Recognition of Duty Credit Entitlement Certificates issued under the ‘Served from India Scheme’
GST – A sweet pill for the Indian pharmaceutical sector

This article aims to:

– Provide an overview of the impact of proposed Goods and Services Tax (GST).
– Highlights some of the key impact areas for the sector.

‘GST is only a question of time’ said Mr. Arun Jaitley, the Finance Minister in an World Economic Forum India Economic Summit held in New Delhi on 4 November 2015.

This evidences the fact that the implementation of the GST is one of the top most priorities for the government. Though, the government has set an optimistic deadline of implementing GST from 1 April 2016, the pre-requisite for GST, i.e. the 122nd Constitutional Amendment Bill is yet to be cleared in the Rajya Sabha and thereafter by at least 50 per cent of the state assemblies.

On the other hand, however, the industry has geared up to accept GST as a reality and is analysing its impact on business. The Indian pharmaceutical industry, like other trades, is eyeing GST as a favourable tax regime which may eliminate the cascading effect of taxes and other anomalies of the present indirect tax structure in the country.
The pharmaceutical business is currently burdened with multiple taxes at the central, state and municipal levels, which are as stated below:

- **Central level:** Basic and additional customs duties on imports, central excise duty on manufacture, excise duty under the Medicinal and Toilet Preparations (Excise Duties) Act, 1955 on manufacture, and service tax on provision and receipt of services.

- **State level:** Value Added Tax (VAT)/Central Sales Tax (CST) on the sale of goods, entry tax levied on entry of goods into the state and electricity duty on the consumption of electricity.

- **Municipal level:** Octroi/local body tax.

Under GST, a simplified tax structure is proposed by way of levy of a Central GST (CGST) and State GST (SGST) simultaneously on the supply of goods and services. An Integrated GST (IGST) would be levied on interstate supplies. Thus, many of the above mentioned central/state/municipal level taxes would be subsumed by GST, with the exception of basic customs duty and electricity duty. GST is expected to bring with itself a considerable reduction in tax cost by removing the anomalies of the current indirect tax structure. But, it also has a few areas of concern for the pharmaceutical sector.

### Impact of a higher GST rate on profit margins

Currently, the tax rates on pharmaceutical products are on the lower side, with an excise duty rate at six per cent (levied on the Maximum Retail Price (MRP) less a prescribed abatement) and a VAT rate at five per cent, giving an effective tax rate of around nine per cent. Certain important life-saving drugs are exempt from excise duty and VAT.

Under GST, pharmaceutical products may be subject to a lower rate (which could be in the range of 12 per cent, i.e. six per cent CGST and six per cent SGST), thereby increasing the tax rate from the current effective tax rate. In case a higher GST rate is proposed, it would increase the price of these products significantly, thereby impacting the end consumer. Where prices are controlled and the MRP cannot be increased, the impact on margins on account of the higher tax rates would have to borne by the companies.

### Shift from MRP based valuations to transaction value under GST

The products in the pharmaceutical industry are subject to an excise duty as well as VAT (in some states) on the MRP basis. As a result, excise duty is paid on the MRP (less a prescribed abatement) and VAT is also paid as a function of the MRP. Such an approach, may not be relevant under GST, as both the central government and the state governments may have the powers to levy GST on every transaction in the value chain. Thus, the MRP basis of taxation might be redundant forcing pharmaceutical companies to relook their pricing policies taking into account the higher tax rates and the available credits under GST.

### Can GST resolve the inverted duty structure

Currently, excise duty at six per cent is applicable to pharmaceutical products while the inputs for manufacturing the products, i.e. the Active Pharmaceuticals Ingredient (API) attracts excise duty at 12.5 per cent. Such an inverted duty structure has resulted in a huge accumulation of differential CENVAT credit for the manufacturers not engaged in export, as there is no refund mechanism for liquidating the accumulated CENVAT credit under the current regime.

Under GST, if a single rate is proposed for all goods (other than those exempted), the rate for an API and the finished formulations is expected to be at par, thereby resulting in no accumulation of credit.

However, if the APIs are subject to a higher GST rate as compared to the finished formulations at a lower GST rate, the problem of an accumulated GST credit may continue and, in fact, could further increase due to higher rates. This might impact the cash flows, unless mechanisms for liquidating the unutilised credits by way of refunds are provided.

