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Dear Readers,

The e-commerce arena in India has witnessed very significant growth over the past few years. There is a lot of investor interest in this sector and some e-commerce businesses have been able to rapidly scale up their operations and generate a level of sales, in the space of three to five years, which has taken many traditional brick and mortar businesses decades to achieve. Amid this rapid growth, profitability has been elusive for most and there are also a number of accounting and reporting issues that are unique to this sector. Our lead feature this month highlights some of the key reporting areas in this sector.

Continuing with our ongoing series, we also examine the increases and changes in reporting responsibilities arising out of the Companies Act, 2013. In addition, we also highlight some of the key observations of the FRRB with regard to ongoing reporting practises of companies in India.

Finally, in addition to our round of regulatory developments, we also cast our lens this month on recent developments on the key matters discussed in and arising out of the 2013 AICPA conference relating to SEC and PCAOB matters.

I hope you continue to find the Accounting and Auditing Update to be a good and informative read. In case you have any suggestions or inputs on topics we cover, we would be delighted to hear from you.

Happy reading!

V. Venkataramanan
Partner, KPMG in India
Revenue recognition

e-Commerce companies often are valued based on revenue multiples and hence, it is one of their most important metrics. Revenue is an area which is susceptible to misuse and fraud. Therefore, it is subject to constant scrutiny by the regulators. This accounting issue is primarily to determine timing of revenue recognition and presentation (gross vs. net). Most of the e-commerce companies either accept payments online through credit cards, internet banking, debit cards or cash on delivery. Additionally, in most of these companies, delivery is the responsibility of the company and hence, it becomes important to determine on when does the ‘risk and rewards’ get transferred to the customer. It is to be noted that this issue is relevant for both B 2 C (Business to Consumer) or B 2 B (Business to Business) models.

One of the indicators to determine the timing of revenue recognition is to know who bears the insurance cost/ risk. In practice, many of the large e-retail companies enter into agreements with logistic providers who are willing to bear insurance cost and risk of delivery and under such contracts, companies would recognise revenue on despatch of goods from the warehouse. Sometimes, cost of delivery is built in to the pricing of the product and the cost of transport is borne by the e-commerce entity; then the risk of delivery and loss is still with the e-commerce company. In such cases, it may be appropriate to recognise revenues only once the products are delivered to the customer. Additionally, in practice, an option is given to the customers to return the goods sold; then it is important to evaluate each such offer more specifically to understand the facts and circumstances and their repercussions on accounting. Generally, 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). Due to the current legal framework in India, a B 2 B entity may not be allowed to make a sale to retail customers and is required to sell its goods to B 2 C companies. This relationship could have an impact on the presentation of revenues in the books of accounts of B 2 C and B 2 B on a gross or net basis.

Under Indian GAAP, the Technical Guide on Accounting Issues in the Retail Sector is issued by the Institute of Chartered Accountant of India (ICAI), provides guidance on presentation of revenues.
As per the Technical Guide, some of the factors that indicate that an entity is acting as a principal in transactions could include (indicative list only):

- The customer understands that the entity is acting as the primary obligor in the arrangement
- The entity is able to set the selling price with the customer
- The entity has inventory risk
- The entity performs part of the services provided or modifies the goods supplied
- The entity has or assumes the credit risk associated with the transaction.

Revenue represents the amount receivable by an entity for its own account. Therefore, for a principal, revenue should be presented at its gross amount and is measured before deducting related costs such as costs for materials and salaries. In an agency relationship, the amounts collected on behalf of and passed on to the principal is not revenue of the agent. The revenue of the agent is the amount of commission, plus any other amount charged by the agent to the principal or other parties. The principal in an agency relationship recognises the gross amount charged to the ultimate customer as revenue. Commission paid to the agent is accounted for as an expense by the principal. Determining whether an entity is acting as an agent or principal is based on an evaluation of the risks and responsibilities taken by the entity, including factors as mentioned above such as inventory risk and responsibility for the delivery of goods or services.

A common example in this field is that an e-commerce company purchases traded goods from a wholesaler. e-Commerce company generally would sell these goods to the end customer and may or may not carry the associated inventory risk as it purchases goods from the wholesaler only when it receives orders from the end customer. However, it may bear the risk of those inventory items that have been returned by the customers.

In such a scenario, the e-commerce company does not seem to bear significant inventory risk, however, it may bear the following:

- credit risk
- is primarily responsible for providing the goods to the customer, i.e., fulfilling the order
- direct pricing discretion
- discretion in selecting the supplier/wholesaler.

Therefore, in this case, the e-commerce company should reflect gross billing to its customers as its revenue.

In another example, let us assume that travel tickets are sold through an e-commerce platform, i.e., the e-commerce company is a travel agent. Travel agents sell airline tickets to the public, generally at a price determined with reference to the market rate, but often pay the airline a discounted amount. The travel agent does not bear any general inventory risk because it does not carry tickets as its inventory and buys tickets only when it receives orders or bookings from customers.

In this case, the travel agent does not bear any inventory risk, nor is it responsible for carrying out the services related to the ticket itself, because this is the responsibility of the airlines. The travel agent provides a service on behalf of various airlines and other suppliers and earns a fee. The travel agent’s revenue should reflect only the fee and not the gross amount billed to the customer.

In some cases, travel agents may bear some credit risk - e.g., when corporate customers have an account with the travel agent and settle the account only after the travel agent has paid the airline for the ticket. The fact that the agency sometimes bears credit risk is not a determining factor and does not compel the agency to reflect the gross billing as revenue.

Usually, an entity working as an agent or broker does not have an exposure to the significant risks and rewards of ownership of goods or rendering of services. An entity having exposure to the significant risks and rewards associated with the sale of goods or rendering of services is acting as a principal.
Taxation

India has a myriad of taxes. Hence, the companies operating in the e-commerce industry need to have a strong taxation team to ensure that they are in compliance with the various tax regulations.

The Internet and new communication technologies have introduced a new channel through which sales may occur. Some of the taxation challenges may arise as a result of the blurring of the distinctions between traditional commerce and commerce involving digitised products. It is a matter of debate, however, as to whether these new channels create new products. Some believe that delivery through these channels alters the character of a product to such a degree that it must be considered a wholly new product, distinguishable from that delivered through traditional channels, and therefore, should be treated as unique for tax purposes.

Direct taxation

One of the keenest legal issues related to e-commerce remains to be taxation of revenues generated on the web. Traditionally, taxing rights on business profit lies with the source country and a business is said to have a source in a country if it has a ‘Permanent Establishment’ (PE) in that country. PE by definition relies on a fixed place of business. In e-commerce, a non-resident business does not need a fixed place of business in another country. Therefore, the concept of PE is not easily applied to e-commerce. Accordingly, as e-commerce companies explore businesses across international borders, this is expected to be one of the most important issues to be dealt with regard to the taxation. It has to be noted that national governments and international organisations (like Organisation for Economic Co-operation and Development (OECD)) have responded to the challenges posed by e-commerce transactions. In India, the Central Board of Direct Taxes had constituted a High Powered Committee to discuss the taxation of e-commerce transactions. It appears that current direct tax laws (including treaties) may not be capable of addressing fully the novel issues brought on by e-commerce. Consensus is yet to emerge amongst major countries on this area.

Inter-state taxes in India

There are challenges with respect to incidence of inter-state taxes (i.e., where the tax incidence is on the end consumer like sales tax, value-added tax, etc.). For example, an e-commerce company based in Karnataka takes an order from a customer in Maharashtra, while goods are supplied from a vendor in West Bengal, the question: the inter-state taxes need to be paid by the vendor in West Bengal; or the e-commerce company in Karnataka, is not free of doubt.

The tax authorities in India do not seem to have a settled position on these issues. Companies may need to consult with their tax specialists as the tax liabilities often have to be evaluated on a case to case basis.

Inventory accounting

In the initial years of a setup, e-commerce companies that cater to retail customers and often carry significant inventory whilst focussing on increasing their revenues through aggressive customer acquisition. However, one of the key challenges for operational success is their inventory management process and ability to effectively manage a lean working capital. Such companies may have built-up inventory in the hope to achieve higher volumes, which is expected to compensate for the low margin on sales. Additionally, a constant change in product portfolio and freebies could lead to challenges in the management of the inventory records.

If an entity does not have a strong control environment to monitor its inventory, then such an entity may face a write down of inventory balances as at the reporting date. Further, ascertaining cost versus net realisable value, whichever is lower, becomes a challenge as the margins on such product portfolios are slim, which may add to the inventory write down provision.

