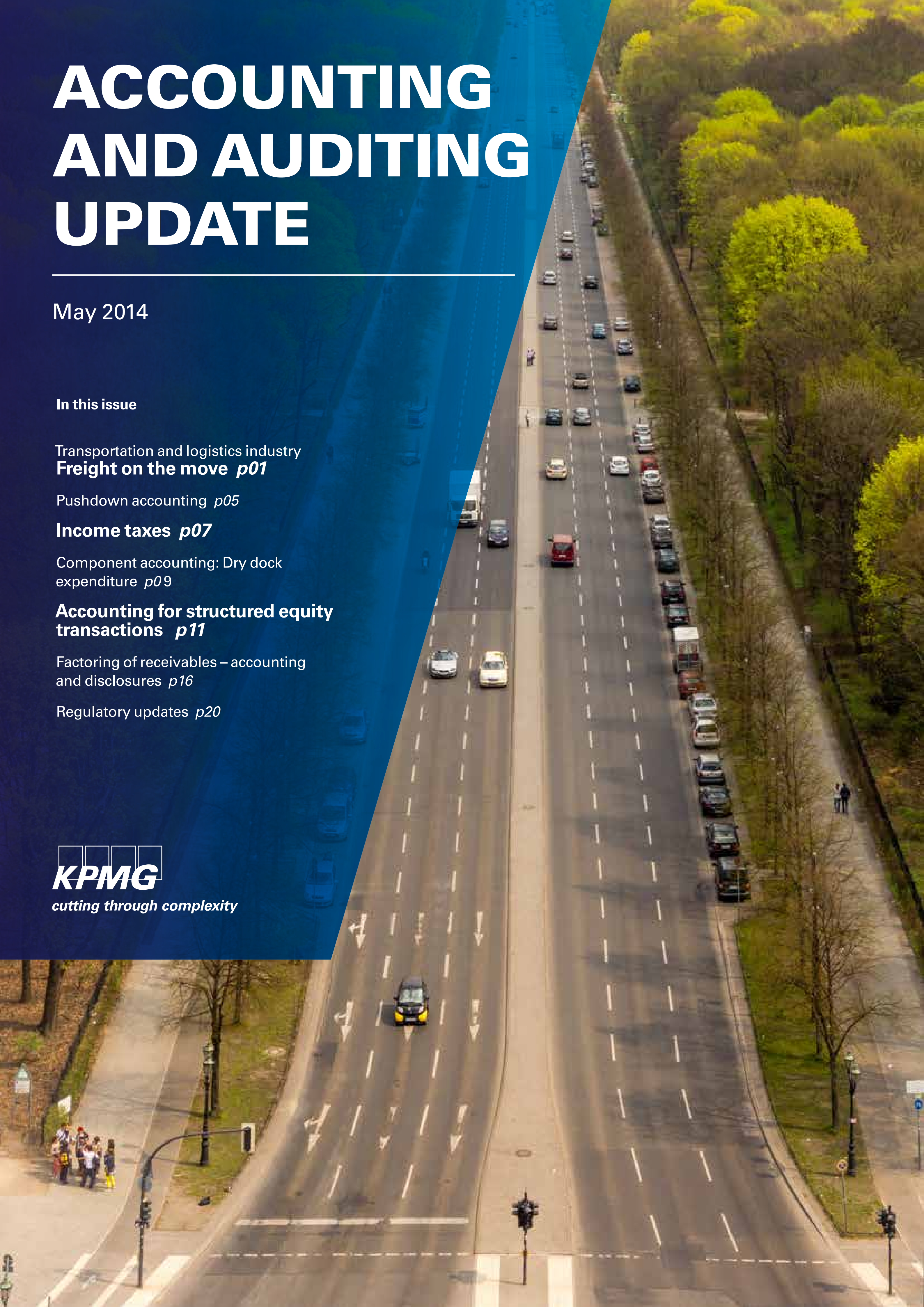

ACCOUNTING AND AUDITING UPDATE

May 2014

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KPMG
cutting through complexity

Editorial

Corporate India is still coming to grips with the new Companies Act and most boards of directors and audit committees are busy understanding the impact of the Act on their functioning and responsibilities. This month, we take a break from our coverage of the Act and focus on other areas of relevance. We will return with some post implementation type reviews in the months to follow.

In previous issues of the AAU, we have covered the e-commerce and aviation sectors. While on the face of it they don't have much in common, their requirement for and dependence on the transport and logistics sector is critical for their growth. This month, we focus on the transport and logistics sector which is a key driver for growth in the economy and which has developed substantially in the past few years in India.

On a somewhat related note, we also examine some of differences we see in practical implementation under Indian GAAP for the accounting for dry docking expenditure.

The transport and logistics sector has also been one that has attracted a lot of private equity investments and we focus in this month on some of the accounting and reporting implications of typical structures and investments used by venture capital/private equity type investors under Indian GAAP and IFRS.

We also examine a couple of recent and important developments under U.S. GAAP relating to the permissibility of following pushdown accounting in private companies and the accounting for income taxes in certain situations.

Finally, in addition to our round up of regulatory developments, we also cast our lens this month on how factoring arrangements are accounted for under Indian GAAP and IFRS. In case you have any suggestions or inputs on topics we cover, we would be delighted to hear from you.

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Transportation and logistics industry

Freight on the move

This article aims to

- Highlight key aspects relating to revenue recognition faced by the transportation and logistics industry.

The transport and logistics (T&L) sector is one of the sectors which contributes significantly to economic growth and activity.

The very concept of trade envisages movement of goods from one place to another. From a safety pin to a very large machine, everything gets transported either by air, sea or land.

The T&L sector is associated primarily with four modes of transport: shipping, railways, airlines and road. The said sector is an amalgamation of several sub-sectors, each having its unique attributes and complexities in its business operations. The sub-sectors primarily include shipping lines, agency operations, freight forwarders, ports and terminal handling operations, container freight stations, warehousing operators, project cargo (contract logistics) services, etc.

This industry is generally cyclical in nature and the freight rates tend to be volatile, reflecting the general mood in the economy. Freight rates and earnings of these sub-sectors are primarily correlated to the demand and supply in the local and global markets. While demand drivers are a function of trade growth and geographical balance of trade, the supply drivers are a function of capacity management and investment in the various fleets/assets, along with technology.

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Insights on revenue recognition

The primary business of logistics companies is the management of capacity. Customers generally pay fee/ charges for the transportation/movement/ handling of cargo between two or more designated locations and for use of warehousing services and infrastructure. Whilst the number of activities/billing points are numerous, the operating margin in these businesses can be low; it tends to increase when different services are combined with outsourcing of supply chain management.

In this article, we highlight certain aspects of complexity in the area of revenue recognition in the various sub-sectors of T&L companies under Indian GAAP.

Under Indian GAAP, AS 9, *Revenue Recognition* provides the following key pointers for recognition of revenue :

- stage of completion of the transactions can be measured reliably (either by completed service method or proportionate completion method) The stage of completion is normally arrived referring to principles set out in AS 7, *Construction Contracts*
- it is probable that future economic benefits of the transactions will flow to the entity
- the cost (both incurred and costs to complete the transactions) are identified and can be measured reliably
- certainty of its collection exists.

The revenue recognition principles provide guidance to companies in estimating the revenue model (either by using the completed service or proportionate completion method). A few key areas across the T&L industry sub-sectors which require exercise of judgement and estimates are set out below:

a. aapplication of the principles of completion (i.e., recognise both revenue and direct costs when the shipment is completed) or proportionate performance methods (allocate revenue between the reporting periods based on the relative transit time in each period along with corresponding cost)

b. agency vs. principal: determining whether an entity acts as an agent or as a principal

c. estimation of cost/revenue accrual at the time of services being provided

d. multiple elements contract arrangement (e.g., where services are sold together but delivered at different times)

e. compliance with regulations (e.g., the Customs Act, 1962, Tariff Authority of Major Ports, etc.) in certain specific circumstances

f. monitoring the progress of the services/milestone (including consideration of the robustness of the IT environment to capture various elements of revenue/cost).