### Cross credits under GST

Another favourable feature of GST is the availability of cross credits across goods and services used in the manufacture/sale of pharmaceutical products. Currently, cross credits of VAT on purchase and CENVAT on inputs, capital goods and input services are not available. Also, for those players in the industry who are merely involved in trading of pharmaceutical products, the credit of service tax paid on input services such as advertising and marketing, logistics, etc. (which incur huge costs) is currently not available as set-off against VAT on the sale of goods.

However, going forward, the GST legislation may govern the sale and manufacture of goods, as well as the provision of services. Hence, there may be no restrictions on cross credits between goods and services.
Implications on the loan-licensee model under the GST regime

Currently, the loan-licensee model for manufacturing of drugs is common in the pharmaceutical sector. The job worker manufactures the drugs as per the specifications provided and sends the finished products back to the principal for further manufacture/sale or delivers the same as per the instructions of the principal, wherein the excise duty is discharged by the job worker or the principal manufacturer as the case may be. Since the activity undertaken by the job worker amounts to manufacture, it is out of the purview of service tax and as there is no sale of goods from the job worker to the principal, VAT is not applicable on the said transaction.

However, under GST, the tax treatment for such supplies to and from the job worker would be different. The job worker charges would be subject to GST, the credit of which would be available to the principal. However, the movement of goods to a job worker in another state would have to be evaluated in light of the one per cent additional tax to be applicable on interstate supplies.

There may also be situations wherein goods have been supplied to the job worker in the current regime but the same are received back from the job worker in the GST regime. In such cases, GST would be applicable on the processing charges (which is today included in the value on which excise duty is paid), though credit of the same would be available to the principal. Also, the impact of one per cent additional tax on the movement of goods by the job worker in one state to the principal/buyer in another state may have to be evaluated.

Discontinuance of CST and its impact on supply chain

As the GST would subsume CST, the current CST cost (of two per cent) on interstate purchases borne by the pharmaceutical companies due to the non-availability of credit on CST paid, would henceforth not be a burden, since IGST would be applicable on interstate supplies and would be available as a set-off. Similarly, in the case of intracompany stock transfers, the administrative hassles relating to declaration forms would come to an end since all stock transfers would attract IGST to which a set-off would be admissible. However, the one per cent additional tax proposed on interstate supplies for a period of two years could continue to be a cost.

As credit of the IGST on interstate transactions would be available, India may become a common market and the decision to sell goods on an interstate basis might not be governed by tax laws, but purely on commercial parameters. Currently, the pharmaceutical industry has a huge network of warehouses whereby stock is transferred from manufacturing locations to the warehouse in another state, and thereafter sold to the local vendors. All this is done possibly to avoid the levy of CST on interstate sales. While this structure allowed pharmaceutical companies to mitigate the CST cost, it also increased the procedural hassles in terms of the non-availability of statutory forms on time (against stock transfers) and restricted the free movement of goods across different states due to state check posts and waybill requirements. This has led to several disputes with tax authorities in various states and continues to be a pain point for many companies even today.
However, going forward, under GST regime, IGST would be applicable on all interstate supplies and would be available as credit to the buyer. This may allow the pharmaceutical sector to enhance its warehouse network without being affected by the indirect tax structure in the country. The only consideration would be to weigh the costs involved in the transportation or meeting the demand on time and the one per cent additional tax for a period of two years, for which no credit would be available.

Also, with GST being applicable on stock transfers, there may be no requirement of Form F, thus reducing the procedural hassles.

**Area based exemptions likely to be converted to refund schemes**

The various area-based exemptions in certain states (such as Himachal Pradesh, Jammu and Kashmir, Sikkim, etc.) wherein pharmaceutical companies enjoy tax exemptions/incentives from excise duty and VAT, may be converted into refund schemes under the GST, so as to not break the GST chain. This will have an impact on the cash flow and pricing, unless the benefits of refunds are passed on to the customers. The pharmaceutical sector should ensure that the proposed GST legislation provides for refunds schemes for the existing hubs so that they do not get impacted and continue to get the agreed benefits.

**Transitional provisions for carry forward of credits**

The pharmaceutical sector also needs to watch out for the transitional provisions for carrying forward credits available as on the effective date of the implementation of GST. The accumulated CENVAT credit due to the inverted duty structure and the unutilised VAT credits availed in the current indirect tax regime, but not utilised should be allowed to be carried forward and set-off against the GST payable.