Hence, it becomes extremely important to maintain, monitor and control inventory for an effective inventory management.
Logistics

Many companies believe that the biggest impediment is unreliable third-party logistics and delays in delivery due to poor surface transport.

It is important to have a well drafted agreement with logistics and reverse logistics providers as the following accounting aspects could have an impact:

- **Accounting for revenues:** Certain logistics providers take over the risk and rewards when such goods are collected from the companies’ warehouse, which could remove the delay and hassle of evidencing delivery for revenue recognition.

- **Mode of payment:** Certain logistics providers collect cash from the respective customers and aggregate the same and deposit it into the company’s bank account, by which the company could mitigate its risk associated with cash handling.

- **Cost recognition:** There are various ways a logistics provider is paid, per piece basis, monthly based on volumes, etc. It is critical that companies understand such arrangements as the related volume discount earned or monthly charges paid would need to be accounted appropriately.

Advertising expenses

To get customers to visit an e-commerce site and make a purchase involves heavy cost due to advertisement and marketing. This cost could continue to be significant till we see a consolidation of the e-commerce sector in India.

Considering that such advertising and marketing costs are significant, the accounting challenge around such expenses is that most companies would like to defer such costs in their financial statements. Under Indian GAAP, all such advertising expenses are recognised as an expense when it is incurred.

Other business environment related issues

Cash handling

Cash handling is one critical issue that affects most of the e-commerce companies. A lot of companies allow customers to pay cash on delivery.

Accordingly, handling of large volumes of cash, which is inherently susceptible to pilferage, can be a constant challenge. It can, however, be curtailed by effective monitoring and segregation of duties. Many companies may institute controls to ensure cash deposits are made daily with effective receipts and checklists. The aid of an effective internal audit would be critical. The company could also institute simple but effective steps like surprise cash counts, expanding cash insurance, etc. for controlling this risk.

Compliance

There are stringent compliance requirements if an e-commerce is in the business of e-retail. The Indian laws have not always kept pace with the technological advancement of the sector. Hence, it is of utmost importance that a company operating in the e-commerce space is registered with the appropriate regulatory authorities like Reserve Bank of India, etc.

Additionally, it is noted that a large number of the e-retail companies are funded by Private Equity/Venture Capitalists, who are foreign investors and hence compliance with Foreign Exchange Management Act (FEMA) is of supreme importance.

Under FEMA, e-commerce activities refer to the activity of buying and selling by a company through the e-commerce platform. Such companies would engage only in B2B e-commerce and not in retail trading, inter-alia implying that existing restrictions on FDI in domestic trading would be applicable to e-commerce as well.

Conclusion

Companies in the e-commerce sector would have to constantly monitor these challenges and watch out for relevant guidance and practice as they emerge. The companies may also have to continuously assess their accounting system capabilities, resource requirements, etc. to keep speed with changing industry, regulations.
The 2013 Act mandates preparation of consolidated financial statements (CFS) by all companies, including unlisted companies, having one or more subsidiaries, joint ventures or associates. Previously, the Securities and Exchange Board of India (SEBI) required only listed companies to prepare CFS. The CFS would be in addition to the standalone financial statements and are required to be prepared in the same form and manner as the standalone financial statements.

The 2013 Act requires CFS to be prepared even for companies who do not have any subsidiaries but only have associates and joint ventures.

Though mandating preparation of CFS is a step in the right direction to align the reporting requirements to the international reporting practices, since standalone financial statements do not present a true picture from an economic entity perspective, there could be some practical challenges as below:

- The absence of an exemption, similar to International Financial Reporting Standards (IFRS), for the intermediate holding companies if the ultimate parent company prepares CFS that are publically available, could lead to preparation of CFS at multiple levels for companies with multi-layered structures (for example, many real estate groups). Let us assume company X (ultimate holding company within a group structure) has a subsidiary (company A). Company A in turn has another subsidiary company B. In such a scenario, both company X and company A would be required to prepare consolidated financial statements under the 2013 Act. Under IFRS, company A could have availed the exemption (subject to the other conditions) if the CFS prepared by company X are publically available. The utility of CFS for companies with no public interest (for example, a private limited company with private limited subsidiaries) could be questioned.

- Absence of transitional provisions for the companies preparing CFS for the first time could pose challenges in retrospective application of the principles of consolidation, especially in computing goodwill or capital reserve.

- Interestingly, the definition of a subsidiary under the 2013 Act is different from the definition under the Indian accounting standards. The 2013 Act defines a subsidiary as an entity where the parent owns more than one-half of the total share capital, which may be different than the voting share capital considered under the accounting standards.

Cash flow statements

All companies, except small and one person companies are now required to present cash flow statement as part of their financial statements. Currently only companies other than small and medium sized companies\(^1\) are required to present cash flow statements.

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1. Small and medium sized company is defined in the Companies (Accounting Standards) Rules, 2006 issued by the Ministry of Corporate Affairs (7 December 2006)
Depreciation

Schedule II to the 2013 Act requires systematic allocation of the depreciable amount of an asset over its specified useful life unlike Schedule XIV of the Companies Act, 1956 (which specifies minimum rates of depreciation to be provided by a company). For large number of assets, Schedule II to the 2013 Act prescribes useful lives that are significantly lower than those envisaged in Schedule XIV to the 1956 Act. The reduction in useful lives of many assets would significantly impact not only the depreciation on new additions to fixed assets but also the depreciation on fixed assets existing at the date Schedule II comes into force. On transition, the carrying amount of an asset is depreciated as follows:

- Over the remaining useful life of the asset as per Schedule II of the 2013 Act
- Recognised in opening retained earnings when the remaining useful life of the asset is nil.

The 2013 Act also permits a prescribed class of companies (yet to be defined) to depreciate assets over their useful lives rather than on the specified useful lives as per Schedule II to the 2013 Act. Accordingly, such companies would have the flexibility to determine the useful lives for assets based on actual planned usage without being constrained by a regulatory-prescribed maximum life.

The 2013 Act also requires that useful life and depreciation for significant components of an asset should be determined separately. This is likely to have a significant impact for several companies that previously capitalised the total cost of an asset without distinguishing individual parts that may have a shorter useful life. While the component approach may result in accelerated depreciation in the first instance, it would also permit companies to capitalise the cost of major replacements/overhauls, which may currently be charged as period costs when incurred. This would involve considerable judgement and its potential impact on the accounting systems cannot be undermined as well.

For intangible assets, Schedule II to the 2013 Act provides that the provisions of relevant Indian accounting standards would apply.

Re-opening or revision of financial statements/board’s report

Currently, companies are generally not permitted to revise or re-open previously approved financial statements/revise the board’s report. Internationally, material misstatements in the accounts related to previous years, whether due to occurrence of fraud or error are reported as a ‘prior period adjustment’ in the financial statements of the period in which such misstatements are discovered. The 2013 Act introduces provisions on re-opening/revision of financial statements in the following circumstances:

- A statutory/regulatory authority (example, Central Government, SEBI, income tax authorities) can apply to the prescribed authority or a court of law when the accounts of the company were prepared in a fraudulent manner or the affairs of the company were mismanaged thereby casting a doubt on the reliability of the financial statements. There is no time restriction to the revision initiated by a statutory regulatory authority.
- Voluntary revision on application by the Board of Directors, if in their opinion the financial statements/board’s report do not comply with the requirements of the 2013 Act (example, non-compliance with accounting standards subsequently discovered). Voluntary revision is permitted after obtaining approval of the prescribed authority in respect of three preceding financial years. Detailed reasons for revision are required to be disclosed in the Board’s report.

These provisions seek to align the requirements in this area to the international standards and are expected to enable all stakeholders to understand the impact of material errors and frauds on the numbers previously reported for each individual year in the past. These provisions also seek to operationalise the previous decision by the SEBI which requires listed companies to restate financial information for audit qualifications.

The new requirements are likely to result in implementation challenges in incidental areas such as determination of taxable profits and ‘Minimum Alternate Tax’ liabilities for the previous periods, which are subsequently revised. Further, a company would also need to consider whether it is required to/may voluntarily file a revised income tax return based on the revised accounts.
**Adjustments to reserves**

The 2013 Act now prohibits most of such adjustments and this would reflect in a uniform and accurate representation of financial results. However, it is currently uncertain whether the restrictions imposed by the 2013 Act would also cover ‘special reserves’ existing at the time of the transition to the 2013 Act, which were previously set-up by companies with the specific objective of adjusting future costs and write-offs.