Typical revenue recognition scenarios across T&L sub-sectors

Agent vs principal consideration

A significant amount of judgement is involved in determining whether the company is a principal or an agent. In the absence of specific guidance in Indian GAAP on determination whether an entity is acting as a principal or as an agent, one may refer to guidance set out by International standards.

An entity is acting as a principal when it has an exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an entity is acting as a principal include:

1. the entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer
2. the entity has inventory risk before or after the customer order, during shipping or on return
3. the entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services
4. the entity bears the customer's credit risk for the amount receivable from the customer.

An entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature indicating that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

The revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. For an agent, the amount collected on behalf of the principal is not revenue. Instead for an agent, revenue is only the amount of commission that it earns.

A principal typically owns vessels and the containers, decides the price and has the customer's credit risk. An agent's primary activities include serving the trades to and from all the destinations in its exclusive area for export and import of cargoes and, carrying out sales and marketing for the vessel services of the principal. The amount collected on behalf of the principal by the agent is called the manifest income for the principal. The agent earns a commission which is a fixed percentage of the freight handled (in terms of volume handled) or a pre-determined cost plus margin mark-up to facilitate the principal's business. The agent at times may also render shipping allied activities to the customers on their own account over and above acting as agency to the principal, the income earned for rendering such services is called non-manifest income.

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Manifest income

The income which pertains to the principal is known as manifest income. This income includes freight, terminal handling charges, demurrage charges, vessel charges, port charges and port related incomes. These income types pertain to the principal and are recorded as income in the books of account of the principal who is the actual risk bearer of the transaction. The agent invoices to the customers specifying it on behalf of the principal and mentions that he is acting only as an agent.

Non manifest income

The income which pertains to an agent is known as non-manifest income. This income represents landside activity and generally includes bill of lading fees, delivery order fees, documentation charges, container cleaning charges, container repair charges, container storage charges, survey charges, fees for re-positioning of containers, fees for special and specific requests, loading/unloading fees, etc. The revenue from these activities is recorded normally on issuance of bill of lading or delivery order, as mentioned in the multimodal operations paragraph above.

NVOCC income (Non Vessel Operating Common Carrier activities)

NVOCC income relates to revenue recognition by freight forwarders who do not own vessels and book cargo slots in shipper lines. This generally pertains to the water mode of transportation. The revenue recognition aspect of this segment is further analysed as import shipment and export shipments. Freight income is one of the significant items in an invoice billed to a final customer. As such, there can be some subjectivity in respect of accounting of freight cost, i.e., whether to be recognised at net (billed less paid to shipper) or gross (gross shown in income and cost of services)? Generally, considering that the risk of carriage rests with the NVOCC operator, revenue is recognised on a gross basis.

Export shipment: Revenue from freight export shipment (ocean/air freight, terminal handling charges, documentation charges, etc.) is typically recognised on the date of sailing of the vessel, irrespective of the date of raising of the invoice. Issuance of a bill of lading (BOL) is normally indicative of completion of services by the freight operator as most of the export related services are rendered prior to sailing of the vessel and therefore, a BOL is a key evidence to recognise revenue for the export related services rendered.

However, there could be certain instances when the freight operator is required to perform services which are to be rendered by him or his agent at the port of destination and beyond. In such cases, the entity needs to evaluate for each aspect of the service what level of services are yet to be rendered, and the appropriate revenue to be recognised for each respective leg of service.

Import shipment: In case of import shipments, most of the service obligations (other than the freight element) are rendered by the freight operator once the cargo reaches the shores of India and till the time the cargo is handed over to the customer. Revenue from import shipment (ocean/air freight, terminal handling charges, documentation charges, etc.) is, therefore, generally recognised upon rendering of related services (i.e., issue of 'Delivery Order' (D.O.) - based on which, the importer/consignee can clear the goods from the customs bonded warehouse).

Further, one has to review the nature of cargo shipped - whether it is a 'nomination shipment' (where the business is generated by the entity) or 'free-hand shipment' (where the business is generated though an agent), in which case, the relevant revenue/commission would be required to be accrued in the books.

As explained above, entities typically need to have a robust set of IT systems to capture various details and stages of completion of each contract/consignment such as the sailing date/arrival date, to estimate revenue and cost. Also, for those export shipments which have sailing dates beyond the reporting period end date (cut off), IT systems should be able to compute revenue and related costs for deferment for the related projects/shipments.

Container freight station ('CFS')

CFS is a location that is designated by carriers for the receiving/stuffing of cargo that is to be loaded onto the containers by the carrier or for de-stuffing of cargo brought in by the carriers. These are also often referred to as 'dry ports' as they perform functions similar to a sea-port. The CFS plays an important role in decongesting container traffic at ports, adding value to container trade and enhancing ports operating efficiency.

CFS revenue comprises primarily revenue from transportation activities (from port to the location and vice-versa), ground rent (charged based on days kept at the location) and container handling charges. In general practice, revenue from the aforementioned activities is recognised on the completion of the respective services.

However, in addition to compliance with the basis of revenue recognition criteria as set out in Indian GAAP, one has to also evaluate the following two matters (a) compliance with laws and (b) multiple arrangement facilities/composite arrangement.

a. Compliance with laws - A CFS is normally designated as a custom bonded area and therefore, needs to be compliant with the Customs Act, 1962 (the Act). One of the key requirements of the Act is that the cargo in the custom designated area needs to be cleared out of the custom area within the prescribed period of 75 days. If the goods are not claimed by the customer, post 75 days, the customs authority has all the rights to auction the goods and have a first claim on the money towards the custom duty payable. As such, the T&L operators needs to carefully examine the following:

    - Normally ground rent is recognised by the T&L operator upto the period the goods remain in the CFS. If the customer does not claim the goods lying in the CFS beyond 75 days, the T&L should exercise caution in recognising revenue relating to ground rent.

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- Regarding accounting of surplus custom claims when goods are not claimed by the customer from CFS, it is a common practice for CFS's to auction unclaimed cargo beyond 75 days, under the guidance of the custom authority. The proceeds from the auctioning of unclaimed cargo claim are first used towards the settlement of outstanding dues towards the customs authority and second application towards the CFS's outstanding dues of the T&L operator, and any balance left would be refunded to the customer. The excess pertaining to the customer may not be claimed by the customer and is recognised as a 'liability' in the books of the T&L operator. The T&L operator should evaluate the timing of recognition of the balance excess claim (to be refunded to the consignee). Generally, one would consider the period allowed by the Limitation Act, 1963 (i.e., three years) to recognise the excess as revenue.

b. **Multiple arrangement facilities/ composite arrangements:** Generally, separate rates are prescribed for each of the services provided (i.e., transportation, ground rent, handling activities like stuffing/de-stuffing, etc.). However at times, a company enters a composite/multiple arrangement with a customer. Understanding the separate performance obligations in a multiple arrangement contract requires exercise of significant amount of judgement.

   For these cases, especially at financial closure date/cut-off period, one needs to evaluate and recognise revenue for the completed services (i.e., in case when the first activity of transportation is complete, one would need to recognise revenue to that extent). The first challenge lies in separation of these components and the second challenge in estimation of the revenue (which is to be accrued). For estimating the revenue, one can refer to similar unbundled revenue transactions which are charged to unrelated parties. In the absence of such transactions, one can estimate a reasonable margin (which is calculated on the entire revenue contract) which needs to be applied in the given cases.