**Preparedness for GST**

In order to foster a smooth transition to GST, companies need to upgrade their IT infrastructure with the active involvement of the supply chain, procurement, accounts and tax departments. Also, there is a need to redesign the supply chain network, warehousing network, and the sourcing pattern also to compare the benefits of in-house manufacturing vis-à-vis an outsourcing model.

Creating awareness with key stakeholders such as suppliers, distributors and internal stakeholders may also have to be undertaken so that they are kept informed of the plan and progress on the GST implementation initiative of the company.

As pharmaceutical companies look forward to revenue growth on one side and the need to reduce costs on another, GST offers a great opportunity to revisit their supply chain and distribution strategy to develop an agile, customised and cost-efficient supply chain.

Companies need to act now to assess the impact of GST on their businesses and functions, and accordingly develop an action plan and road map for the future.

As mentioned by Mr. Arun Jaitley at the World Economic Forum India Economic Summit ‘Obstruction to GST cannot be indefinite. Expect GST to become a reality soon’, the pharmaceutical industry needs to gear up and be ready to accept GST as and when implemented.
This article aims to:

- Provide an insight into the tax deductibility of expenses incurred towards providing freebies to medical practitioners by the pharmaceutical and allied health sector industry.

There has been a debate on the issue of tax deductibility of expenses incurred while providing freebies to medical practitioners by the pharmaceutical and allied health sector industry. This debate has primarily arisen on account of the Central Board of Direct Taxes (CBDT) circular wherein it has been specified that such an expenditure will not be allowed as a deduction under the provisions of Section 37(1) of the Income Tax Act, 1961 (IT Act).
Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 (MCI Regulations)

The Medical Council of India (MCI) governs the professional code for doctors in India. It issued the MCI Regulations stipulating the guidelines relating to the professional conduct, etiquette and ethics for registered medical practitioners. These regulations were made more stringent on 10 December 2009, wherein medical practitioners were not allowed to receive, inter alia, any gift, travel facility, hospitality, cash or monetary grant from the pharmaceutical and allied health sector industries.

Expenses claimed under the IT Act

Section 37(1) of the IT Act provides for the deduction of any revenue expenditure in the computation of business income, if such an expense is laid out or expended wholly or exclusively for the purpose of business or profession.

However, as per the Explanation to Section 37(1) of the IT Act, a claim of any such expense would not be allowed, if the same has been incurred for a purpose, which is either an offence or prohibited by law.

The CBDT issues a circular disallowing the expenditure incurred on medical freebies

The CBDT issued a circular1 on 1 August 2012 stating that the claim of any expense for providing any gift, travel facility, hospitality, cash or monetary grant or similar freebies to medical practitioners in violation of the provisions of the MCI Regulations, would be an inadmissible expenditure under Section 37(1) of the IT Act, being an expense prohibited by law. This disallowance would be in the hands of the assessee who is engaged in the pharmaceutical or allied health sector industry.

The CBDT also stated that a sum equivalent to the value of freebies enjoyed by the aforesaid medical practitioner or professional association would be taxable in the hands of the medical practitioners as ‘business income’ or ‘income from other sources’, as the case may be, depending on the facts of each case.

The Himachal Pradesh High Court upholds the validity of the CBDT circular

In pursuance to the CBDT circular, the Confederation of Indian Pharmaceutical Industry (an apex body for small-scale manufacturers of drugs and pharmaceuticals) filed a writ petition in the Himachal Pradesh High Court challenging the validity of the CBDT circular.

The Himachal Pradesh High Court2 held that the MCI Regulations are statutory regulations which are issued in the interest of the patients and the public at large.

The court observed that there has been an increase in the number of complaints that medical practitioners do not prescribe generic medicines and instead prescribe branded medicines in lieu of the gifts and other freebies granted to them by some pharmaceutical companies.

It accordingly upheld the validity of the CBDT circular and held that any act prohibited under the MCI Regulations would amount to an act prohibited by law.

The court also held that if the assessee satisfies the assessing authority that the expenditure is not in violation of the regulations framed by the MCI, then it may claim a deduction of such expenses.

An alternate perspective

As per an alternate view, expenditure incurred in providing medical freebies to medical practitioners are allowable as a deduction on account of the following lines of reasoning:

- The MCI Regulations are applicable only to doctors and their professional associations, and have no relevance or force of law to the pharmaceutical companies. In other words, the said regulations are binding only on medical practitioners and not on pharmaceutical companies. Accordingly, the MCI Regulations should not be regarded as a ‘law’ as far as pharmaceutical companies are concerned and hence, the expenses incurred by such pharmaceutical companies cannot be disallowed under Section 37(1) of the IT Act.