The restrictions on utilisation of securities premium deserve to be mentioned separately. The prescribed class of companies will be able to utilise the securities premium only to issue fully paid equity bonus shares, writing off expenses/commission paid/discount allowed pertaining to issuance of equity shares and buy back of its shares. This would mean that such prescribed companies will not be able to utilise the securities premium to adjust premium payable on redemption of redeemable preference shares or debentures. The gain or loss on such redemption would be routed through statement of profit and loss which is in line with the international standards.

**Uniform accounting year**

As part of transition provisions, companies would be given a period of two years to change their accounting year to 1 April to 31 March. The following illustration explains the transition time line:

Company A is an Indian subsidiary of an overseas parent, company B. While company A has a calendar year end, company B has an April-March year end. Hypothetically assuming the section mandating this change is notified and effective from 1 April 2014. In line with the transitional provisions, company A will have to align the accounting year to April-March by 31 March 2016. It would follow that company A can follow calendar year end for 2013 and 2014, but would have to align to March year end by 31 March 2016.

This requirement would help comparability of financial information between companies in India and would avoid the practice of changing year ends by companies.

An important point to note is that this exemption may not be available for a company that is an associate or joint venture of a company incorporated outside India.

**Mandatory reporting on internal financial controls**

For the first time, the 2013 Act requires directors of the listed companies to provide assurance on adequacy and effectiveness of internal financial controls. The term internal financial control is defined in the 2013 Act to mean inter alia orderly and efficient conduct of business, and prevention and detection of frauds and errors. This is an onerous requirement. In order to provide assurance on internal financial controls, companies will have to document and test controls every year.

The directors would then have to rely on the management’s evaluation of adequacy and operating effectiveness of such control. The term internal financial control as defined in the 2013 Act is wider in coverage even when compared to the requirements of the Sarbanes Oxley Act which includes internal control over financial reporting.

We expect that the regulators and rule makers will provide additional guidance to companies on how these internal financial controls are required to be tested in order to provide this level of assurance.
Disclosures

Mark Kronforst, Chief Accountant in the Division of Corporation Finance (DCF) and other SEC Staff (Staff) encouraged registrants to take a fresh look at their disclosures with an eye to eliminating unnecessary or immaterial matters. For instance, they suggested removing disclosures arising from historical Staff comments to the extent the facts and circumstances of registrants have changed or if the disclosure is no longer material. Mr. Kronforst and other Staff cited the following disclosure areas that registrants may want to review:

- Critical accounting estimates, which often repeat information in significant accounting policies in the notes to the financial statements.
- Litigation matters, which are often repeated in sections of the 20F/10-K, including legal proceedings, MD&A, risk factors, and the notes to the financial statements.
- Stock compensation disclosures, including those in an initial public offering, to focus on providing meaningful and concise information.
- New accounting pronouncements, particularly when the expected impact to the company is immaterial.
- MD&A
  A former DCF Director and representatives from two large registrants shared their views on best practices for preparing high-quality and meaningful MD&A.
  - Keep the overview section clear and concise, focus on key activities for the period, use bullet points, and avoid duplication. A good overview may be the most important discussion in the document.
  - Focus MD&A on why something occurred, in addition to what, when, and how it occurred.
  - Use plain English, keeping in mind MD&A is the key source of information for investors with limited accounting knowledge.
  - Present data in tables and limit jargon.
  - Quantify each factor when more than one factor (e.g., price, volume, foreign exchange) is used to explain a change from prior year results.
- Review peer company MD&A and SEC comment letters.
- Avoid using overly generic risk factors and provide transparency when negative events have already happened rather than disclosing them as potential events.

Division of corporation finance areas of focus

Craig Olinger, Deputy Chief Accountant, DCF, moderated a panel of SEC Staff that addressed areas of particular Staff focus. As detailed below, these areas include both accounting and disclosure matters and highlight relevant requirements and Staff guidance.
Income Taxes

Frequent Staff comments about income taxes include the income tax rate reconciliation, valuation allowances, and indefinitely re-invested earnings.

Income tax rate reconciliation: The Staff recommended the following:

- Clearly label items within the rate reconciliation and disclose the underlying nature of material reconciling items.
- Disclose each material foreign jurisdiction, its associated tax rate, and the amount of tax when there are material reconciling items.
- Do not aggregate or offset material reconciling items.
- Ensure consistency of reconciling items disclosed in the rate reconciliation with amounts reported elsewhere in the filing.
- Evaluate whether adjustments presented as changes in estimates are better characterised as an error (e.g., a significant rate adjustment resulting from comparing the income tax return to the income tax provision).

Valuation allowance: The Staff cautioned registrants about the use of boilerplate disclosures about the valuation allowance in critical accounting estimates. For example, registrants often disclose that they considered the four sources of income in determining the realizability of deferred tax assets (DTAs). However, this disclosure often is too vague because it does not give readers sufficient information about the key judgements made in deciding whether to establish, adjust, or release a valuation allowance. A better disclosure would provide the relative magnitude of each source of taxable income that contributed to supporting the realizability of the DTAs, as well as an evaluation of the negative evidence.

In instances where registrants have either initially recognised or reversed an existing valuation allowance, the Staff is likely to question the timing and judgements involved, particularly the key changes in the registrant’s circumstances from previous periods.

Indefinitely reinvested foreign earnings: All evidence should be considered when registrants assert that un-repatriated earnings will be indefinitely reinvested, particularly the parent’s liquidity needs.

The Staff frequently identifies omitted financial statement disclosures such as the cumulative amount of indefinitely reinvested earnings, and the unrecognised deferred tax liability, as well as a discussion of the events that would cause the reinvested earnings to become taxable. If estimating these amounts is not practicable, registrants should make that statement.

Pensions and other post-retirement benefits

The Staff also reminded registrants that ASC paragraph 715-20-50-1d requires specific disclosures of how ‘Expected Rate of Return on Assets’ (EROA) was determined. The Staff frequently requests that MD&A disclosure provide:

- A sensitivity analysis of how a change in EROA would impact the results of operations.
- The range of alternative assumptions for the EROA.
- The historical performance of the plan assets, both in recent years and over a longer period of time, as well as disclosure of any significant limitations to the historical information used.
- Both the geometric mean and arithmetic mean (compounded return versus simple return, respectively) if there is a significant difference in determining historical performance.
- An explanation of changes in the EROA.

Business combinations

Business versus asset acquisition: The Staff continues to issue comments related to whether the transaction is an acquisition of an asset or a business. This analysis can be complex, especially in the biotech and real estate industries where the Staff cited examples involving the acquisition of residential or commercial properties with existing lease arrangements such as nursing homes. The conclusion can result in significant differences in the accounting for contingent consideration, goodwill, acquisition costs, and in-process research and development.

Measurement-period adjustments: The Staff reminded attendees that it is appropriate to characterise an adjustment to assets acquired or liabilities assumed in a business combination as a measurement-period adjustment (as opposed to a correction of an error) only if:

- The acquirer obtains new information about facts and circumstances that existed at the time of the acquisition that, if known then, would have impacted the amounts recognised.
- The company’s initial disclosures indicate that the accounting for the acquired assets and assumed liabilities is incomplete.
- The measurement period has not ended.

The Staff clarified that the measurement period ends when the acquiring company obtains the necessary additional information or determines that additional information is unobtainable. In either case, the measurement period can not exceed one year from the acquisition date.

Goodwill

When the components of newly created goodwill are not obvious from other disclosures, registrants should provide additional insight. For example, the expectation of synergies may explain why a premium was paid in an acquisition.

When there are significant indications of impairment, such as an adverse business change or when market capitalisation falls below book value and no impairment charge has been recognised, the Staff will likely comment.

The Staff recommended consulting Financial Reporting Manual (FRM) section 9510 for disclosure considerations when there is uncertainty about the recoverability of goodwill. Disclosure about critical accounting estimates should put investors on notice about the potential for a future material impairment charge and describe the types of changes in circumstances or assumptions that could reasonably be expected to affect the impairment conclusion. The Staff reminded registrants that in periods when an impairment is recognised, disclosures should specify the change in circumstances that caused the impairment because the Staff will often ask ‘why now?’

When impairment is not recognised for ‘at-risk’ reporting units, the Staff is interested in how close a reporting unit is to failing ‘step 1’ of the impairment test.
The Staff recommend the following disclosures:

- Percentage by which fair value exceeded carrying amount as of the date of the most recent test
- Amount of goodwill allocated to the reporting unit
- Description of the methods/key assumptions used and how the assumptions were determined
- Discussion of the degree of uncertainty associated with key assumptions
- Description of potential events that could affect key assumptions.

Non-GAAP financial measures

The Staff reminded that non-GAAP disclosures should be clearly labeled to avoid confusion. Registrants should not use common U.S. GAAP terms in their non-GAAP disclosure in a manner that is inconsistent with the definition in the U.S. GAAP.