Project/contract revenue recognition

This sub-sector specialises in providing end-to-end project logistics solutions, including planning for movement of project cargo (over dimensional cargo, overweight consignment, etc.).

The key areas of judgement relevant for this sub-sector are set-out below:

a. **Revenue recognition- proportionate performance methods:** Since the contract for project services is to provide end to end integrated logistics solutions (that comprises activities related to consolidation of cargo, transportation, freight forwarding and customs clearance services), the entity needs to monitor each leg of the service in order to determine the timing of revenue recognition. The contractual arrangement to bill the customer would be driven through an achievement of a milestone, which may or may not reflect the activity which triggers revenue recognition.

   Revenue from these contracts needs to be recognised when the outcome of the service contract can be estimated reliably; contract revenue and the related costs are recognised as income and expense when the related activities are performed, measured by reference to the contract activity at the reporting date. In certain contracts, when the billing milestone approximates the completion of service, it is common for the entity to recognise revenue at the time of billing.

   When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

b. **Grossing up or netting off of the revenue and related cost:** As per the contractual arrangement with the customer, a company normally incurs certain expenditure on behalf of the customer (which is in nature of tolls, custom duties, octroi, other incidental taxes, etc.) which are primarily the expenses of the customer and the same are then recovered from the customer at cost by the company (via a customer invoice).

   Mere invoicing of such reimbursable expenses does not make them eligible to be recorded as an expense. These are expenses which are incurred by the company in its role as an 'agent' of the customer and therefore, it is inappropriate to recognise the gross receipts as income and the gross payments as an expense instead should be recorded net in the books of account.

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Pushdown accounting

This article aims to

- Summarise the recent deliberation of the FASB[1] on pushdown accounting.

Pushdown accounting is commonly referred to as determination by acquiring entity of new accounting and reporting basis in the acquired entity's separate financial statements. Under U.S. GAAP, there is a limited guidance on pushdown accounting in the acquired entity's separate financial statements.

ASC 805-50-S99-1 through S99-4, provides guidance for SEC registrants on the pushdown basis of accounting. The guidance indicates that if a purchase transaction results in an entity becoming substantially wholly owned, its standalone financial statements should be adjusted to reflect the basis of accounting of the acquirer. The guidance further states that pushdown accounting is required when 95 per cent or more of an entity's ownership is acquired, permitted when 80 to 95 per cent is acquired, and prohibited when less than 80 per cent is acquired. The existence of other interests, such as public debt, preferred stock, or a significant non-controlling interest, however, may impact the acquired entity's ability to adjust its standalone financial statements to reflect the acquirer's basis of accounting. The guidance also indicates that holdings of investors who both mutually promote the acquisition and collaborate on the subsequent control of the acquired entity should be aggregated for the purpose of determining whether the acquired entity has become substantially wholly owned. As the guidance is only applicable to SEC registrants, diversity in practice exists on the application of pushdown accounting by entities that are not SEC registrants.

1. FASB: Financial Accounting Standards Board

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FASB had various discussions in the past on pushdown accounting and during November 2013 in FASB's Emerging Issues Task Force meeting, the Task Force discussed and tentatively decided that pushdown accounting would be required for a public business entity if the change-in-control event causes the entity to become substantially wholly owned by the acquirer. The Task Force also tentatively decided that both public business entities and non-public entities would have the option to apply pushdown accounting in their separate financial statements upon occurrence of a change-in-control event in which an acquirer obtains control of the entity. The Task Force discussed the change-in-control-based pushdown accounting model and tentatively decided that, consistent with business combinations accounting, that consideration does not need to be exchanged in a transaction in order to qualify for pushdown accounting.

At the 13 March 2014 meeting, the Task Force reached a consensus-for-exposure to provide an option to apply pushdown accounting for an entity that is a business or nonprofit activity, both public and nonpublic, whose control has been obtained by an acquirer in its separate financial statements. That option would be evaluated and can be elected by the acquired entity for each individual acquisition separately based on specific facts and circumstances. The Task Force reached a consensus-for-exposure that the entity would recognise goodwill that arises from the change in control event, but not recognise bargain purchase gains in the income statement, and the acquisition-related debt incurred by the acquirer would not be recognised in the acquired entity's separate financial statements unless the acquired entity is required to recognise a liability for such debt in accordance with other applicable U.S. GAAP. Further, the consensus-for-exposure does not change the current SEC guidance on pushdown accounting.

Disclosure

The Task Force also reached a consensus-for-exposure to require the acquired entity that elected to apply pushdown accounting would provide the disclosures required in Topic 805 (except Subtopic 805-50), as applicable, as if the acquired entity were the acquirer. If the acquired entity does not elect to apply pushdown accounting, it would disclose (a) that the entity has undergone a change in control event whereby an acquirer has obtained its control during the reporting period, and (b) its decision to continue to prepare its financial statements using its historical basis that existed prior to the acquirer obtaining control of the entity.

Transition and effective date

The Task Force reached a consensus-for-exposure that pushdown accounting should be applied prospectively to an event in which an acquirer obtains control of the entity for which the acquisition date is on or after this issue's effective date, which will be determined after the Task Force considers stakeholder feedback on the proposed amendments.

At the 26 March 2014, FASB Board Meeting, the Board ratified the consensus-for-exposure reached at the 13 March 2014, EITF meeting, and decided to expose the resultant proposed update for public comment for a period of 90 days.

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Income taxes

This article aims to

- Summarise the recently issued FASB guidance on the income taxes that affects the presentation of current and deferred income taxes on balance sheets for both public and private companies.

ASC Topic 740, Income Taxes, governs accounting for income taxes under U.S. GAAP and details the concepts of accounting relating to the income tax expense for financial reporting while taking into account the differences between the tax bases of assets and liabilities and the carrying amounts of assets and liabilities recognised in financial statements. Topic 740 also provides detailed guidance on accounting and presentation for uncertainty in income taxes. Uncertainty in income taxes refers to uncertainty about how tax positions taken or to be taken on a tax return will be treated under the tax law and how it should be reflected in the financial statements before the uncertainty is ultimately resolved with the taxing authority. The difference between tax positions taken in a tax return and amounts recognised in the financial statements generally result in either increase in liability for income taxes payable/reduction in refund receivable or reduction in deferred tax asset/increase in deferred tax liability or both.

As a result of application of guidance under Topic 740 on uncertain tax positions, the amount of benefit recognised in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for a particular year as a result of a tax position. These differences represent unrecognised tax benefits. The liability in respect of an unrecognised tax benefit can be settled through a cash payment or through a reduction of a net operating loss or other tax carry forward.

Topic 740 provides guidance on accounting for uncertainty in income taxes recognised in an entity's financial statements, and also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

However, Topic 740 lacks specific guidance on the presentation of an unrecognised tax benefit in the financial statements in the case of a net operating loss carry forward, a similar tax loss, or when a tax credit carry forward exists. As a result of this, there exists diversity in practice in presentation of unrecognised tax benefit where some companies used the 'gross presentation' approach by presenting the unrecognised tax benefit as a liability, unless the benefit is directly associated with a tax position taken in a tax year that results in, or resulted in, the recognition of an net operating loss or tax credit carry forward for that year and the carry forward has not been used. On the other hand, some companies took a 'net presentation' approach by presenting unrecognised tax benefits for a net operating loss or tax credit carry forward as a reduction of a deferred tax asset in certain circumstances. To eliminate this diversity in practice, the Financial Accounting Standards Board (FASB) released guidance on how companies should present unrecognised tax benefits on their financial statements when they also have a net operating loss, similar tax loss or tax credit to carry forward. The guidance, found in Accounting Standards Update (ASU) No. 2013-11, Presentation of an Unrecognised Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, affects the presentation of current and deferred income taxes on balance sheets for both public and private companies.