- The CBDT circular is binding on the tax authorities only and is not mandatory for the assessee; and accordingly it is possible for the assessee to make claims to the contrary.

Recent development

Uniform Code for Pharmaceuticals Marketing Practices (UCPMP)

On 12 December 2014, the Department of Pharmaceuticals in the Ministry of Chemicals and Fertilizers (referring to its letter dated 19 March 2012) enclosed a copy of the UCPMP with the intention to provide a uniform code and encourage good marketing practices by the pharmaceutical companies. The UCPMP was to be voluntarily adopted w.e.f. 1 January 2015 for a period of six months. This period was extended further for two months till 31 August 2015 and has now been further extended by four months till 31 December 2015.

If the UCPMP is made mandatory and its non-compliance is made to be an offence, or if the provision of freebies to medical practitioners by pharmaceutical companies is expressly made to be prohibited by law, then, expenditure on such freebies would be inadmissible under Section 37(1) of the IT Act.

---

1. Circular No. 5/2012 [F. No. 225/142/2012-ITA.II], dated 1 August 2012.
2. CWP No. 10793 of 2012-J.
Regulatory updates
The IRDA provides an update on implementation of Ind AS in the insurance sector

**Background**

The Ministry of Corporate Affairs (MCA) through its notification dated 16 February 2015 laid out a road map for the prescribed class of companies other than insurance companies, banking companies and Non-Banking Finance Companies (NBFCs) for the implementation of Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS).

Recently on 29 September 2015, the Reserve Bank of India (RBI) through its Fourth Bi-monthly Monetary Policy Statement, 2015-16 also informed its stakeholders that it has recommended to the MCA a road map for the implementation of Ind AS for banks and NBFCs from 2018-19 onwards. The RBI constituted a working group (under the chairmanship of Shri Sudarshan Sen) to examine issues relating to Ind AS application by banks and NBFCs and the report of this working group has been opened up for comments by stakeholders till 30 November 2015.

**New development**

The Insurance Regulatory and Development Authority of India (IRDA) through its order dated 17 November 2015 stated that the insurance sector in India would be converging with IFRS after the issuance of the revised standard on insurance contracts i.e. IFRS 4, Insurance Contracts by the International Accounting Standards Board (IASB). Currently, IFRS 4 is being deliberated by the IASB and a final standard is expected to be issued in 2016.

In order to prepare the Indian insurance sector towards convergence with Ind AS, the IRDA has constituted an implementation group (under the Chairmanship of Smt. V.R Iyer) to lay down the road map for the convergence.

**Next steps**

The implementation group will examine the implications of implementing Ind AS, address the issues and facilitate formulation of operational guidelines to converge with Ind AS in the Indian insurance sector. The terms of reference for the implementation group are as under:

- Review the applicability of Ind AS notified by MCA
- Study the impact of Ind AS on the insurance sector
- Identify issues involved in implementation of Ind AS
- Provide a road map in addressing the IT system requirements on an ongoing basis
- Identify IRDA regulations/stipulations which need to be reviewed in the light of Ind AS implementation
- Identify legislative amendments, if any, which may be required to converge towards Ind AS
- Prepare formats for the financial statements of insurers under Ind AS
- Draft application guides/educational material to facilitate smooth convergence
- Recommend measures for capacity building among various stakeholders for implementation
- Suggest measures to deal with any other tasks related to implementation of Ind AS.

The implementation group would form sub-groups to focus on issues specific to life and ‘other than life’ insurance business. The sub-groups would be focussing on the impact and changes required on the following aspects:

- Financial statements, disclosures and audit report
- Investments
- Solvency margin.

The implementation group would be submitting its report in three months.