Operations in China and other Foreign jurisdictions

The Staff noted that it is important to disclose information that allows investors to understand the judgements, assumptions, and risks related to consolidation conclusions for foreign variable interest entities (VIEs), particularly in China, but also in other jurisdictions such as Russia and India where there are foreign ownership restrictions. Disclosures should provide information about how contracts convey power and economic benefits, and should include significant contract terms, such as when the arrangements expire, mutual consent provisions, and revocability clauses. If there is uncertainty about the agreement’s enforceability, the Staff stated that registrants should disclose how these uncertainties affect the consolidation analysis and the potential consequences if the evaluation would change.

The Staff also suggested disclosing the following risk factors specific to China:

- Substantially all operations are concentrated in China
- The holding company relies on contractual agreements to consolidate a VIE
- Uncertain legality with respect to China’s approval of these structures
- Potential for conflicts of interest
- Limited legal protections available to companies and investors and cash transfer and exchange restrictions into and out of China.

The Staff expects disclosures in MD&A about restrictions on transferring cash in and out of China.

Current accounting practice issues

Mr. Dan Murdock, Deputy Chief Accountant, SEC’s Office of Chief Accountant (OCA), highlighted the areas of most frequent accounting consultations with the OCA:

- Revenue recognition, specifically gross versus net presentation and multiple-element arrangements
- Business combinations, specifically push-down accounting and the definition of a business
- Consolidation, primarily related to variable interest entities and the determination of a primary beneficiary
- Financial assets, in areas such as the allowance for loan losses impairment, and valuation
- Financial instruments with characteristics of debt and equity.
The Staff discussed IFRS application issues for foreign private issuers (FPI) that frequently generate Staff comments:

- **Income tax related disclosures** – clarify the components of the rate reconciliation and the nature of and changes to deferred tax assets and the reasons for any unrecognized tax assets
- **Loss contingencies** – enhance the discussion about (1) significant judgements surrounding the contingency, and (2) the estimation of the timing and amount of anticipated cash outflows
- **Operating segment disclosures** – provide greater transparency of segment profit and loss, and how amounts reconcile to consolidated net income and ensure entity-wide disclosures over major customers and geographic locations are not omitted
- **Asset impairment losses** – clarify valuation assumptions and the source of the discount rate
- **Goodwill** – provide greater transparency about the level at which goodwill is measured and allocated to cash generating units (CGUs) or groups of CGUs for impairment testing
- **Consolidation** – provide greater transparency about consolidation conclusions
- **Revenue recognition** – when revenue streams are highlighted outside the basic financial statements (i.e., MD&A) as growing or important to the registrant, provide details of the revenue stream within the significant accounting policies footnote and disclose the methods used to measure and recognize the revenue.

The Staff gave these additional reminders about FPI reporting issues under IFRS:

- An explicit statement that the financial statements are prepared using ‘IFRS as issued by the IASB’ must be included.
- Audit reports that emphasize a going concern risk must use the ‘substantial doubt’ language from PCAOB standards (as opposed to the suggested language contained in the International Auditing Standards).
- Opening balance sheets required to be presented alongside audited financial statements must also be audited.
- Transition to IFRS 11 is required for most calendar-year IFRS reporting entities at the beginning of 2013. Investees that were previously proportionately consolidated may be accounted for using the equity method and should be evaluated for significance under Rule 3-09 to determine whether separate financial statements of the entity are required.

### Foreign private issuers

In emphasising the continued focus by the management on ICFR, Mr. Paul Beswick, SEC Chief Accountant, said, “Let’s not lose ground. Let’s stay focused on the importance of ICFR.” He noted that maintaining ICFR must be an iterative and ongoing process with the appropriate involvement of management and support throughout the company.

Brian Croteau, Deputy Chief Accountant, SEC’s Office of the Chief Accountant, highlighted the coordinated effort between the SEC’s different offices and divisions and the PCAOB on ICFR matters. “As we maintain or increase the intensity of our focus in this area… I remain convinced that at least some of the PCAOB’s inspection findings related to the audits of ICFR are likely indicators of similar problems with management’s evaluation of ICFR, and thus potentially also indicative of risk for unidentified material weaknesses.” He observed that it is surprisingly rare to see management identify a material weakness in the absence of a material misstatement and questioned whether this could be a result of deficiencies not being identified or whether their severity is not being evaluated appropriately. For instance, comment letters may be issued by the Staff to better understand how registrants consider ICFR when they observe corrections of errors or changes in internal controls. Mr. Murdock also noted that if registrants consult with the Staff on an accounting issue on a post-filing basis, and the Staff objects to the accounting conclusion, they may be interested in how registrants evaluate any potential deficiencies in ICFR. The Staff also reminded attendees that any material change to internal controls should be disclosed under Item 308(b) of Regulation S-K.

### COSO update

In May 2013, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) released its updated Internal Control – Integrated Framework (2013 Framework). The 2013 Framework updates the original COSO Framework released in 1992. COSO Chairman Robert B. Hirth, Jr. stated that the update was necessary due to significant changes in companies’ business and operating environments. He said that businesses are now more technology driven, global, and subject to increased regulatory requirements.

The following table summarises the updates included in the 2013 Framework.

<table>
<thead>
<tr>
<th>What is not changing</th>
<th>What is changing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core definition of internal control.</td>
<td>Changes in business and operating environments should be considered.</td>
</tr>
<tr>
<td>Three categories of objectives and five components of internal control.</td>
<td>Operations and reporting objectives expanded.</td>
</tr>
<tr>
<td>Each of the five components of internal control are required for effective internal control.</td>
<td>Fundamental concepts underlying the five components are articulated as 17 principles. The 17 principles are further supported by points of focus</td>
</tr>
<tr>
<td>Important role of judgement in designing, implementing, and conducting internal control, and in assessing its effectiveness.</td>
<td>Additional approaches and examples relevant to operations, compliance, and non-financial reporting objectives added.</td>
</tr>
</tbody>
</table>
Auditor independence

Mr. Croteau emphasised that auditor independence in both fact and appearance is the foundation of an audit, and is required to increase auditor objectivity and credibility. Violations in independence can call into question the reliability of a company’s financial reporting and the effectiveness of the audit committee’s oversight of the auditor, potentially leading to unplanned auditor changes and costly re-audits. While auditors are responsible and held accountable for their independence from their audit clients, Mr. Croteau reminded management and audit committee members about their shared responsibilities.

FASB is currently working on several new projects as under:

i. Going concern
ii. Consolidation
iii. Repurchase agreements
iv. Private company issues (matters being evaluated are intangible assets arising in a business combination, treatment of goodwill subsequent to a business combination, VIÉ guidance on common control leasing arrangements, IRS10, etc.)
v. Disclosure framework.

Other accounting standards and guides

Richard Paul, Chairman of AICPAs Financial Reporting Executive Committee, summarised three recently released non-authoritative AICPA Accounting and Valuation Guides:

- Testing goodwill for impairment – includes the qualitative assessment for impairment under ASU 2011-08 (i.e., the so-called ‘step zero approach’)
- Assets acquired to be used in research and development (R&D) activities, or in-process R&D – includes guidance on subsequent accounting for in-process R&D post-acquisition and examples using fair value techniques under ASC Topic 820
- Valuation of privately-held-company equity securities issued as compensation – includes examples

for valuing private company securities where few, if any, observable inputs are available.

The AICPA also plans to develop additional Accounting and Valuation Guides on Business Combinations, the Fair Value Measurement of Portfolio Company Investments, and Revenue Recognition.

PCAOB standard-setting activities

Marty Baumann, Chief Auditor, PCAOB, updated participants on a number of key standard-setting projects aimed at advancing the quality of and transparency about public company audits.

Changes to the Auditor’s Reporting Model: In August 2013, the PCAOB proposed an auditing standard on changes to the auditor’s reporting model, and amendments to the auditor’s responsibilities about other information in a company’s annual report filed with the SEC. Mr. Baumann stated that a key aspect of the proposal is a requirement for the auditor to communicate critical audit matters, which would be those matters the auditor addressed during the audit that involved the most difficult, subjective or complex auditor judgements, posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence, or posed the most difficulty to the auditor in forming an opinion on the financial statements.

Another key aspect of the proposal is the requirement to provide information about auditor tenure (i.e., the number of years that the auditor has consecutively served as the auditor). Mr. James Doty, Chairman PCAOB, said that the proposal responds to investors’ long-standing request for more informative, insightful, and relevant audit reports, and resulted from extensive outreach to stakeholders about what changes would be most useful and achievable. Based on the PCAOB’s outreach, Mr. Baumann indicated that while investors value the audit, they desire more meaningful communication about the work and findings of the auditor.