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Presentation

Under the ASU, companies must show the liability related to the unrecognised tax benefit, or a portion of an unrecognised tax benefit, for a net operating loss carry forward, similar tax loss or tax credit carry forward as a reduction of a deferred tax asset if settlement is required or expected in case the uncertain tax position is disallowed.

However, the company should present the unrecognised tax benefit as a liability and should not combine it with deferred tax assets if:

- The carry forward or tax loss is not available on the financial statement date to settle any additional income tax liability that would result from the disallowance of the tax position under the applicable tax law
- The applicable tax law does not require the company to use and the company does not intend to use the deferred tax asset for such purpose.

The assessment of whether a carry forward or tax loss is 'available' is based on the unrecognised tax benefit and deferred tax asset (i.e., the carry forward or tax loss) that exist at the reporting date and presumes disallowance of the tax position at the reporting date.

As per ASC Topic 740-10-45-11, a company that presents a classified statement of financial position must classify an unrecognised tax benefit that is presented as a liability as a current liability, or reduce the amount of an net operating loss carry forward or amount refundable to the extent the company anticipates the payment or receipt of cash within one year or, if longer, the operating cycle.

The guidance does not require any new recurring disclosures because it does not affect the recognition or measurement of uncertain tax positions.

A few additional considerations

Careful consideration must be given to the applicable law regarding the character of the unrecognised tax benefits and their carry forward attributes within the context of specific jurisdictional tax laws. For example, the applicable tax law might not allow foreign tax credit carry forwards to offset unrecognised tax benefits that would not generate appropriate foreign source income upon settlement. In such a case, a company can not net a foreign tax credit carry forward.

A company can 'net' unrecognised tax benefits against deferred income taxes related to carry forwards or tax losses only. The company has to ensure that, upon settlement of the unrecognised tax benefit, the carry forward attribute would be used to offset the taxable income or tax generated by the settlement.

Better disclosures

FASB believes that the rules in ASU 2013-11 will more appropriately disclose the manner in which a company would settle any additional income tax liability resulting from the disallowance of a tax position on the reporting date when net operating loss carry forwards, similar tax losses or tax credit carry forwards exist.

The ASU is effective for fiscal years and interim periods within those years beginning after 15 December 2013 for public entities. For non public entities, the guidance is effective for fiscal years and interim periods within those years beginning after 15 December 2014. Early adoption is permitted. The ASU should be applied prospectively to unrecognised tax benefits that exist at the effective date. Retrospective application is permitted.

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Component accounting
Dry dock expenditure

This article aims to

- Highlight the various considerations and accounting challenges that arise on accounting of dry docking expenditure.
- Discuss the diversity in accounting and reporting.

Dry docking is a term used for repairs or when a ship is taken to the service yard. In dry docking, a ship is removed from the water to enable maintenance and inspection work to be performed on the exterior part of the ship that stays below the waterline. Usually, dry docking is done at periodic intervals, say every three years. There are regulations that also mandate inspections of the ship's bottom to be carried out at regular intervals to ensure safety of the vessels. Companies in shipping industry and other companies which use vessels for their activities, such as oil and gas companies, often incur significant expenditure towards dry dock expenditure.

The accounting for dry dock expenditure needs a specific consideration as to whether the expenditure:

- should be treated as a normal repair and maintenance expenditure and written-off in the statement of profit and loss in the year in which it is incurred
- should be amortised over a specified period.

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Accounting treatment under International Financial Reporting Standards (IFRS)

IAS 16, *Property, Plant and Equipment,* deals with component accounting. It provides that when an item of property, plant and equipment comprises individual components for which different depreciation methods or rates are appropriate, then each component is depreciated separately. IAS 16 para 14 states *"a condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed"*. Therefore, a separate component may be either a physical component or a non-physical component that represents a major inspection or overhaul. For example, a company acquires a new vessel for INR1,000 and the useful life of the ship is 25 years and the next dry-docking is due in three years. At the acquisition date, the dry-docking costs for similar ships that are three years old are approximately INR100. Therefore, the cost of the dry-docking component for accounting purposes is 100 and this amount would be depreciated over the three years to the next dry-docking. The remaining carrying amount (assuming there are no further components), is INR900 and should be depreciated over 25 years. It may be noted that costs associated with routine repairs and maintenance should be expensed as incurred including routine maintenance performed, whilst the vessel is in dry dock.

Accounting treatment under Indian GAAP

With regard to component accounting, unlike IFRS, Indian GAAP does not provide a detailed guidance. AS 10, *Accounting for Fixed Assets,* para 8.3 provides that *"in certain circumstances, the accounting for an item of fixed asset may be improved if the total expenditure thereon is allocated to its component parts, provided they are in practice separable, and estimates are made of the useful lives of these components. For example, rather than treat an aircraft and its engines as one unit, it may be better to treat the engines as a separate unit if it is likely that their useful life is shorter than that of the aircraft as a whole"*. Besides this, no other specific guidance is provided with regard to componentisation under Indian GAAP. It may also be noted that AS 10, in the context of subsequent expenditure, provides that only the expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

Another aspect to analyse is whether dry docking expenditure can be considered as an 'intangible asset'. AS 26, *Intangible Assets*, prescribes certain criteria to meet the definitions of an intangible asset, i.e., identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. Considering the nature of dry-dock expenditure, it does not seem to meet all these criteria, and, accordingly, recognition of this expenditure as an intangible asset does not appear to be appropriate.

In view of the above, one could argue that the limited guidance under AS 10, with regard to identifying components, can be applied to inspection costs also. On the other hand, other view could be that this expenditure does not increase benefits beyond previously standard of performance and, hence, should be recognised as expense when incurred. Further, it is also not clear as to which items of costs should be categorised as dry docking expenditure since, besides inspection costs, there may be other costs including routine repairs and maintenance expenses, which are incurred while dry-docking activity is carried out.

The practices followed by some of the Indian companies may be noted as below (source: published annual reports for 2012-2013):

- Shipping Corporation of India - Dry-dock expenditure is recognised in the Profit & Loss account to the extent work is done, based on technical evaluation.
- Oil and Natural Gas Corporation Limited - Dry docking charges of Rigs/ Multipurpose Supply Vessels (MSVs), Geo Technical Vessels (GTVs), Well Stimulation Vessels, Offshore Supply Vessels (OSVs), Rig/equipment mobilisation expenses and other related expenditure amortised over the period of use not exceeding five years and the balance is carried under head 'Unamortised Expenditure' in the balance sheet.
- Essar Shipping Limited - All expenses relating to the operation of the fleet including crewing, insurance, stores, bunkers, dry docking, charter hire and special survey costs, are expensed under fleet operating expenses on accrual basis.

From a plain reading of the above accounting policies, there appears to be divergence in practice with regard to accounting treatment of dry docking expenditure.

Conclusion

It may be noted that Ind AS 16, which is yet to be notified, contains the same requirements as under corresponding IAS 16 in this regard. However, pending notification of Ind AS, Indian companies are required to follow the requirements of existing AS 10, which does not contain a specific guidance in this regard. While under current Indian GAAP, component accounting, including identification of non-physical components, is not dealt with in the manner in which it has been dealt with under IFRS. A specific guidance from the standard-setting body with regard to accounting treatment of dry-docking expenditure would be useful to help ensure uniformity in accounting practices.

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Accounting for structured equity transactions

This article aims to

- Explain the various kinds of instruments issued to investors by Indian companies, especially to private equity and venture capital investors.
- Highlight key matters for accounting consideration for such instruments under Indian GAAP and IFRS.

Over the last decade several private equity and venture capitalist organisations have provided growth capital to numerous Indian businesses to support their new ventures or growth plans. As most of these businesses mature, these investors are increasingly looking at options to exit from these investments.

Mostly these investors would invest in the businesses using a variety of instruments, some of which we have described in our article. We have aimed to provide a brief analysis of how various kinds of instruments may impact a company's financial position under Indian GAAP and IFRS.

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Common equity shares

These represent the common stock of the company which carries voting right of the investors and allows them to be equity holders and hence, at par with promoter shareholders. Investments through common equity shares are somewhat less common as they may pose exit challenges to investors given current Indian regulatory requirements.

Multiple classes of equity shares (e.g., series A or series B equity shares)

These represent different classes of equity shares with differential dividend and voting rights. Such instruments enable investors to carry higher dividend rights as compared to a common stock holder and also enable differential voting rights, if required. Multiple classes enable investors to exit in certain circumstances.

Redeemable preference shares

Redeemable preference shares (RPS) are issued in the event the investor wants to be a lender with potentially higher returns. Redeemable preference shares allow an investor to exit through exercise of the redemption option, which would generally be triggered post an initial contractual period. Mostly RPS would have stated coupon rates.

Redeemable and optionally convertible preference shares

These instruments are a variance to RPS as described above as they additionally contain a conversion option with the investor. The conversion option allows the investor to convert its investment into common equity shares on certain terms based on some underlying conditions. These typically help the investor to get a minimum guaranteed return with a potential upside through the conversion option in the event the business performance is good, driving a higher equity valuation.

Compulsorily convertible preference shares (CCPS)

CCPS is probably the most commonly seen instrument in India which is used by investors to infuse capital into businesses. Whilst these instruments allow the investors to convert at a future date based on an agreed ratio, it allows the conversion option to be variable depending on the business performance. In several instances conversion options are linked to future business performances, thereby allowing investors to get higher shares in the event the performance is not in line with projections, thereby protecting investor community from loss in valuations.

Compulsorily convertible debentures (CCD)

Similar to CCPS, CCD's are instruments which would be converted into equity shares by the investor at a future date.

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In addition to the above instruments, various kinds of options and warrants, etc. may be embedded within these instruments. We have attempted to describe few of those below:

1. Anti dilution protection – Most, if not all, investor agreements contain a clause which protects the investor from the investee company raising capital from others at a valuation lower than the base at which the present investor invested into the company. This is also referred to as the 'Down Round Protection'. This feature essentially helps ensure that if the company raises further capital at a valuation lower than its earlier investment level, the company will issue additional shares to compensate investor's value diminution. Essentially, it protects the investor from a downside risk in the event the business raises further capital at lower valuation, thereby diluting the investor's equity holding in the company. This clause also protects an investor for adjustments arising from issuance of bonus shares/share splits, etc.
2. Warrants – In several cases, companies issue warrants along with their preference or equity shares to provide specific rights to the investors or promoters. For example, warrants are issued to investors to enable them to purchase additional shares in future at discounted/fixed prices. In certain cases, these warrants are conditional and get triggered based on specific conditions in future which are generally outlined in the initial investment agreement between the company and the investor.
3. Put option – Written put options provides the holder with the right (but not an obligation) to sell an underlying asset (CCPS, CCD, OCPS, etc.) at a specified date (or on the occurrence of certain events) at a specified price (or at a variable price to be determined in future) to a given party. These are included in investment agreements to provide the investor with an option to sell his holding back to the company or the promoter, and thereby exiting from the company. These are generally triggered in the event the company is unsuccessful in doing an IPO within a specific period of time or any other event agreed at the time of the investment. These put options can be exercised on the company or on the promoter depending on how the agreement between the investor and the company has been agreed upon.
4. Call option – A call option is an instrument which provides the company or its promoters the right (but not an obligation) to buy an agreed quantity of a particular asset from the investor at a specified time (or on the occurrence of certain events) and at a specified price (or at a variable price determined in the future).

The above instruments have significant accounting implications from an accounting perspective and hence, companies need to be careful while structuring these instruments.

Accounting of the underlying instruments under Indian GAAP

Under Indian GAAP, in the absence of any specific accounting guidance on such structured equity/fund issuances, the classification of the instruments issued in the balance sheet tends to depend on the legal form of each instrument. All investments which are structured through equity and preference shares would be classified as share capital and would be classified within shareholders' equity. This is primarily driven by Schedule VI to the Companies Act, 1956, which has been carried forward under the Companies Act, 2013 as well. Preference shares would be classified within shareholders' equity even in the event the preference shares are mandatorily or optionally redeemable.

However, under Indian GAAP any investment in a company which is legally structured as a bond/debentures is classified as a borrowing even if it is compulsorily convertible.

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Accounting for the additional features under Indian GAAP

Whilst the accounting under Indian GAAP would be primarily driven by the legal form of the instrument, in practice additional features like put and call options or a down round protection are not being accounted for given the lack of authoritative guidance under Indian Accounting Standards.

These features would generally require detailed disclosure in the financial statements outlining the terms and conditions of each of these features.

Accounting under IFRS for underlying instruments

IAS 32, *Financial Instruments: Presentation,* contains detailed guidance on classification of financial liability and equity instruments. The accounting of these instruments can be complex.

Under IAS 32, Para 11, an instrument is classified as a financial liability if it is:

- a contractual obligation:
  - to deliver cash or other financial assets or
  - to exchange financial assets or financial liabilities with another entity under potentially unfavourable conditions (for the issuer of the instrument) or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative that comprises an obligation for the entity to deliver a variable number of its own equity instruments or
  - a derivative that will or may be settled other than by the entity exchanging a fixed amount of cash or other financial assets for a fixed number of its own equity instruments.

An equity instrument is accordingly, anything which is not a financial liability and represents a residual interest in an entity.

Basic principles of accounting under IFRS

Accounting under IFRS is determined not only by considering the legal form of the instrument but by also considering the underlying substance of the transaction. Accordingly, one needs to evaluate the entire contract and all its features to determine if the instrument needs to be classified as a financial liability or equity.

Instruments classified as equity

Investments generally which are made through plain vanilla equity shares or compulsorily convertible preference shares are classified as equity instruments since they represent residual interest in the entity. It is important to note that any specific features can cause the entire instrument to be classified outside of equity.

Generally, the features such as discretionary dividend do not impact equity classification of the underlying instrument, since the entity doesnot have an unconditional obligation to pay cash.

However, if the compulsorily convertible preference shares contain rights to convert into variable number of equity shares the same would represent a financial liability in accordance with the definition contained in IAS 32.

Instruments classified as financial liability

As indicated in earlier part of this article, classification under IFRS would be driven by the substance of the instrument and all other terms and conditions and not by legal form.

Investments made through instruments which contain an unconditional obligation to deliver cash or another financial asset as described above would result in the instrument being classified as financial liability. This will mean that mandatorily redeemable preference shares would be recognised as financial liabilities. Additionally, if there are obligations to pay cash which are outside the control of the issuer, that would also result in the instrument being classified as a financial liability.

IFRS has detailed guidance which can result in instruments getting classified as financial liability. The most commonly seen features are as follows:

- instruments that are redeemable at the option of the holder (e.g. redeemable preference shares)
- non-redeemable preference shares with dividends that are not discretionary
- instruments that are redeemable or become redeemable:
  - at the option of the holder or
  - on the occurrence of an uncertain future event that is beyond the control of both the holder and the issuer of the instrument and
- subordinated liabilities.

Companies should carefully assess such contracts to evaluate appropriate classification since treatment as a financial liability could have a significant negative impact on the company's net worth (shareholder's equity) and income statement (because of related interest charge, etc.).

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Accounting under IFRS for additional features

We see several of the features described earlier in our article being present in various investment structures. We have aimed to briefly outline below the potential impact of various features on overall accounting.

Down round/anti-dilution protection

Anti-dilution clauses that only protect an investor from bonus/share splits would typically not require any separate accounting. However, other clauses that protect an investor against future fair value losses due to fresh equity issuances in future, would generally meet the definition of a derivative. In such cases, the down-round protection features embedded within conversion clauses may qualify as an embedded derivative feature that needs to be separated from the host instrument and accounted for at fair value through the statement of profit and loss.

Warrants to purchase shares

In many instances companies issue warrants to investors enabling them to purchase additional shares for a fixed price in future. Often these warrants are conditional and become exercisable only on occurrence of certain events. In certain cases warrants are issued to promoters to enable them to purchase additional shares in the company in case certain future events occur or do not occur.

Mostly these warrants provide an option to purchase shares at low costs, thereby providing additional value to the holder of these warrants.

Companies will need to evaluate these warrants and assess whether they would be derivatives which would need to be separated from the host instrument. Additionally, depending on the features of the warrants, the company will need to determine if the derivative qualifies as an equity instrument or should be accounted for as a derivative liability at fair value through profit or loss.

Put options

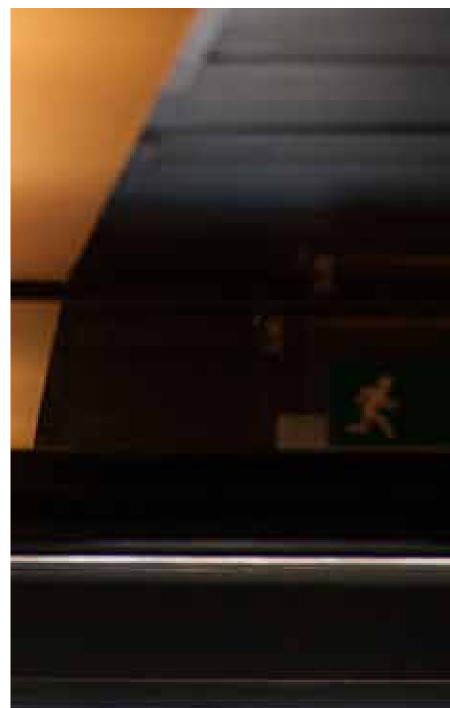
Put options embedded within financial instruments which are held by the investor would generally result in the underlying instrument being classified as a liability. However, careful consideration is required for situations where non-controlling interests (minority shareholders) have puttable instruments, as the conclusions in the consolidated financial statements at a parent level could be different from the conclusions at a separate financial statement level of the issuing entity.

Call options

Company may also have call options to buy back the instruments from the holder. Mostly these call options would be within the control of the company, and hence would not be financial liabilities.

Conclusion

As it is evident from the discussions above, accounting for financial instruments, particularly from a classification perspective can be quite complex and has a significant impact on the company's net worth and profitability. Many of the companies that attract private equity/venture capital funding may consider overseas IPOs and stake sales as a final exit route/ liquidity event. In such situations, understanding the impact of accounting for such instruments under IFRS/other international reporting standards at the time these investments are made, is important as it has a definite impact on financial statements and therefore, potentially the valuation and marketability of an IPO/ proposed stake sale.



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Factoring of receivables

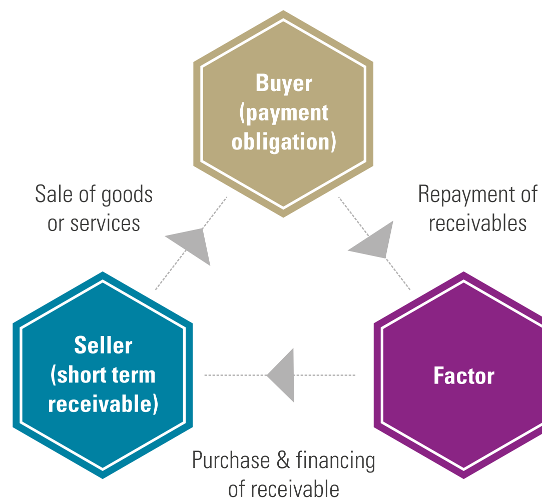
accounting and disclosures

This article aims to

- Explain the accounting and disclosure requirements of factoring of trade receivables under Indian GAAP and International Financial Reporting Standards (IFRS).

Factoring is a commercial transaction in which an entity transfers its trade receivables (invoices) to a third party, which is generally a specialised financial organisation (factor) to obtain cash on an immediate basis. A factor is essentially a funding source that agrees to pay an entity the value of the invoice less its commission and fees. The legal title to the receivables may or may not be transferred to the factor.

Factoring process



Source: Accounting and Auditing Update, May 2014

Factoring improves the working capital management of an entity though factoring can be a relatively expensive form of financing. Factors provide a valuable service to entities that operate in industries where it takes a long time to convert receivables into cash.

Factoring arrangements are often referred to as 'with recourse' or 'without recourse'.

In a 'with recourse' arrangement, the entity transfers its invoices to a factor with an understanding that the entity will buy back any uncollected invoices. This is a lower cost form of factoring because an entity continues to bears the credit risk. Alternatively, in a 'without-recourse' arrangement, factor assumes responsibility for all bad debts. The factor legally takes ownership of the debt and as a result, this type of facility attracts higher fees as the factor assumes additional risks with respect to receivables.

When an entity factors its trade receivables, it should consider all facts and circumstances of the arrangement to determine whether or not the trade receivables should be 'de-recognised' from its balance sheet. This analysis should be based on substance of the entire arrangement, including any guarantees or other recourse related aspects of the arrangment.

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Guidance under Indian GAAP

Currently, there is no specific guidance provided on de-recognition of factored trade receivables under the Companies (Accounting Standards) Rules, 2006 issued by the Ministry of Corporate Affairs on 7 December 2006.

The Institute of Chartered Accountants of India (ICAI) had issued a Guidance Note on Accounting for Securitisation and AS 30 *Financial Instruments: Recognition and Measurement* which provide guidance on factoring of trade receivables. The guidance note was withdrawn post issuance of AS 30 as a recommendatory standard. ICAI withdrew the recommendatory status of AS 30 from 1 April 2009. AS 30 is now neither recommendatory or mandatory standard. Therefore, the entities may apply either the guidance note or AS 30. However, while applying AS 30 the entities should apply

- the accounting treatments covered by any of the existing notified accounting standards (e.g., AS 11, AS 13, etc.) the existing accounting standards would continue to prevail over AS 30
- In cases where a relevant regulatory authority has prescribed specific regulatory requirements (e.g.. loan impairment, investment classification or accounting for securitisations by the RBI,etc.), the prescribed regulatory requirements would continue to prevail over AS 30.

The Expert Advisory Committee (EAC) of ICAI has also issued an accounting opinion with respect to the factoring of trade receivables which throws light on accounting treatment for factoring.

EAC opinion[1]

The accounting treatment of factored trade receivables depends upon the fact whether significant risks and rewards incidental to ownership of factored trade receivables have been transferred to the factor or not. In case significant risks and rewards incidental to ownership of the factored trade receivables have not been transferred to the factor, the debts should continue to be recognised in the books of the entity. On the other hand, if significant risks and rewards incidental to ownership of the factored trade receivables have been transferred to the factor, the factored trade receivables should be derecognised from the books of the entity.

The significant risks and rewards incidental to ownership of the factored trade receivables would get transferred to the factor, if and only if the entity has transferred to the factor:

- all significant rights or other access to benefits relating to the said debts
- all significant exposure to the risks inherent in those benefits.

The significant rewards/benefits relating to the ownership of the trade receivables are the future cash flows arising from the payments by debtors. Similarly, significant risks relating to ownership of trade receivables are slow payment risk and the credit risk (i.e., the risk of bad debts).

Guidance under AS 30, Financial Instruments – Recognition and measurement

According to AS 30, it can be inferred that an entity can derecognise a financial asset relating to factored trade receivables if:

a. it transfers the contractual rights to receive the cash flow from the factored trade receivables and

b. it transfers substantially all the risk and rewards of the ownership of the said receivables.

Additionally, an entity should assess whether the derecognition criteria are applied at a consolidated financial statements level or separate financial statements level. If trade receivables are transferred within the group, then the consolidated financial statements will not reflect derecognition for intra-group transfers, including transfers to consolidated special purpose entities, even if such transfers qualify for derecognition in the individual financial statements of the entity that is the transferor. In this article, we are assuming that factor and the transferor entity do not belong to a group.

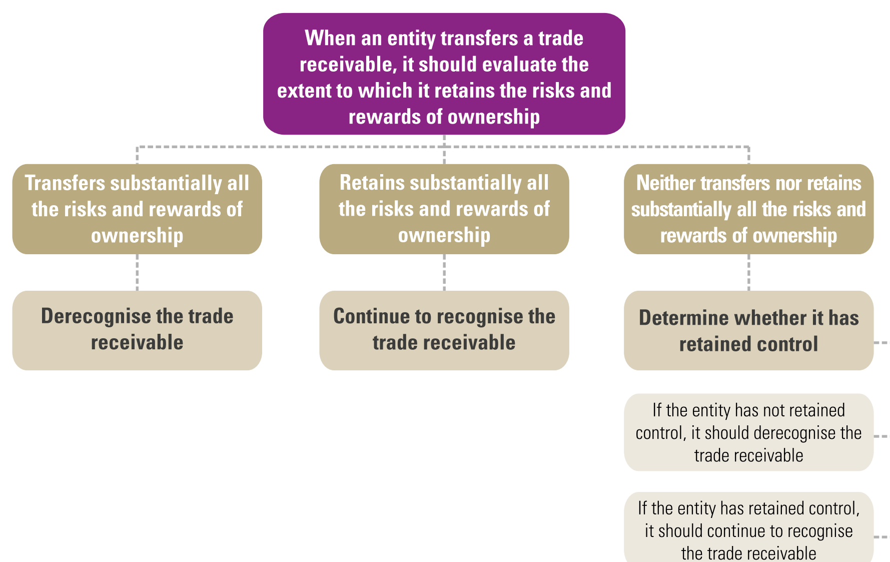
Transfer of contractual right

In order to be considered a transfer of the contractual rights to receive the cash flows of the factored trade receivables, the transfer of legal title should result in a transfer of all existing rights associated with the factored trade receivables without any additional restrictions being imposed as a result of the transfer. For example, an entity that has trasnferred a trade receivable has transferred its rights to receive the cash flows from the asset. In this situation, the factor has unconditional and exercisable rights to all the future cash flows.

If the arrangement qualifies as a valid transfer of contractual right, the next step is to do an analysis of the extent to which it transfers the risks and rewards to the factor.

1. ICAI EAC opinion Volume XXI Query no. 41

Transfer of risk and rewards



Source: Accounting and Auditing Update, May 2014

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The risks and rewards analysis is performed by comparing the entity's exposure, before and after the transfer, to the variability in the present value of the future net cash flows from the trade receivables. This evaluation can be done either separately for each type of risk that the trade receivables under consideration is exposed to or for all the risks arising from the trade receivables.

The risks and rewards which are reasonably expected to be significant in practice should be considered in evaluating this test.

The different types of risks that an entity needs to evaluate are as follows:

- credit risk, also called 'default risk' or 'risk of default'
- interest rate risk, comprising fair value interest rate risk and cash flow interest rate risk
- prepayment risk (i.e., the risk that the principal is repaid earlier than expected; 'prepayment risk' is not defined in the standard)
- late-payment risk (i.e., the risk that payments received from the underlying financial assets are made later than expected, sometimes called 'slow-payment risk'; late-payment risk is not defined in the standard).

The entity (transferor) should also consider interest rate risk and late/slow payment risk especially in case of long-term receivables where the transferor continues to pay interest to the factor until the underlying debtor settles the factor retaining the risk of late/slow payment.

Dispute risk also known as 'warranty' or 'dilution risk' is the risk that there is or will be a dispute over a financial asset e.g., a receivable because of a claim from the customer that the quality of goods delivered or services performed varied from what was agreed contractually. Dispute risk should not be included in the risks and rewards analysis, because it relates to the existence of a trade receivable rather than to the risks and rewards inherent in an existing trade receivable.

Control

An entity is considered to have lost control if the factor has the practical ability to unilaterally sell the transferred trade receivable in its entirety to an unrelated third party without needing to impose additional restrictions on the sale. If there is a market for the trade receivable (i.e., if the trade receivable is readily obtainable), then the factor often has the practical ability to sell the trade receivable, even if the contractual arrangements between the transferor and the factor restrict such a sale. Conversely, the factor does not usually have the practical ability to sell the trade receivable if there is no market for the trade receivable, even if the contractual arrangements between the transferor and factor permit such a sale.

On derecognition of a trade receivable in its entirety, the difference between carrying amount and consideration received should be recognised in the statement of profit and loss.

If the arrangement does not result in de-recognition of the receivables:

- the entity continues to recognise the trade receivables in its balance sheet
- the proceeds received from the factor are recorded as a liability.

Further, AS 29, *Provisions, Contingent Liabilities and Contingent Assets* defines contingent liability as follows:

A contingent liability is:

a. a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise, or

b. a present obligation that arises from past events but is not recognised because:

   i. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or

   ii. a reliable estimate of the amount of the obligation cannot be made.

In case where the receivables are derecognised from the balance sheet, the entity does not have any further obligation towards the factor for any default of payment of receivables. The disclosure under AS 29 is not required for 'without recourse' factoring arrangement since the entity is discharged with from its liabilities/obligations and the factor bears all significant risks towards collection of receivables.

Analysis under IFRS

The factoring transactions need to be analysed to determine whether or not the underlying receivables should be derecognised in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*. The requirements of AS 30 are identical to the requirements of IAS 39 as stated in the above mentioned paragraphs. Accordingly, the above guidance and analysis will be applicable for IFRS as well.

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Illustration

Illustration : Debt factoring with full recourse[2]

Entity ABC sells receivables due in six months with a carrying amount of INR100 for a cash payment of INR95, subject to full recourse. Under the right of recourse, the transferor is obliged to compensate the transferee for the failure of any debtor to pay when payment is due. In addition to the recourse, the transferee is entitled to sell the receivables back to the transferor in the event of unfavourable changes in interest rates or credit ratings of the underlying debtors.

The transaction is accounted for by the transferor as a collateralised borrowing because it does not qualify for derecognition. Even assuming that the contractual rights to all of the cash flows on the receivables have been transferred as a matter of law, this transaction still fails the derecognition requirements because the transferor has retained substantially all the risks and rewards associated with the financial assets. The transferor is obliged to compensate the transferee for the failure of the debtors to pay when payments are due. In addition, the transferor has granted the transferee a put option on the transferred financial assets allowing the transferee to sell the receivables back to the transferor in the event of actual credit losses and/ or changes in underlying credit ratings or interest rates. Consequently, the transferor has retained substantially all the risks and rewards of ownership of the receivables.

The transferor recognises INR95 as a financial liability. The transferor continues to recognise the receivables as financial assets. Cash received on the receivables by either the transferor or the transferee reduces both the receivables and the financial liability. If uncollected receivables are returned to the transferor for cash, then the financial liability is reduced and an impairment loss is recognised if one was not previously recognised by the transferor.

Summary of the accounting and disclosure requirement

Type of Factoring	Has contractual rights to receive the cash flow been transferred?	Has substantially all the risk and rewards of the ownership been transferred?	Derecognise receivables?	Contingent Liability?	Presentation
With recourse	Yes	No	No	No	Continue to recognise the receivables and proceeds received from the factor which are recorded as a liability
Without recourse	Yes	Yes	Yes	No	Difference between carrying amount and consideration received should be recognised in the statement of profit and loss

Conclusion

An entity needs to adopt a step by step analysis of the contractual terms and risk and rewards to determine whether or not de-recognition of factored receivables is appropriate. Legal form of contracts and achievement of legal sale / transfer is not adequate in itself to result in derecogniton for accounting purposes.

2. KPMG's Insights into IFRS (10th edition)

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Regulatory **updates**

Amendments to Clauses 35B and 49 of the equity Listing Agreement

The Securities and Exchange Board of India (SEBI) has amended the corporate governance norms (the revised norms) for listed companies in India to be effective from 1 October 2014.

The revised norms, inter-alia, have significantly revised the requirements relating to independent directors, their compensation, related party transactions, etc. The revised norms have also introduced several new requirements such as governing principles for corporate governance, limit on number of directorships of independent directors, new disclosure requirements such as appointment letter and resignation letter of directors, etc.

Although, most of these amendments are in line with the requirements of the Companies Act, 2013, some of the changes are more stringent under the amended norms. For example, for applying the requirements relating to maximum tenure of independent directors (which is a maximum of two terms of five years), the Companies Act, 2013 allows the requirement to be applied prospectively. However, the revised norms mandate consideration of existing term for calculating such maximum term.

For a clause by clause comparison with the pre-revised corporate governance norms along with comparison with Companies Act, 2013 please refer to KPMG's First Notes dated 22 April 2014.

Additionally, the SEBI has also amended clause 35B of the Equity Listing Agreement extending the e-voting facility to all shareholders' resolutions to be passed at the general meeting instead of such facility being open to only businesses transacted through postal ballot as per the pre-revised clause 35B.

[Source: 'SEBI's Circular CIR/CFD/POLICY CELL/2/2014 dated 17 April 2014]

Prohibition on undertaking concurrent audit of a bank by its statutory auditor performing quarterly review – ICAI's clarification

The Institute of Chartered Accountants of India (ICAI) has clarified that the concurrent audit and the assignment of quarterly review of the same bank can not be undertaken simultaneously by the same auditor, since concurrent audit is similar to internal audit, and thus would be prohibited to be undertaken by the statutory auditor (performing the quarterly review).

[Source: ICAI's announcement http://www.icai.org/new_post.html?post_id=10516&c_id=219 dated 2 April 2014]

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Proposed new roadmap for implementation of Ind AS converged with IFRS

The ICAI has finalised the revised roadmap for implementation of Indian Accounting Standards (Ind AS) which has been submitted to the Ministry of Corporate Affairs (MCA) for its consideration. Salient features of the revised roadmap are as under:

1. There will be two sets of accounting standards namely Ind AS (converged with the International Financial Reporting Standards (IFRSs)) and existing notified accounting standards (AS)
2. Ind AS should be applied by the specified class of companies (see point 3 below) to prepare consolidated financial statements as defined in the Companies Act, 2013. AS should be applied for preparing individual financial statements of the companies preparing consolidated financial statements and of classes of companies not specified
3. Ind AS should be applied by following specified class of companies for preparing consolidated financial statements for financial years beginning on or after 1 April 2016, along with comparatives for years ending on 31 March 2016, or thereafter:
    a. Whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India
    b. Companies other than those covered in (a) above, having net worth of INR 5 billion or more
    c. Holding, subsidiary, joint venture or associate companies of companies covered under (a) or (b) above.

Calculation of net worth

4. The net worth should be calculated as per the stand alone audited balance sheet of the company as at 31 March 2014, or the first balance sheet for accounting periods ending after 31 March 2014.
5. For companies which are not in existence on 31 March 2014 or an existing company which meets the criteria for the first time after 31 March 2014, the net worth should be calculated on the basis of the first balance sheet ending after 31 March 2014
6. The net worth should be calculated as the paid-up Share Capital plus Reserves and Surplus less Revaluation Reserve.

Voluntary adoption

7. Companies which are not covered by the categories mentioned in point 3 above will have the option to apply Ind AS voluntarily for their consolidated financial statements provided they prepare such financial statements consistently thereafter.
8. Further the option to prepare voluntary consolidated financial statements as per Ind AS is irrevocable.

Discontinuing use of Ind AS

9. It is clarified that once a company starts following Ind AS it should continue to prepare consolidated financial statements as per Ind AS even if subsequently it does not meet the eligibility criteria as mentioned in point 3 above.

Banks, NBFCs and insurance companies

10. The ICAI has clarified that the roadmap for banks, NBFCs and insurance companies will be decided in consultation with the Reserve Bank of India and Insurance Regulatory and Development Authority.

[Source: ICAI's announcement dated 9 April 2014]

Clarification on calculation of Net Owned Funds (NOF) of an NBFC

As per section 45 IA of the Reserve Bank of India (RBI) Act, 1934, NOF means the aggregate of the paid-up equity capital and free reserves as disclosed in the last balance sheet of the company after deducting accumulated balance of loss, deferred revenue expenditure and other intangible assets. This amount is further required to be reduced by company's investment in shares of subsidiary companies, companies in the same group and all other NBFCs, book value of debentures, bonds, advances and deposits made with subsidiaries and companies in the same group.

In this regard, it had been observed by the RBI that some NBFCs for the purpose of calculating NOF, were not reducing its investments in subsidiary companies and group companies from the paid up capital and free reserves owing to the fact that such investments were made by the Venture Capital Fund (VCF)/ Alternative Investment Fund (AIF) sponsored by the NBFC.

The RBI has now clarified that for the purpose of calculating NOF, substance would take precedence over form. As such while arriving at the NOF figure, investment made by an NBFC in group companies should be deducted even where the investment is made indirectly through an AIF/VCF in cases where the funds in the VCF have come from the NBFC to the extent of 50 per cent or more, or where the NBFC is a beneficial owner in case of trusts if 50 per cent of the funds in the trusts are from the concerned NBFC.

For this purpose, 'beneficial ownership' means holding the power to make or influence decisions in the trust and being the recipient of benefits arising out of the activities of the trust.

[Source: RBI's circular - RBI/2013-14/554 - DNBS (PD) CC.No. 373 /03.10.001/2013-14 dated 7 April 2014]

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Introducing Voices on Reporting

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

In our call this month, we discussed questions that are frequently being asked by corporates on the steps companies should consider taking immediately to comply with new requirements of the Companies Act, 2013 and our perspectives on complying with these requirements. We also presented an update on the new corporate governance requirements issued by the Securities and Exchange Commission of India as well as briefly touched upon the new standard on revenue recognition expected to be issued by the International Accounting Standards Board (IASB) in the coming days.

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

The April 2014 edition of the Accounting and Auditing Update covers our initial analysis on the impact of the Companies Act, 2013 rules that have been notified and impact on the Companies Act, 2013 on the auditors. We have examined practical issues faced by banks as they look to implement the Reserve Bank of India's guidelines on unhedged foreign currency exposures. We also share some of our insights into what is involved in the journey towards an U.S. IPO.

In this issue, we also highlight the complexities in accounting for government grants and assistance in India and accounting for brands purchased in a defensive acquisition. We also examine under U.S. GAAP, the recently issued guidance on the accounting of service concession arrangements. Finally, we provide an overview of key regulatory developments during the recent past including the recent notifications issued by the Ministry of Corporate Affairs.

SEBI's amendments to corporate governance norms

The SEBI Board has on 17 April 2014, amended the corporate governance norms for listed companies in India to be effective from 1 October 2014. Although, most of these amendments are in line with the requirements of the Companies Act, 2013, some of the changes are more stringent under the amended norms.

Our First Notes gives an overview of this amendment.

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