(Source: IRDA announcement dated 18 November 2015 and KPMG IFRS Notes: The IRDA provides an update on implementation of Ind AS in the insurance sector dated 20 November 2015)
The CBDT requests for comments on the issues/challenges for proper implementation of the ICDS

**Background**

On 31 March 2015, the Ministry of Finance (MOF) issued 10 Income Computation and Disclosure Standards (ICDS), operationalising a new framework for the computation of taxable income. All assesses are required to adopt these standards for the purposes of computation of taxable income under the heads ‘Profits and gains of business or profession’ or ‘Income from Other Sources’. The Central Board of Direct Taxes (CBDT) notified these standards under Section 145(2) of the Income-tax Act, 1961 (the Act) vide ‘Notification No. 33/2015 dated 31 March 2015. The following is the list of the ICDS notified by the CBDT:

- ICDS I relating to accounting policies
- ICDS II relating to valuation of inventories
- ICDS III relating to construction contracts
- ICDS IV relating to revenue recognition
- ICDS V relating to tangible fixed assets
- ICDS VI relating to the effects of changes in foreign exchange rates
- ICDS VII relating to government grants
- ICDS VIII relating to securities
- ICDS IX relating to borrowing costs
- ICDS X relating to provisions, contingent liabilities and contingent assets.

These standards are applicable for the previous year commencing from 1 April 2015, i.e. Assessment Year 2016-17 onwards.

**New development**

Post the notification of the ICDS, it has been brought to the notice of the CBDT by many stakeholders that further clarifications and guidance are required on certain provisions for its proper implementation. Therefore, the CBDT has raised these issues to an expert group committee comprising departmental officers and professionals. The committee is currently examining these issues.

**Next steps**

In order to issue a thorough guidance/clarification on the implementation issues, the CBDT has requested the stakeholders as well as the general public to share the issues and challenges they face while implementing the ICDS. The period for inviting these suggestions/comments ends on 15 December 2015.

(Source: CBDT Press release dated 26 November 2015 and KPMG FIRST Notes: The CBDT requests for comments on the issues/challenges for proper implementation of the ICDS dated 27 November 2015)
SEBI provides relaxation to listed entities for filing financial results under IFRS

Background
The Securities and Exchange Board of India (SEBI) on 2 September 2015 notified the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations). As per Regulation 33(1)(c) of the Listing Regulations, standalone financial results and consolidated financial results should be prepared as per the Generally Accepted Accounting Principles (GAAP) in India by the listed entity. Additionally, the listed entity may also submit the financial results, as per the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. As a result of this, the option to publish consolidated financial results as per IFRS was withdrawn. The Listing Regulations would come into force from 90 days of the notification of the Listing Regulation.

New development
Many representations were made by the stakeholders highlighting the issues arising from the implementation of the aforesaid regulation. Accordingly, SEBI, through its letter, dated 6 November 2015 has provided the following relaxation to the listed entities:

- The financial results for the quarters ending 31 December 2015 and 31 March 2016 and year ending 31 March 2016 may be filed under IFRS by listed entities which had exercised the option of preparing consolidated financial statements under IFRS for the first quarter of FY 2015-16, as per the dates specified in the Listing Regulations.
- The relaxation granted is without any prejudice to the requirements of the Companies Act, 2013 with respect to reporting of financial statements.

The MCA extends the last date for filing of annual return and financial statements forms

Background
Rule 11(1) of the Companies (Management and Administration) Rules, 2014 requires that every company should prepare its annual return in the Form MGT-7. Section 92(4) of the Companies Act, 2013 (2013 Act) requires a copy of annual return should be filed within 60 days from the date on which the Annual General Meeting (AGM) is held.

Rule 12(1) of the Companies (Accounts) Rules, 2014 requires that every company should file the financial statements with the ROC together with Form AOC – 4. Section 137 of the 2013 Act requires that every company should file such form with the ROC within 30 days of the date of the AGM.

On 13 July 2015, the MCA issued a general circular no. 10/2015 where it has clarified that the Forms AOC-4, AOC-4 XBRL and MGT-7 can be filed with the ROC till 31 October 2015 without payment of additional fees. On 28 October 2015, the MCA has further relaxed that Forms AOC-4, AOC-4 XBRL and MGT-7 can be filed with the ROC upto 30 November 2015, without payment of additional fee.

Recent development
On 30 November 2015, in continuation with above mentioned circulars, the MCA has further relaxed that Forms AOC-4, AOC-4 XBRL and MGT-7 can be filed with the ROC upto 31 December 2015, without payment of additional fee.
SEBI board meeting

The Securities and Exchange Board of India (SEBI) held its board meeting in Mumbai on 30 November 2015 and through a press release- PR No. 283/2015, notified the general public on the important decisions taken by it. Some of the important decisions/deliberations are as follows:

- Listing of stock exchanges subject to compliance of certain conditions as per the Securities Contracts (Regulation) Rules, 1957 (SECC) Regulations, 2012
- Revised guidelines for deemed public issue
- Mandatory applicability of Business Responsibility Reporting (BRR) for top 500 listed entities based on market capitalisation as on 31 March every year
- Delisting of small companies
- Initiation of public consultation paper for:
  - Disclosure requirements for issuance and listing of Green Bonds
  - Exit opportunity to dissenting shareholders under the Companies Act, 2013 (2013 Act)
  - Public issuance of convertible securities.