Transparency Re-proposal: Recently, the PCAOB re-proposed an auditing standard on audit transparency that would require audit firms to disclose the name of the engagement partner as well as the names of other firms and persons that participated in the audit. Mr. Doty believed the proposal, “…holds the promise of improving audit quality by sharpening the mind and reminding auditors of their responsibility to the public.” Both Mr. Doty and Mr. Baumann believed that identifying the engagement partner in the auditor’s report will be useful to audit committees and investors in assessing the potential risk for deficient audits, and in the evaluation of engagement partners’ qualifications and experience. Mr. Baumann suggested the proposal’s provisions requiring disclosure of the name of other audit firms and individuals participating in the audit will be very useful for investors because different firms

...
participating in the audit may have very different inspection results or may be located in a jurisdiction where the PCAOB cannot perform inspections.

Related Parties Re-proposal: In May 2013, the PCAOB re-proposed an auditing standard on auditing related party transactions to strengthen auditor performance requirements in three critical areas: (1) related parties, (2) significant unusual transactions, and (3) a company’s financial relationships and transactions with its executive officers. Mr. Baumann indicated that he expects the PCAOB to adopt a final standard in the first quarter of 2014, with the final standard applicable to audits of financial statements for fiscal years beginning on or after 15 December 2014.

Broker-Dealer Audit Requirements: In July 2013, the SEC finalised amendments to broker-dealer financial responsibility requirements and financial reporting rules. Mr. Baumann emphasised that the amendments will require, among other things, audits of broker-dealers to be conducted in accordance with PCAOB standards, and no longer under AICPA standards for fiscal years beginning on or after 1 June 2014. In October 2013, the PCAOB adopted two new attestation standards and a new auditing standard related to these amendments. This will have a significant impact on the entities which are registered under the Dodd Frank Act. The auditors’ report now needs to mention compliance with PCAOB auditing standards and such audits may be subject to the inspection process.

Other PCAOB Auditing Standards

Consistent with comments made by SEC Staff in prior years, Mr. Croteau emphasised that a number of important standards related to auditing estimates, including fair value, and use of the work of specialists and other auditors, have been on the PCAOB’s agenda for years without public proposals being advanced. Mr. Baumann said he expects a proposal on auditing estimates, including fair value, to be issued in late 2014. He also indicated that the PCAOB is targeting a proposal in the first quarter of 2014 related to using the work of specialists and other auditors. Mr. Doty stated that the PCAOB will be reviewing its existing quality control standards in light of its experience in inspecting firms’ systems of quality control. Mr. Baumann discussed the PCAOB’s plans to issue a concept release to address audit firm quality controls and stated that the inspections staff has identified deficiencies in audit firms’ systems of quality controls as well as important drivers of audit quality.

PCAOB Inspection Trends and Continued Areas of Focus

Ms. Helen Munter, Director, Division of Registration and Inspections, PCAOB, indicated a similar trend in inspection findings during 2013 compared to the prior year, with the top three areas being: ICFR, auditing of estimates, and responding to the risk of material misstatement. With respect to internal control over financial reporting, Ms. Munter indicated that findings focused on the testing of controls, particularly related to the extent of testing of management review controls. Mr. Baumann highlighted the issuance of a PCAOB Staff Audit Practice Alert in October, which highlights certain requirements in PCAOB auditing standards for audits of ICFR where deficiencies have frequently been cited. Mr. Baumann believed that the alert “...should be mandatory reading for all auditors performing parts of ICFR audits as it holds the potential to reduce the number of adverse inspection findings.”

Revenue recognition

The new proposed revenue recognition standard is a key area of focus and the companies have started preparing well in advance to meet with the extensive requirements of this standard. The following are the key points:

1. Transition is a key area of focus
   (retrospective, retrospective using practical expedient, cumulative effect on the date of adoption)

2. 5 step model:
   a. Identify the contract with the customer
      i. Oral, written or implied (different from SAB 104)
      ii. New framework for contract modification
      iii. Collectability is key to determine this criteria
   b. Identify the separate performance obligations
      i. Step 1 – whether a good or service is distinct
      ii. Step 2 – focus whether the good or service is distinct in the context of the contract (i.e., the good or service is not highly interdependent or interrelated)
      iii. Change from SOP 81-1 where the contract is a unit.
   c. Determine transaction price
      i. Key focus on variable consideration
      ii. It’s an ongoing assessment
      iii. Time value of money and probability weighted approach
   d. Allocate the transaction price to performance obligations
      i. VSOE guidance no longer relevant
      ii. Expected cost plus margin approach
      iii. Adjusted market assessment approach
      iv. Residual approach if price is highly variable and uncertain.
   e. Recognise revenue when each performance obligation is satisfied
      vi. Point of time vs over the period
      vii. When does control pass (analysis needs to be in-depth).

3. License accounting will be an area of change

4. Extensive disclosures and can be onerous for filers

5. Disclosure for disaggregated revenue will be a major challenge (there could be different ways to present this).

Legislation, Rulemaking and enforcement

Several matters related to Dodd-Frank Act, JOBS Act, Crowdfunding, Pay Ratio disclosures, Conflict Minerals Reporting and FCPA and the related rules/requirements were re-emphasised and clarified where needed.
Determining whether a performance target that can be met after the requisite service period is a performance condition or a condition that affects the grant-date fair value of the awards and

- Determining whether the host contract in a hybrid financial instrument is more akin to debt or to equity.

Share-based compensation awards often contain performance linked vesting conditions. Generally, under U.S. GAAP, performance conditions affect the vesting of an award and accordingly are factored in determining quantum of share-based compensation expenses that needs to be recorded by an entity. Performance conditions do not affect determination of grant date fair value. Performance linked awards are accounted for when it is probable that the performance condition will be met. However, if ultimately performance conditions are not met the share-based compensation recorded until vesting date is reversed.

Companies may grant share-based compensation awards that include a performance condition and allow employees to earn the awards even if the performance condition is achieved after the requisite service has been provided. For example, nonpublic companies may issue awards that only transfer upon consummation of a successful initial public offering (IPO). Emerging Issues Task Force (hereinafter referred to as ‘EITF’ or ‘Task Force’) noted that currently there exists diversity in accounting for share-based payments containing performance conditions, which can be met after the requisite service period. In certain instances, the performance condition can be met even after an employee is no longer with the company and has retired/resigned. Some companies account for them with a performance condition where a compensation expense is recognised only if achievement of performance condition is considered probable. Others believe that these awards represent a post-vesting restriction and accordingly, should be incorporated in the determination of grant-date fair value.

Task Force listed the issue in the EITF agenda to deliberate the matter and provide guidance to resolve the diverse accounting practices. EITF reached consensus-for-exposure that in the case of such awards, the performance conditions that affect vesting would not be reflected in estimating the grant date fair value of the awards. Compensation costs would be recognised when the achievement of the performance condition is considered probable, which may be after the recipient’s service period ends or may never be probable. Any previously recognised compensation cost would be reversed if the performance target is not achieved or the requisite service period is not rendered.

This issue would apply to all reporting entities that grant their employees share-based payments in which the terms of the award provide that the performance target could be achieved after the requisite service period. That would be the case when an employee is eligible to retire or is otherwise eligible to terminate employment before the end of the period in which a performance target (for example, an IPO or change in control event) could be achieved and still be entitled to benefit from the award if and when the performance target is achieved.

At its 13 September 2013 meeting, the FASB’s Emerging Issues Task Force (EITF) discussed three issues and reached two consensuses-for-exposure on:

1. Determining whether a performance target that can be met after the requisite service period is a performance condition or a condition that affects the grant-date fair value of the awards and

2. Determining whether the host contract in a hybrid financial instrument is more akin to debt or to equity.

EITF reaches two consensuses-for-exposure

During the deliberation process, FASB staff identified three potential views in accounting for these types of share-based payments. They are as following:

<table>
<thead>
<tr>
<th>Performance condition approach</th>
<th>Non-vesting condition approach</th>
<th>Substantial confidence approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Performance condition affects the vesting</td>
<td>• Performance condition affects grant-date fair value</td>
<td>• Accounted as a performance condition when the requisite service period ‘substantively coincides’ with measurement period for performance target</td>
</tr>
<tr>
<td>• No compensation cost if achievement of performance condition is not probable</td>
<td>• Grant-date fair value is discounted based on probability of achievement of performance condition</td>
<td>• Otherwise treated as non-vesting condition that affects grant-date fair value and is expensed over requisite service period.</td>
</tr>
<tr>
<td>• Cost may be recognised after the service period or after an employee that has met the service condition leaves the company, when achievement of performance condition becomes probable</td>
<td>• Compensation cost recognised over service period</td>
<td></td>
</tr>
</tbody>
</table>

It may be noted that each approach will result in material differences for both measurement and timing of compensation expense.

The Task Force while reaching at this consensus noted that the performance condition approach would be consistent with ASC Topic 718 Compensation—Stock Compensation (SFAS 123R) wherein the Board concluded that reflecting a performance condition in the grant-date fair value of an award was generally not considered to be measurable with sufficient reliability for financial reporting purposes. Estimating probability scenarios that reflect the likelihood of achieving the performance target would pose significant challenges for companies to implement. Accordingly, the Board decided that the outcome of vesting conditions should reflect the amount of compensation cost that is ultimately recognised on the basis of the number of awards that vest to the awardee.

The proposals of the Task Force are at divergence with the recent amendments to the definition of a performance condition under IFRS 2, *Share-based Payment*\(^ {13} \). Under the amended definition, performance targets that could be achieved after the requisite service period would not be accounted for as performance conditions under IFRS 2 but would instead be accounted for as a non-vesting condition. However, Task Force concluded that improvement in U.S. GAAP was critical at this stage and hence, the consensus should be issued as a new guidance.

Based on the discussions, the Task Force agreed to issue a consensus-for-exposure based on performance condition approach. The issue would be taken up for further discussion in its 13 March 2014 EITF meeting.

In India, several of the technology and other startups grant stock options with vesting linked to a successful IPO, accounting for such option will be impacted if the accounting followed hitherto was under a different approach. Once approved and issued, it will be applicable prospectively to share-based payment awards granted or modified on or after the effective date with earlier adoption permitted. Companies should continue to watch this space for updates based on further EITF discussions.

\(^ {13} \) Annual Improvements to IFRSs 2010–2012 Cycle, issued in December 2013. Under the amendments, the definitions of ‘vesting conditions’ and ‘market condition’ have been amended and the definitions of ‘performance condition’ and ‘service condition’ have been added. An entity shall prospectively apply that amendment to share-based payment transactions for which the grant date is on or after 1 July 2014. Earlier application is permitted.
Determining whether the host contract in a hybrid financial instrument issued in the form of a share is more akin to debt or to equity

Several companies in India have raised capital from private equity and venture capitalists by issuing different classes of shares, including preferred stock, that entitles the investors to certain preferences and rights over the other equity shareholders. Most of these preferred stock arrangements are not mandatorily redeemable and accordingly, are not liability instruments under ASC Topic 480 Distinguishing Liabilities from Equity (SFAS 150). However, the terms of some of these preference shares may include conversion rights, redemption rights, voting powers, and liquidation and dividend payment preferences, among other features. One or more of those embedded features may meet the definition of a derivative under U.S. GAAP. Shares that include such embedded derivative features are referred to as hybrid financial instruments.

Companies raising equity through such hybrid financial instrument issued in the form of a share is required to separate an embedded derivative feature from the host contract (that is, the underlying share) and account for the feature as a derivative in accordance with guidance under ASC Subtopic 815-10 Derivatives and Hedging (SFAS 133) if and only if all of the following criteria under U.S. GAAP are met:

a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract.

b. The contract (the hybrid instrument) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6-11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

As per paragraph (a) above, one such criterion for separation is that the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract.

In the case of derivatives embedded in a hybrid financial instrument that is issued in the form of a share, the above criterion requires evaluating whether the nature of the host contract is more akin to debt or to equity and whether the economic characteristics and risks of the embedded derivative feature are clearly and closely related to the host contract. If the host contract is similar to equity, then equity-like features (for example, a conversion option) would be considered clearly and closely related to the host contract and thus, would not be separated from the host. If the host contract is akin to debt, then equity-like features would not be considered clearly and closely related to the host. In the latter case, an entity may be required to separate the equity-like embedded derivative feature from the debt host contract and account for the feature as a derivative pursuant to ASC Subtopic 815-10 if certain other criteria under U.S. GAAP are met.

The Task Force noted that presently there are three potential approaches which companies follow to evaluate whether the nature of the host contract within a hybrid financial instrument issued in the form of a share is more akin to debt or to equity. The potential approaches to evaluate the host contract that were discussed include:

(a) consider all of an instrument’s terms and embedded derivative features (that is, use a whole-instrument approach)

(b) exclude the embedded derivative feature being evaluated (that is, use a chameleon approach), or

(c) exclude all embedded derivative features (that is, use a pure-host approach) when determining the nature of the host contract.

On this issue, the Task Force reached a consensus-for-exposure that in evaluating the terms and features of a hybrid financial instrument, the existence or omission of any single term or feature, including a fixed-price, non-contingent redemption feature held by the investor, would not necessarily determine the economic characteristics and risks of the host contract and one should consider all terms and features. Task Force noted that whilst some terms or features may be given more weightage, however, they believe that all terms and features should be considered and this evaluation would involve exercise of significant judgement.
Some believed that existence of a redemption feature would significantly influence the overall analysis since through this option an investor can call back its invested amount and hence, be similar to a debt holder who can call back his capital under certain circumstances. However, Task Force believed that this in itself cannot be the only economic outcome e.g., if the company does not have sufficient capital; it would not be able to redeem the security even if such redemption option is exercised.

Further, Task Force noted that under various state laws and corporate charters, a preferred share can not be redeemed if it would cause the issuer to become insolvent. Accordingly, even with a redemption option, an investor may be exposed to the residual risks (that is, negative movements) of an equity investment.

These issues will be taken up for further discussion on 13 March 2014 EITF meeting.

In India, several private equity and venture capital investee companies will be impacted if the accounting followed hitherto was under a different approach. Once approved and issued, the effects of initially adopting the amendments resulting from this Issue would be applied retrospectively with cumulative effect adjustment reflected in retained earnings as of the beginning of the annual reporting period in which the amendments are adopted. Early adoption would also be permitted. Companies should evaluate impact on their existing hybrid instruments since this can impact separation of embedded derivatives and can, therefore, potentially increase financial reporting complexity.
Enhancing financial reporting:
A compilation

Composition and functions of Financial Reporting Review Board (FRRB)

In order to enhance the financial reporting practices followed by various enterprises, the Institute of Chartered Accountants of India (ICAI) constituted the Financial Reporting Review Board (FRRB) in July 2002. The FRRB seeks to review the general-purpose financial statements of the enterprises with a view to establish:

a. Compliance with the generally accepted accounting principles in the preparation and presentation of the financial statements
b. Compliance with the disclosure requirements prescribed by the regulatory bodies, statutes and rules and regulations relevant to the enterprise and
c. Compliance with the reporting obligation of the enterprise as well as the auditors.

The review of the general purpose financial statements and the auditor’s report thereon can either be initiated suo moto by the FRRB, on reference made by any regulatory body or where serious accounting irregularities in the general purpose financial statements have been highlighted in the media reports. The draft rules on the Companies Act, 2013 propose to form a Committee on Accounting Standards which could conduct scrutiny of financial statements in cooperation with FRRB for a period of two years from the commencement of the said rule.

Recently, Securities and Exchange Board of India (SEBI) has set up a mechanism to review and process qualified audit reports filed by the listed entities. The listed companies are required to file annual audit reports to the stock exchanges along with the applicable Forms (Form A: ‘Unqualified’/‘Matter of Emphasis Report’; Form B: ‘Qualified’/‘Subject To’/‘Except For Audit Report’). The stock exchange would then carry out a preliminary scrutiny of qualifications and may refer to SEBI for further examination, if required. To deal with cases referred to it, the SEBI has set up a separate committee - Qualified Audit Review Committee (QARC)-comprising representatives from the ICAI, stock exchanges, etc. If, prima facie, QARC is of the view that qualification is significant and the explanation given by the listed company concerned/its Audit Committee is unsatisfactory, it may refer the matter to FRRB for their consideration.

Implication in the case of material non-compliance and/or non-compliance affecting the true and fair

Where material non-compliance affecting the true and fair view of financial statements has been observed, the FRRB would refer the case to the Director (Discipline) of the ICAI for initiating action against the auditor. The FRRB, however, does not have relevant powers to initiate similar actions against the management of such companies as grant of relevant powers are pending with the Government. As a result, the FRRB is obligated to inform the irregularity to the relevant regulatory body like SEBI, Ministry of Corporate Affairs, Reserve Bank of India, etc. as the case may be.

Key observations

This article seeks to summarise key observations of the FRRB during its review of financial statements and as published by FRRB from time to time.

<table>
<thead>
<tr>
<th>Accounting standard</th>
<th>Matter contained in the annual report</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting Standard (AS) 1, Disclosure of Accounting Policies</td>
<td>Capital employed in the investments constitutes more than 50 per cent of the net worth of the company and where the 'Schedule of Other Income' in the financial statements discloses that the dividend income constitutes a significant portion of the total income.</td>
<td>A separate accounting policy on dividend income should be presented when an entity has significant investments and a large amount of dividend income arises from such investments. Non-disclosure of such policy is not in consonance with the requirements of AS 1.</td>
</tr>
<tr>
<td></td>
<td>Land as an item of closing stock.</td>
<td>Inclusion of land as a separate item of closing stock indicates that the land is a significant item of inventory. Accordingly, a disclosure of policy regarding valuation of land should be provided to meet the requirements of AS 1.</td>
</tr>
<tr>
<td>AS 2, Valuation of Inventories</td>
<td>Accounting policy regarding inventories inter alia stated that raw materials, store and spares and work-in-progress are valued at the lower of cost and the net realisable value.</td>
<td>The company should have additionally disclosed the cost formula used for valuation of inventories as required by AS 2.</td>
</tr>
<tr>
<td></td>
<td>Accounting policy regarding inventory provides that inter unit transfers are valued at transfer price.</td>
<td>Transfer price may include profit margin. Therefore, the policy seems to be against the concept of prudence and generally accepted accounting principle of not recognising any unrealised gains in the financial statements.</td>
</tr>
<tr>
<td></td>
<td>Finished goods are valued at a monthly average selling prices. Joint products were neither separately determined nor a standard margin was applied.</td>
<td>The principles for valuation of joint products are available in AS 2. It was viewed that the company should have used the available guidance in this regard.</td>
</tr>
<tr>
<td></td>
<td>Inventories were described ‘as taken, as valued and certified by the management’ in the financial statements.</td>
<td>Guidance Note on ‘Audit of Inventories’ suggests to omit the words ‘as taken, as valued and certified by the management’. The users of the financial statements may perceive that the auditor had merely relied on the management’s certificate without carrying out any other appropriate audit procedures to satisfy himself about the existence and valuation of inventories.</td>
</tr>
<tr>
<td>AS 6, Depreciation Accounting</td>
<td>For revalued assets, depreciation (other than amount added on revaluation) was based upon the rates specified in Schedule XIV of the Companies Act, 1956 and on the amount added on revaluation, depreciation was provided on residual life as estimated by the valuers.</td>
<td>As per AS 6, depreciation on total revalued amount is required to be provided on the estimate of the remaining useful lives of assets concerned.</td>
</tr>
<tr>
<td>AS 10, Accounting for Fixed Assets</td>
<td>For revalued assets, the company had transferred an amount equivalent to additional depreciation from revaluation reserve to other income.</td>
<td>For revalued assets, the additional depreciation relatable to revaluation is adjusted by transfer of revaluation reserve to statement of profit and loss (instead of inflating other income) and an appropriate note by way of disclosure should be made in line with the ‘Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets’.</td>
</tr>
<tr>
<td>AS 11, The Effects of Changes in Foreign Exchange Rates</td>
<td>The export sales accounted with reference to the Mate’s Receipt(^\text{15}).</td>
<td>As per AS 11, the export sales should have been recognised by applying the rate existing on the date of transaction.</td>
</tr>
<tr>
<td></td>
<td>Accounting policy stated that sales include exchange difference on sales transactions.</td>
<td>As per AS 11, foreign exchange fluctuations arising on export sales are monetary items and thus, it should not be included as a part of revenue.</td>
</tr>
</tbody>
</table>

\(^{15}\) Mate’s receipt is a receipt given by the First mate, First officer or cargo supervisor of the conveyance certifying the total quantity of the consignment received on board a vessel or an aircraft.
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</tr>
</thead>
<tbody>
<tr>
<td>AS 13, Accounting for Investments</td>
<td>Provision is made for any permanent diminution in the value of long term investments.</td>
<td>AS 13 requires a provision for diminution to recognise a decline, other than temporary, in the value of long term investments. FRRB felt that there is a difference between ‘permanent’ and ‘other than temporary’ and normally, no diminution in value of investments may be termed as permanent.</td>
</tr>
<tr>
<td>AS 15, Employee Benefits</td>
<td>Some enterprises have considered employer managed provident fund scheme as a defined contribution scheme.</td>
<td>Rules relating to the employer managed provident fund scheme generally require that the companies should provide for deficiency in the rate of interest on the contributions based on its return on investment as compared to the rate declared for provident funds managed by the Government. Thus, the company, in substance, has to guarantee a specified rate of return. In such a scenario AS 15 and ASB Guidance on Implementation of AS 15 provides that where the company is obligated to provide agreed benefits to employees and the actuarial risk (that benefits will cost more than expected) and investment risk would fall, in substance, on the company, the plan would in effect be a defined benefit plan. Thus, employer managed provident funds should be accounted as defined benefit plans.</td>
</tr>
<tr>
<td>AS 18, Related Party Disclosures</td>
<td>Some enterprises stated that there are no material individual transactions with the related parties during the year which are not in the normal course of their business or at an arm’s length basis and, accordingly, do not provide any disclosures as per AS 18. Others only provided significant transactions with the related parties.</td>
<td>AS 18 does not prescribe for classification of transactions with related parties as significant/insignificant or material/immaterial transactions. Accordingly, non-disclosure of related party transactions on the pretext that no significant transactions have taken place or that only significant transactions are required to be disclosed is not in line with the requirements of AS 18.</td>
</tr>
<tr>
<td>AS 20, Earnings per Share</td>
<td>The companies had omitted to disclose the nominal value of shares along with the figures of earnings per share.</td>
<td>Although the nominal value of equity share had been disclosed in the Schedule of Share Capital, the disclosure of nominal value of shares along with earnings per share on the face of Profit and Loss Account is required under AS 20.</td>
</tr>
<tr>
<td>AS 22, Accounting for Taxes on Income</td>
<td>The deferred tax assets are recognised on carry forward of unabsorbed depreciation and tax losses only if there is virtual certainty that such deferred tax assets can be realised against future taxable profits.</td>
<td>As per AS 22 deferred tax assets should be recognised only when virtual certainty is supported by convincing evidence. Further, the companies should disclose the nature of the evidence supporting the recognition of deferred tax assets as per AS 22.</td>
</tr>
<tr>
<td>AS 26, Intangible Assets</td>
<td>The company had neither stated the nature of goodwill nor had given any reason for not amortising the same.</td>
<td>Accounting of goodwill is dealt by AS 14, Accounting for Amalgamations (when it arises on amalgamation) and AS 26 (other than covered in AS 14 as well as internally generated goodwill). AS 26 requires depreciable amount of intangible assets to be allocated on a systematic basis over the best estimates of its useful life. Further, AS 14 provides that goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Thus the accounting policy was not in line with AS 26 or AS 14. While the FRRB has raised observation for requirement of amortisation for AS 14 and AS 26, AS 10 continues to suggest that the purchased/acquired goodwill could either be written off over a period or carried forward as an asset.</td>
</tr>
</tbody>
</table>
Classes of companies eligible to file shelf prospectus* widened

The Securities and Exchange Board of India (SEBI) has permitted the following classes of companies to raise funds through public issuance of non-convertible debt securities by filing shelf prospectus:

a. Public financial institutions and Scheduled Banks
b. Issuers authorised by the notification of CBDT to make public issue tax free secured bonds
c. Infrastructure Debt Funds – Non-Banking Financial Companies (NBFC)
d. NBFCs, registered with RBI, Housing Finance Companies registered with the National Housing Bank (NHB) and entities which have listed their shares/debentures in the stock exchanges for at least three years complying with the following criteria:
   • net worth of INR 5,000 million
   • track record of three years of distributable profits
   • having a credit rating of not less than ‘AA-’
   • having no default history or regulatory action pending with RBI, SEBI or NHB.

Such shelf prospectus will be valid for a period of one year. However, with respect to subsequent issues, an information memorandum containing material updates need to be filed.

Hitherto, only scheduled banks and public financial institutions were permitted to file shelf prospectus under the Companies Act, 1956.

*Definition of shelf prospectus as per the Companies Act, 2013 – Shelf prospectus is a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus

Also refer to ‘KPMG’s First Notes’ dated 3 February 2014 for a detailed discussion on the regulation.

Source: PR No. 125/2013

Deferred tax liability on special reserve created the Income Tax Act, 1961

The Income Tax Act, 1961 under section 36(1)(viii) allows specified entities a deduction while computing income chargeable to tax if they create a special reserve for an amount not exceeding 20 per cent of the profits derived from eligible business computed under the head ‘profits and gains of business or profession’. Allocation to such reserve would stop if the aggregate amount carried to special reserve exceeds twice the amount of the paid up share capital and of the general reserves.

The Reserve Bank of India16 has observed that few banks are not creating deferred tax liability (DTL) on such special reserve under AS 22, Accounting for Taxes on Income as those banks do not intend to withdraw from such reserve in the future. However, the RBI believes that creation of DTL on special reserve is a matter of prudence and therefore, should be created.

Accordingly, RBI has chalked out following steps to be undertaken:

a. if the expenditure due to the creation of DTL on special reserve as at 31 March 2013 has not been fully charged to the profit and loss account, banks may adjust the same directly from reserves. The amount so adjusted may be appropriately disclosed in the notes to the accounts of the financial statements for the financial year 2013-14.

b. DTL for amounts transferred to special reserve from the year ending 31 March 2014 onwards should be charged to the profit and loss account of that year.

EAC

The Expert Advisory Committee of the ICAI had issued an opinion on 6 October 2004 on this issue and had taken a view that an entity is required to create a DTL on the special reserve created and maintained under section 36(1) (viii) of the Income Tax Act, 1961. DTL should be created irrespective of the fact that withdrawal of the reserve may or may not happen since the company is capable to withdraw the reserve resulting into reversal of the difference between accounting income and taxable income (i.e., timing difference).

SEBI makes IPO grading mechanism voluntary

SEBI has made the IPO grading mechanism voluntary. The change has been brought about because SEBI had received requests from investor associations, Association of Investment Bankers of India, etc. Also, the advisory committee of SEBI recommended this change and this change would help align with the principles laid down by Financial Stability Board on reducing the reliance on credit rating agencies.

Source: PR No. 125/2013

RBI releases framework for revitalising distressed assets

The Reserve Bank of India (RBI) released a ‘Framework for Revitalising Distressed Assets in the Economy’ on 30 January 2014 which sets out guidelines for the early recognition of financial distress, taking prompt steps for resolution and ensuring fair recovery for lending institutions. The new framework reiterates RBI’s focus on putting assets to work and incentivising the speedy resolution of NPA or NPA like exposures in the banking system and also introduces a set of structural reforms such as the setting up of the Central Repository of Information on Large Credits (CRILC) to facilitate the dissemination of information on large credits. It also lays emphasis on the coordination of lender actions through the establishment of Joint Lenders’ Forums within the lending system.

Also refer to ‘KPMG’s First Notes’ dated 31 January 2014 for a detailed discussion on the framework.


PCAOB proposes amendments to require communication in the auditor’s report of certain participants in the audit

The Public Company Accounting Oversight Board (PCAOB) has recently issued proposed amendments designed to improve the transparency of audits. For all audits conducted in accordance with the PCAOB standards, the proposed amendments would require the auditor to communicate in the auditor’s report:

- the name of the engagement partner
- certain information about other independent public accounting firms that participated in the audit
- certain information about other persons not employed by the auditor that participated in the audit

Communication regarding the name of the engagement partner in the auditor’s report

Following are the key features regarding the disclosure of the name of the engagement partner in the auditor’s report:

- This is a disclosure requirement and the auditor’s report would continue to be issued and signed by the firm. Owing to this requirement the engagement partner is not required to sign the auditor’s report in his own name.
- The wording would be, “the engagement partner on the audit for the [period] ended [date] was [name]”. This statement would be inserted at the end of the first paragraph of the auditor’s report.
- Additional requirements would apply in instances such as:
  - Where the financial statements for all periods presented were audited during one audit engagement (for example, in an initial public offering or re-audit of multiple periods), the names of the engagement partners on the audits for all periods presented should be disclosed.
  - Similarly, where an auditor’s report is dual dated and the engagement partner has changed after the original date of the report, the names of both engagement partners should be disclosed.
Communication regarding other independent public accounting firms that participated in the audit

Following is required to be disclosed in the auditor’s report regarding other independent audit firms that participated in the audit:

• The name of the firm. The disclosure would include member firms within a network.
• The country in which the firm’s headquarters is located.
• The percentage of hours attributable to audits or audit procedures performed by such firm(s) in relation to the total hours spent in the most recent period’s audit. In this regard,
  – The total hours would be calculated as of the date of the auditor’s report and will include hours spent in conducting internal control over financial reporting, when applicable and the hours spent in performing the interim period’s review
  – Where the hours incurred by such firms is five per cent or more of the total hours spent in the most recent period’s audit, then disclosure should be made as a single number or by listing such firms and their headquarters’ location, within the applicable ranges such as five per cent to less than 10 per cent, 10 per cent to less than 20 percent, etc.
  - If the hours spent by any firm/s is less than 5 per cent of the total hours spent in the most recent period’s audit, then all such firms should be disclosed as a group under the heading ‘other firms’. Thus, the individual names of such other firms and the individual location of the headquarters is not required to be given.

Communication regarding other persons not employed by the auditor that participated in the audit

Other persons not employed by the auditor include persons engaged by the auditor with specialised skill or knowledge in a particular field other than accounting or auditing. Following are the disclosure requirements in the auditor’s report where the hours spent by such other persons is 5 per cent or more of the total hours spent in the most recent period’s audit. Such disclosures are made using the phrase “persons not employed by our firm”:

• The country of the person(s) (i.e., the country of residence of a natural person or the headquarters’ location of a person that is an entity) and
• The percentage of hours attributable to audit procedures performed by the person(s) in relation to the total hours in the most recent period’s audit.

Similar to the requirement of other firms, the percentage of hours spent could be communicated as a single number or within a series of ranges.

However, in cases where the hours spent by other persons is less than 5 per cent of the total hours spent in the most recent period’s audit, the auditor would not be required to communicate the location of the person(s) not employed by the auditor. In this case, the auditor would communicate the percentage of hours for all such person(s) as a group, using the phrase “other persons not employed by our firm”.

It is important to note that no disclosure would be required about the following participants in the audit:

• Engagement Quality Reviewer
• Securities and Exchange Commission Practice Session Appendix K reviewers
• Internal auditors or other personnel working under the direction of the management and who provided direct assistance to the auditor.

The PCAOB believes that the additional information would enhance the transparency of public company audits and would be useful to investors. The requirements are meant only for disclosure purposes and would not change the performance obligations of the auditor in conducting the audit. The proposals do not provide an effective date as yet.

Missed an issue of Accounting and Auditing Update?

The January 2014 edition of the Accounting and Auditing Update focuses on the pharmaceutical sector and provides insights into accounting issues relating to companies operating in the generics space. We also cover the complex area of hedge accounting with its accounting challenges and examine the IASB’s new hedge accounting rules (IFRS 9). Continuing with our series of articles on the Companies Act, 2013, we have included in this issue an article highlighting role and responsibilities for directors and those in positions of governance. The issue also highlights the implications of the U.K. Bribery Act.

This month, we also have covered some interesting practical aspects relating to the identification of and reporting obligations concerning related party transactions for Indian companies and an overview of the key regulatory developments during the recent past including the considering the practical application of an EAC opinion regarding the amortisation of ‘right of way’ intangible assets.

The December 2013 edition of the Accounting and Auditing Update casts its lens on the telecom sector and provides insights into accounting issues that are relevant to this sector. We also examine accounting implications of different types of outsourcing contracts. Continuing with our series of articles on the Companies Act, 2013, we have included in this issue an article highlighting the impact on mergers, acquisitions and restructurings. This month, we also examine some accounting complications relating to a relatively common type of benefits/compensation – car lease arrangements for employees. In addition, we have covered recent developments relating to the SEBI guidance on measures to ensure greater compliance with requirements of the Equity Listing Agreement and an overview of the key regulatory developments during the recent past.

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

Bangalore
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 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
4/F, Palal Towers
M. G. Road, Ravipuram,
Kochi 682 016
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,
Salt Lake City, Kolkata 700 091
Tel: +91 33 4403 4000
Fax: +91 33 4403 4199

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
Introducing First Notes

We are pleased to share with you that we have launched our financial reporting publication – First Notes.

First Notes is our ‘hot, off the press’ update that aims to provide a very timely heads up on key accounting and regulatory developments that affect reporting for entities in India. It is an additional way for us to connect with you, in addition to the monthly Accounting and Auditing Update.

To get a copy of this publication, please write to aaupdate@kpmg.com