SEBI circulars

The SEBI has also issued various circulars dated 30 November 2015. The circulars are discussed below:

1. Scheme of arrangement by listed entities and relaxation under Rule 19(7) of the Securities Contracts (Regulation) Rules, 1957

   - Regulations 11, 37 and 94 of the Listing Regulations place obligations with respect to scheme of arrangement on listed entities and stock exchanges. The circular prescribes the key requirements for listed companies regarding:
     - Submission of documents
     - Eligibility conditions for entities seeking relaxation under rule 19(7) of the Securities Contracts (Regulation) Rules, 1957

   - Explanatory Statement/notice/proposal accompanying resolution sent to shareholders for seeking approval of scheme.

   The requirements for a scheme of arrangement, separately stating those to be met before the scheme is submitted for sanction by the court and after the scheme is sanctioned by the court, require to be availing exemptions under Rule 19(7) of the SCRR. The circular states that the SEBI has now provided an additional requirement for an auditor’s certificate to be issued for availing exemptions under Rule 19(7) of the SCRR. The circular comes into force on 1 December 2015.

2. Formats for publishing financial results

   The SEBI has prescribed the following formats for listed entities for publishing their financial results which are largely similar to the requirements of the earlier Listing Agreement:

   - Formats for presenting the quarterly financial results including segment reporting by:
     - Companies other than banks
     - Banks
   - Half-yearly statement of assets and liabilities
   - Format for limited review report and audit report.

   Additionally, some of the revised disclosure requirements as per the new circular are as follows:

   - Format of financial results to be published in the newspapers - SEBI prescribed the format for publishing financial results (Standalone/Consolidated) in the newspaper. In the previous listing agreement, the companies were required to publish a copy of the financial results in newspaper which were submitted to the stock exchange. The new format requires disclosures for key parameters such as total income, net profit, reserves, etc., to be published and referenced to the results available on the website of the stock exchange to be included.

   Comparatives under Ind AS - Companies adopting the Ind AS in terms of Companies (Indian Accounting Standards) Rules, 2015 notified by the MCA on 16 February 2015, while publishing quarterly/annual financial results under Regulation 33 of the Listing Regulations, 2015, would have to ensure that the comparatives filed along with such quarterly/annual financial results are also Ind AS compliant.

   The circular is applicable from 1 December 2015.

3. Non-compliance with certain provisions of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) and Standard Operating Procedure (SOP) for suspension and revocation of trading of specified securities

   Regulation 97 of the Listing Regulations states that recognised stock exchanges should monitor compliance by listed entities with the provisions of the Listing Regulations. The new circular of SEBI states that recognised stock exchanges should impose fines as action of first resort in case of non-compliance with the provisions of the Listing Regulations and invoke suspension of trading in case of subsequent and consecutive defaults. The circular prescribes the procedure in order to maintain consistency and uniformity of approach. The circular comes into force on 1 December 2015.

4. Disclosure of holding of specified securities and holding of specified securities in dematerialised form

   Regulation 31 of the Listing Regulations deals with the disclosure of shareholding pattern and manner of maintaining shareholding in dematerialised format. The new circular presents the specific requirements in this regard which are as follows:

   - Holding of specified securities would be divided
   - Format for disclosure of holding of specified securities is provided in Annexure I of the circular

   The circular is applicable from 1 December 2015.
The SEBI through its circular CIR/CFD/CMD/14/2015 prescribed manner of achieving minimum public shareholding as required by SCCR regulation. The methods prescribed by the circular are similar to those required under previous listing agreement except where the listed entity adopts any other method other than the mentioned are required to report to SEBI with appropriate details and SEBI is required to communicate its decision within 30 days from the date of receipt of the proposal or the date of receipt of additional information as sought from the company. The circular comes into force on 1 December 2015.

(Source: SEBI Board meeting dated 30 November 2015, SEBI circular CIR/CFD/CMD/12/2015, CIR/CFD/CMD/13/2015, CIR/CFD/CMD/14/2015, CIR/CFD/CMD/15/2015 dated 30 November 2015)

5. Manner of achieving minimum public shareholding

Regulation 38 of SEBI Listing Regulations 2015 provides that the listed entity should comply with minimum public shareholding requirements in the manner as specified by the Board from time to time. Rule 19(2)(b) and 19A of SCCR prescribes the minimum level of public shareholding required to achieve by listed entities.

On 10 April 2015, the ICAI issued an application guide to address certain practical issues arising in the implementation of Schedule II of the 2013 Act relating to depreciation related provisions. The application guide also provided examples for a better understanding of the Schedule II of the 2013 Act. As opposed to the Schedule XIV of the Companies Act, 1956 (1956 Act), post that, the ICAI in May 2015 issued a revised version of the application guide which provided an updated guidance for computing depreciation for assets working in double/triple shift.

The ICAI has now issued an Exposure Draft (ED) of the draft Guidance Note (GN) on some important issues arising from Schedule II to the 2013 Act. This GN has been issued with the objective of providing guidance on certain significant issues that may arise when companies practically implement Schedule II of the 2013 Act. Further, use of this ED would help to establish consistent practice with respect to the accounting for depreciation. Time period to give comments closed on 25 November 2015.

(Source: ICAI ED – Draft Guidance Note on Some Important Issues Arising from Schedule II to the Companies Act, 2013 dated 10 November 2015)
KPMG in India offices

Ahmedabad
Commerce House V
9th Floor, 902 & 903
Near Vodafone House,
Corporate Road, Prahlad Nagar
Ahmedabad - 380 051.
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bengaluru 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,6th Floor,
Tower – 1,Godrej Waterside,
Sector – V,Salt Lake,
Kolkata – 700091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3058 5764/65
Fax: +91 20 3058 5775

www.kpmg.com/in
KPMG in India’s IFRS institute

KPMG in India is pleased to re-launch its IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India. The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

IFRS Notes

The IRDA provides an update on implementation of Ind AS in the insurance sector

20 November 2015

Background

The Ministry of Corporate Affairs (MCA) through its notification dated 16 February 2015 laid out a road map for the prescribed class of companies other than insurance companies, banking companies and Non-Banking Finance Companies (NBFCs) for implementation of Indian Accounting Standards (Ind AS) convergence with International Financial Reporting Standards (IFRS). Recently on 29 September 2015, the Reserve Bank of India (RBI) through its Fourth Bi-monthly Monetary Policy Statement, 2015-16 also informed its stakeholders that it has recommended to the MCA a road map for the implementation of Ind AS for banks and NBFCs from 2018-19 onwards.

New developments

The Insurance Regulatory and Development Authority of India (IRDA) through its order dated 17 November 2015 stated that the insurance sector in India would be converging with IFRS after the issuance of the revised standard on insurance contracts i.e. IFRS 4, Insurance Contracts by the International Accounting Standards Board (IASB). Currently, IFRS 4 is being deliberated by the IASB and a final standard is expected to be issued in 2016.

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

SEBI provides relaxation to listed entities for filing financial results under IFRS

1 December 2015

The Securities and Exchange Board of India (SEBI) on 2 September 2015 notified the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations). As per Regulation 33(1)(c) of the Listing Regulations, standalone financial results and consolidated financial results should be prepared as per the Generally Accepted Accounting Principles (GAAP) in India by the listed entity. Additionally, the listed entity may also submit the financial results, as per the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. As a result of this, the option to publish consolidated financial results as per IFRS was withdrawn. The Listing Regulations would come into force from 90 days of the notification of the Listing Regulation.

Many representations were made by the stakeholders highlighting the issues arising from the implementation of the aforesaid regulation. Accordingly, SEBI, through its letter dated 6 November 2015 has provided following relaxation to the listed entities:

• The financial results for the quarters ending 31 December 2015 and 31 March 2016 and year ending 31 March 2016 may be filed under IFRS by listed entities which had exercised the option of preparing consolidated financial statements under IFRS for the first quarter of FY 2015-16, as per the dates specified in the Listing Regulations.

• The relaxation granted is without any prejudice to the requirements of the Companies Act, 2013 with respect to reporting of financial statements.

Follow us on:
kpmg.com/in/socialmedia

Download KPMG India apps: