Accounting and Auditing Update

Issue no. 9/2016 | Transport, Logistics and Leisure

IN THIS EDITION

Transport and logistics survey results, May 2016  p1
Maritime  p15
Logistics  p23
Port and Container freight station  p29
Rail  p33
Aviation  p37
Leisure  p43
Goods and Services Tax  p47
Regulatory updates  p49

www.kpmg.com/in
In continuation with our current series of the Accounting and Auditing Update, we focus this month on the Transport, logistics and leisure.

This sector encompasses various sub-sectors. In this edition, we cast our lens on six sub-sectors: maritime, logistics, ports and container freight station, rail, aviation and leisure. Each of these sub-sectors has a unique set of accounting, reporting, regulatory and tax challenges and our articles seek to highlight these in detail.

The Indian Accounting Standards (Ind AS) which are largely converged with International Financial Reporting Standards (IFRS), are bringing about a paradigm shift in financial reporting in India. For the sub-sectors discussed in this publication, the guidance relevant to revenue recognition and property, plant and equipment is likely to throw up potential challenges while applying the requirements of Ind AS.

With respect to direct tax issues, these sub-sectors are facing a number of issues. For example: the treatment of service tax collected as part of gross income, ports facing ambiguity on claiming tax holiday and certain withholding tax issues. Where indirect taxes are concerned, we’ve highlighted service tax issues especially those faced by the rail, ports, logistics sub-sectors.

Some of the relief measures given to the sector are 100 per cent deduction of capital expenditure under Section 35D of the Income-tax Act, 1961 for a new infrastructural facility and deferment of the requirements on the Place of Effective Management.

This month, we’ve also published the results of a survey that we ran with a number of leading transport and logistics companies on the key regulatory changes that they face. We’ve gathered perspectives on Ind AS, the Companies Act, 2013, Income Computation and Disclosure Standards (ICDS) and the proposed Goods and Services Tax (GST) to name a few. Some of the results of the survey provide food for thought on the level of preparedness and the extent of the challenges faced by the companies in this sector.

The proposed GST legislation is awaited and our article on this topic highlights its expected impact on the supply chain, shipping and logistics sub-sectors.

Finally, our publication provides a regular round-up on the regulatory updates including the guidance note on CARO 2016 issued by the Institute of Chartered Accountants of India and a summary of the clarifications given by the Ind AS Transition Facilitation Group in its second bulletin.

As always, we would be delighted to receive any kind of feedback or inputs on the topics that we have covered.
Overview
India’s transport and logistics sector - Poised for growth

The Transport and Logistics (T&L) sector in India is riding on a positive growth trajectory in the backdrop of a challenging global economy. In the early 2000s, the sector was challenged with below par facilities and infrastructure, low technology penetration and regulatory challenges. There has now been a paradigm shift in the way infrastructure and regulations are being addressed by the government through myriad initiatives which are paving the way for India to be at par with global standards.

The Indian logistics market, estimated at over USD120 billion in 2015, is poised to reach approximately USD160 billion by 2018, growing at a Compound Annual Growth Rate (CAGR) of about 9 per cent. The sector is witnessing several trends, e.g. a shift of focus from global to domestic, optimisation to innovation of processes, emergence of e-commerce, and newer business models.

The logistics sector in India is highly fragmented and is faced with infrastructural challenges, bottlenecks in hinterland connectivity and an unfavourable modal mix that is skewed towards roads as a major mode of transportation.

In spite of the above, the sector has become an integral part of the country’s economic development and is amongst the high growth focus sectors in India. It is evolving significantly, driven by rising investments, mega infrastructure projects and favourable regulatory policies, amidst improving economic conditions. The sector encompasses the following sub-sectors:

Roads

Roads continue to constitute a significant component of India’s logistics industry, accounting for 60 per cent of the total freight movement. Rapid progress in augmenting road infrastructure in recent years could lead to efficient usage of road transport, given its ability to facilitate last-mile connectivity and integrate various modes of transportation.

Rail

With rail freight in India touching the 1 billion tonne mark in 2013, it is expected to grow at a CAGR of 4.4 per cent in the next six to seven years to reach 1.32 billion tonnes by 2019. The Indian Railways envisages an investment of INR8.5 lakh crore by 2020 on several initiatives, such as the Dedicated Freight Corridor project, high speed trains, rapid electrification, technology enablement and improved customer experience.

Ports

The Indian ports handled over 1,000MMT of traffic in FY15, growing at a CAGR of approximately 5 per cent year-on-year from 743MMT in FY09. The cargo traffic is expected to reach 1,758MMT by 2017, growing at a CAGR of 17 per cent for the next three to four years.

The implementation of the Sagarmala project (July 2015) is expected to drive the growth of maritime related businesses. There is also an increasing focus on coastal shipping, inland waterways, port rail connectivity and shipbuilding.

Air

India aims to become the third largest aviation market by 2020, and the largest by 2030, driven by factors including increased competition, low-cost carriers, airports modernisation, improved technology in both air-side and land-side operations, Foreign Direct Investment (FDI) and increased emphasis on regional connectivity.

Government initiatives

The Union Budget 2016‒17 laid down a clear focus on developing highways and rural road infrastructure to elevate the sector’s proposition. An allocation of INR70,000 crore to expedite the creation and expansion of highways, in addition to an investment of INR27,000 crore (along with the state governments) in developing rural roads, is expected to augment the country’s economic growth.

From a modal perspective, the implementation of the Sagarmala project, alongside the development of national waterways as a potential mode of transport, indicates the government’s focus on the maritime sector. The government is also laying emphasis on improving the efficiency of the railways. In addition, development of underused airstrips and smaller airports could help drive the aviation sector. The allocation of funds in infrastructure is, hence, likely to propel the transport, warehousing and logistics businesses rapidly over the medium-term.

Way forward

The growing emphasis on alternative transport modes, rapid infrastructure investments, rise in outsourcing, driven by growing business complexities, significant drop in fuel prices and the roll-out of Goods and Services Tax (GST), are expected to be positive enablers for the sector. From a policy and regulatory perspective, the integration of various logistics ministries, an emphasis on the ‘Make in India’ initiative and the launch of mega infrastructure initiatives in the sector, are also expected to strengthen the sector’s growth.

Jaideep Ghosh
Partner and Head
Transport, Logistics and Leisure
KPMG in India

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
Transport and logistics survey results, May 2016
In the present transport and logistics (T&L) sector environment, we believe the government’s focus to develop infrastructure and capacity in this space, combined with the use of IT solutions and emphasis on the ‘Make in India’ initiative, and given the imminent roll-out of the Goods and Services Tax (GST), can help enhance logistics growth as well as exports from the country.

To gather in-depth perspectives, we surveyed 12 Chief Financial Officers (CFOs) and gathered their inputs on the major issues facing the economy in the transport and logistics sector over next few years, with topics ranging from business outlook to the implementation of new regulations – Ind AS, General Anti-Avoidance Rule (GAAR), Income Computation and Disclosure Standard (ICDS) and GST, amongst many others.

These CFOs represent large T&L players with presence across the value chain in India.

**Key findings**

Some of the results of the survey provide food for thought on the level of preparedness and the extent of challenges faced by companies in this sector currently. The findings provide powerful insights into the thinking and strategies that can shape business directions and resulting accounting, for years to come.

**Ind AS**

Ind AS is bringing about a paradigm shift in financial reporting which is going to potentially affect many key metrics of performance. Our survey results showed that 58 per cent of the respondents do not have any previous experience in preparing financial statements under IFRS and approximately 64 per cent believe that they need to impart training to their staff to understand the implications of while adoption, while taking care of the interests of investors, bankers and other stakeholders. 89 per cent of our respondents have not factored impact of Ind AS into their budgeting process.

**ICDS**

Another significant change is the issuance of the ICDS, issued for the purpose of tax computation. While majority of the respondents anticipate that ICDS would require changes to the existing processes and systems, a convincing majority believes that there is an adequate time for implementation. Most of the respondents feel that major implementation challenges are revenue recognition, borrowing costs and foreign exchange difference capitalisation.

**Impact of direct tax**

As India prepares to evolve into the next level of the logistics growth trajectory, 89 per cent of the respondents in the sector believe that the regulatory policies and infrastructure investments could be enhanced to keep pace with the changing dynamics of the economy.

**GST**

GST has been in the offing for quite some time. The new regime is expected to broaden the tax base, foster a common market across the country, reduce compliance costs and promote exports. Many respondents believe that the roll-out of GST would have positive impact on the sector and approximately 33 per cent of the respondents believe that, one year would be an appropriate time to implement GST. Further, the respondents anticipate that the roll-out and implementation of GST would lead companies to re-design and enhance their networks to shift to a hub and spoke model, having a primary and secondary hub.
Q1
What are the key factors impacting the T&L sector industry in India?

- Inadequate infrastructure: 24%
- Low profitability: 19%
- Limited IT penetration: 23%
- Highly fragmented market: 14%
- All of the above: 14%

Q2
What is your view on the regulatory environment for the T&L sector?

- Conducive to growth: 82%
- Needs significant reforms: 18%

Q3
Is it important to build capabilities across the value chain or focus on sector specific solutions?

- Yes, it is important: 67%
- Focus should be on sector specific solutions: 25%
- Not sure: 8%
Q4
How essential is the adoption of technology for business transformation?

- Critical to our business: 64%
- Increasingly gaining importance: 36%

Ind AS

Q5
Does your company have any previous experience in IFRS financial statements, for example through a group reporting pack, listing abroad, etc.?

- Yes: 42%
- No: 58%
Q6
Which one of the following do you think is/are the critical challenge(s) for transition to Ind AS?

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

Q7
How confident are you in terms of having trained staff on Ind AS?

- Confident - have adequate trained work force
- Active training in progress
- Do not have trained work force

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

- Yes
- No
- Not required
Q9
Have you identified all accounting differences and disclosure requirements, and related changes that your company needs to adapt to, once Ind AS is in place?

Q10
Has your company or would your company be preparing annual budgets for next year on the basis of Ind AS?

Q11
Is your company ready for the adoption of Ind AS by 1 April 2016 with prior year comparatives, including training of staff, having understood the implications of adoption, taking care of interests of investors, bankers and others?
Q12
Do you foresee a change in the Accounting Information Systems (AIS) to bring out the desired information as per Ind AS? If yes, have you started the process of enabling changes in the same?

Q13
The Income Computation and Disclosure Standards (ICDS) have been notified and are applicable from Assessment Year 2016-17 onwards. The adoption of ICDS is expected to significantly alter the way companies compute their taxable income, as many of the concepts from existing Indian GAAP have been modified. This may also require changes to existing process and systems. Do you agree that ICDS would require changes to existing processes and systems?
Q14
Do you believe you have adequate implementation time?

- Yes: 73%
- No: 27%

Q15
What are the key implementation challenges of ICDS that you foresee?

- Borrowing costs: 24%
- Revenue recognition: 28%
- Government grants: 8%
- Financial instruments: 12%
- Foreign exchange capitalisation: 28%
- Other areas: 0%
The Companies Act, 2013

Q16

The Companies Act, 2013 (2013 Act) has introduced Section 134(5)(e) of the 2013 Act which requires the directors’ responsibility statement to state that the directors, in the case of listed company, have laid down the Internal Financial Controls (IFC) to be followed by the company and that such internal controls are adequate and were operating effectively. In your view would IFC improve or enhance internal processes and will it be time consuming and provide benefits as compared to costs incurred to implement it?

Q17

Have there been other areas such as related party transaction approvals required under the 2013 Act that have been challenging to implement?
Direct taxes

Q18
Do you think, phasing out of deductions/exemptions would reduce investment in the infrastructure industry?

Q19
What are your comments on the implementation of digitisation in the income tax department i.e. electronic filing of returns/appeals, digitisation of tax office and electronic interface with department, etc.?
**Q20**

In order to boost the aviation sector, should government provide some tax benefits to companies engaged in the setting up of Maintenance, Repair and Operation (MRO) companies facilities in India?

![Bar chart showing 71% yes and 29% no]

**Q21**

Should the government provide better clarity on claiming tax holidays under Section 80-IA of the Income-tax Act 1961, for companies operating Inland Container Depots and Container Freight Station?

![Bar chart showing 89% yes and 11% no]

**Q22**

Do you foresee that ICDS in its current form would increase litigation with the tax department?

![Bar chart showing 50% yes and 50% no]
GST

Q23
Do you think the implementation of GST will impact T&L sector?

- Yes - Positive impact: 82%
- Yes - Negative impact: 0%
- No impact: 0%
- Can't say: 18%

Q24
Do you think T&L sector has analysed the exact impact of GST and accordingly formed strategies to adapt with GST and make most out of the changes anticipated in the T&L sector in the wake of GST?

- Yes: 55%
- No: 18%
- Can't say: 27%

Q25
The Finance Act, 2016 has levied service tax on ocean freight for the import of goods. This will enable the availability of CENVAT credit pertaining to these services. Do you think this change will impact your industry?

- Yes, favourable: 27%
- Yes, unfavourable: 37%
- No: 27%
- Can't say: 9%
Q26
How much time do you think your industry will need to prepare for the implementation of GST?

- 3 months
- 6 months
- 9 months
- 1 year
- More than a year

Q27
In the T&L sector, opportunities are changes in current socio-economic environment. Which of the following factors are expected to affect business:

- (a) Warehousing hubs
- (b) Public private partnerships
- (c) Inland ports

- Warehousing hubs 48%
- Public private partnerships 25%
- Inland ports 25%

Q28
This sector is also affected by regulations set by the governments in various countries. Which regulation is expected to have the most impact on the T&L sector?

- GST 37%
- Foreign Direct Investment 16%
- Pricing 28%
- Development 21%
### Other findings

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>80%</strong></td>
<td>Of the respondents believe that the GST roll out is critical for the industry, would be a game changer and will help the sector to function in a more organised manner.</td>
</tr>
<tr>
<td><strong>82%</strong></td>
<td>Of the respondents believe that the sector needs significant regulatory reforms and that those reforms are a high priority to streamline the operational procedures such as customs, railways, terminal operators, tariff regulations, etc.</td>
</tr>
<tr>
<td><strong>36%</strong></td>
<td>Of the respondents feel that for providing end-to-end solutions, an asset light model is the way to go; whereas <strong>45 per cent</strong> believe that an asset heavy model is essential for the business.</td>
</tr>
<tr>
<td><strong>55%</strong></td>
<td>Of the respondents believe that not only is the implementation of Ind AS an accounting change but it will change the way business is managed. Survey results indicated that the participants believed that the introduction of Ind AS will make the financial statements more transparent and easy to interpret and will help to attract easy investment. Further, <strong>54 per cent</strong> indicated that the effective implementation of Ind AS requires extensive involvement of top management and <strong>15 per cent</strong> felt that, only with the involvement of finance, the implementation can be managed and rolled out successfully.</td>
</tr>
<tr>
<td><strong>100%</strong></td>
<td>Of the respondents think that, the ICDS requires a change in the existing systems and processes and <strong>73 per cent</strong> of the respondents are of the view that the industry has sufficient implementation time. However, <strong>50 per cent</strong> believe that ICDS may increase litigations with tax departments.</td>
</tr>
<tr>
<td><strong>64%</strong></td>
<td>Of the respondents believe that they are not ready for the adoption of Ind AS by 1 April 2016, with prior year comparatives. Further, <strong>50 per cent</strong> are still at the stage of giving training and creating awareness for it.</td>
</tr>
<tr>
<td><strong>55%</strong></td>
<td>Of the respondents believe that the Place of Effective Management (POEM) implementation in the financial year 2016-17 will not have an impact on the residential status of a subsidiary/holding company abroad.</td>
</tr>
<tr>
<td><strong>60%</strong></td>
<td>Of the respondents believe that implementation of GST will have a positive impact in the T&amp;L sector and <strong>33 per cent</strong> believe that the industry needs one year time to complete the implementation.</td>
</tr>
<tr>
<td><strong>89%</strong></td>
<td>Of the respondents believe that the government should provide better clarity on claiming tax holidays under Section 80-IA of the Income tax Act 1961, for companies operating Inland Container Depots and Container Freight Stations.</td>
</tr>
<tr>
<td><strong>55%</strong></td>
<td>Of the respondents believe that there will not be any GAAR implementing impact on T&amp;L sector, whereas <strong>36 per cent</strong> were not sure of any implementation implications.</td>
</tr>
</tbody>
</table>
Maritime

This article aims to:

– Highlight key accounting issues in the maritime sector
– Provide an overview on the direct issues in the maritime sector.
The maritime sector mainly comprises shipping and shipping agencies. This article provides an overview on them.

**Shipping**

**Key accounting issues**

**Revenue recognition**

Revenue and related cost recognition usually depends on a number of entity-specific circumstances, which are also influenced by the substance of the transaction, the arrangements with the clients, the entity’s informal practices and the country’s legislation.

Revenues in a shipping company mainly comprise freight earnings from cargo which include containers and non-container revenues and cruise ships.

With respect to revenue recognition, within the industry globally, participants generally have one of the two common methods to adopt; either percentage of completion or the completed voyage method. Judgement as to which method is adopted can have a significant impact on results of the company. Correspondingly, the revenue recognition policy would have an impact on the cost as well. Under Ind AS the Indian companies would be required to adopt the percentage completion method for accounting for revenue.

**Pooling arrangements**

One of the most common arrangements for working together in the shipping industry is the ‘Pool’. A pool is a collection of vessels, under different ownerships, operating under a single administration. The pool managers typically market the vessels as a single, cohesive fleet unit, collect earnings and distribute under a pre-arranged points weighting system.

Pool structures differ and therefore, impact the allocation of costs and revenue between pool participants.

**Residual value**

Residual value, together with the useful economic life, determines the depreciation charge each year. An inappropriate estimate of residual value can impact the carrying value of the asset and the level of annual depreciation. Residual values are difficult to estimate given the:

- Long economic life of vessels
- Uncertainty over the future market conditions in which the vessel will operate
- Repairs and maintenance policies
- Fleet deployment and operating cycles

**Depreciation**

One of the most difficult accounting estimates in the shipping industry is the useful economic life of vessels. This, with the residual value, determines the effective depreciation rates and is also an important factor in assessing whether a vessel’s carrying value is impaired. If the estimated useful economic life is inappropriate, or circumstances change such that it has to be revised, material misstatements could occur.

**Key considerations**

The disclosure and application of estimated useful economic life accounting policy varies greatly across companies. A large proportion of companies adopt 25 years across all vessels; 20 years and 30 years are also commonly adopted. One would expect specialist vehicles with different characteristics to sit at either end of the range.

Using an example we could note the impact of useful life on the annual profit for a vessel costing USD70 million, the difference between a 20 years and a 30 years useful economic life would result in a USD1.2 million annual profit impact. On its own, this might not be significant, but for some larger fleets one can see how this difference could become material.
The method of depreciation should reflect the pattern in which the benefits associated with the asset are consumed. Methods of depreciation usually adopted are the straight-line method, the reducing balance method and the sum-of-the-unit’s method. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

Providing a breakdown of a company’s fleet and which vessel types are being depreciated over which periods, would provide enhanced clarity.

**Impairment**

The accounting standard requires companies to review for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. The sector is capital intensive and historically the earnings have been volatile and the sector is also vulnerable to economic recession, external demand and price shocks.

Recoverability of an asset is assessed by comparing its carrying amount to value in use and fair value less costs to sell. Value in use is generally, the future discounted cash flows that the asset or cash generating unit (CGU) is expected to generate over its remaining useful life.

In order to assess impairment, estimates and assumptions are made regarding expected cash flows which require considerable judgement – not least whether the CGU is an individual vessel, or the fleet as a whole.

Other critical assumptions include:

- Spot market rates for vessels
- The operating costs of vessels and
- The estimated economic useful life.

In making these assumptions reference is made to existing contracts and forecasts of macro and micro-economic conditions.

**Key considerations**

Companies are taking different approaches to assessing CGUs. Establishing a CGU depends upon how a company operates. Accounting standards require companies to assess impairment at the individual asset level wherever possible or as a group of assets if cash flows are generated only in combination with other assets.

A shipping company should disclose in the accounting policies its accounting policy on impairment along with detailed disclosure around the assumptions it is using in assessing impairment.

**Component accounting and dry-docking**

A major change brought by the Companies Act, 2013 has been around the requirement relating component accounting. This has necessitated a review of the asset base to identify individual parts of larger assets that have different economic lives.

Ships broadly comprise:

- Hull
- Keel
- Engine
- Navigation system and
- Other fit out assets.

Normally, these assets are treated as separate components and depreciated over their estimated useful lives. These assets are maintained and (in some limited circumstances) replaced as part of the regular dry-docking activity.

The cost of dry-dock and the assets which are replaced may only be determined when the ship is out of water, but in many cases, dry-dock primarily repairs the asset in order to avoid significant capital spend on overhauls in the future.

**Key considerations**

In circumstances where certain expenses incurred during dry-docking exercise do not meet the criteria to be accounted as a separate component, such expense may be considered as part of the dry-docking costs i.e. if the assets individually are not significant enough to be accounted as a component then a group of such assets could be bundled.

Historically, there were two methods of accounting for dry-docking costs; the capitalised cost method and the accrual method.

- Under the capitalised cost method, a company capitalises all costs related to dry-docking and depreciates the costs over the period to the next expected dry-dock, usually between two to five years. Under this method, the amount of capitalised dry-docking costs varies based on the extent of procedures performed during the dry-docking period.
- Under the accrual method, a company estimates the cost of the next upcoming dry-docking and accrues these costs on a systematic basis up to the next dry-docking. The actual dry-docking costs incurred are then written off directly against this accrual. This method allows matching actual expenses related to wear and tear to the vessel against the revenues earned.

**Analysis of component accounting and dry-docking costs**

Clearly there is an inter-dependency of assumptions on component accounting and dry-docking costs, and during the dry-docking it is possible that parts of a ship will be replaced ahead of the useful economic life assumptions.

It is noted that, companies are being pragmatic in this regard, with an assumption that the superstructure, engines, hull and navigation equipment have broadly the same lives and only change this assertion if persuasive evidence exists, or indeed if the impact would be material. One area which requires significant judgement is with regard to technological developments, particularly around navigation equipment, where the operational service life of an asset may be longer than the period to when the technology becomes redundant.

**Additional matters for consideration**

Repairs and maintenance of owned assets cannot be provided for since these costs are associated with the future use of the assets. Major inspections and overhauls, do not meet the asset recognition criteria and would be treated as a separate component.

Companies are also, seeking to identify embedded maintenance on initial recognition of the asset. Broadly, if a new ship costs USD70 million, some of the cost may relate to assets that will deteriorate over a period up to dry-dock and will need to be replaced. In simplest terms, USD1 million of the cost of painting the ship and the ship will be re-painted every four or five years. As a consequence, it is appropriate to depreciate USD1 million over five years and USD69 million over the asset’s full life.
Proportion of total cost incurred to date can be determined by different methods if they reliably measure the services performed. The stage of completion may be recognised by reference to the stage of completion at the balance sheet date if:

- The amount of revenue can be measured reliably
- It is probable that the economic benefits of the transaction will flow to the entity
- The stage of completion can be measured reliably, and
- The costs incurred for the transaction and the costs to complete the services can be measured reliably.

Ind AS does not allow the completed contracts method; the percentage of completion method should be followed to recognise revenue from services. A transaction's stage of completion may be determined by different methods if they reliably measure the services performed. These methods include, for example, the proportion of total cost incurred to date.

### Key impacts under Ind AS

Under Ind AS, revenue recognition is defined, as the gross inflow of economic benefits during the period arising in the course of the entity’s ordinary activities when those inflows increase equity and are not contributions from equity participants.

Revenue from services should be recognised by reference to the stage of completion at the balance sheet date if:

- The actual number of days it takes to complete the voyage
- The contract for a single voyage may state several alternative destination ports
- The destination port may change during the voyage, or
- The rate may vary depending on the destination port.

Additionally, these factors will impact the cost forecasts too, which adds to the complexity.

- Cruise ship revenue is recognised along similar lines as freight, either completed voyage or percentage of completion, depending on the length of the voyage.
- The rate may vary depending on the length of the voyage.
- Also, it is common for companies to not recognise revenue during days that the vessel was off-hire. Additionally, revenue is not recognised until the charter has been agreed to by the customer and the entity, even if the vessel has discharged its cargo and is sailing to the anticipated load port on its next voyage.

Each company will need to plan the way in which they will be able to ascertain the percentage of completion of the voyage and accrue revenue. We anticipate that some companies will have very sophisticated means by which to establish how much revenue to recognise, whilst others may choose a broader basis of estimating.

### Residual value

Though there are not many changes with respect to the estimation of residual value under Ind AS. However, it would be useful for shipping companies to provide a sensitivity analysis of the residual values, where material. An indicator of the impact of a five per cent swing (say) in the residual value would provide readers of financial statements with a valuable insight into the sustainability of the depreciation charge.

### Component accounting and dry-docking

While there are two methods of accounting for dry-docking costs; the capitalised cost method and the accrual method.

Ind AS mandates the capitalised cost method. On purchase of a new vessel, companies are seeking to identify embedded maintenance costs expected to be incurred.

Capitalised dry-docking often represent significant costs to shipping and cruise line companies; therefore, the development of the accounting policy is a very important issue, as this policy must be followed consistently from one accounting period to another.

While the basic principles of accounting for revenue Ind AS are similar to those followed under current practice, Ind AS required companies to follow percentage completion method and lays down additional criteria to enable revenue recognition.

Ind AS, will also compel management to actively monitor the underlying assumptions in respect of economic useful lives, residual values, dry-docking costs, etc. which in turn will require increased sophistication in the financial reporting process.

Overall, transition to Ind AS will result in more appropriate depiction of the assets and contractual arrangements, with emphasis on substance of the transaction rather than the form driving the revenue recognised and treatment of the cost capitalisation and subsequent depreciation of the vessels.

---

### Shipping agency business

Determining whether an entity is acting as a principal or as an agent requires judgement and consideration of all relevant facts and circumstances. An entity is acting as a principal when it has 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, and
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 an 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. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

The income generated from the agency commission can be categorised in two parts, namely: manifest income and non-manifest income.

**Manifest income**
The income which pertains to a principal is known as manifest income as he is the risk bearer of the transaction. This income includes freight earned, Terminal Handling Charges (THC) charges, demurrage charges, container handling charges, vessel charges, port charges and port related incomes, recoveries from the port on account of reconciliations, etc. 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.

**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, documentation charges, container cleaning charges, stevedoring charges, berthing income, loading/unloading fees, etc. The revenue from these activities are recorded normally on issuance of bill of lading or delivery order.

**Direct tax issues**

**Service tax collected on specified shipping income to be excluded in gross freight for computing deemed taxable income under Section 44B of the Income-tax Act, 1961**

In India, Foreign Shipping Companies (FSC) are running their business under principal-agency model. Such FSC incorporate a local company which undertakes agency functions and are rewarded at an arm’s length in order to meet the transfer pricing regulations. Since, the agency company is resident in India, there are no major challenges from a direct tax perspective except for determination of the arm’s length price. FSC earning income from India are covered under presumptive scheme of taxation. Section 44B of Income-tax Act, 1961 (IT Act) contains special provisions for computing profits and gains of a non-resident engaged in the business of shipping. For such assessees, profits and gains will be considered at an amount equal to 7.5 per cent of the amount paid or payable to the non-resident or to any other person on his/her behalf on account of the carriage of passengers, livestock, mail or goods shipped at any port in India and also of the amount received or deemed to be received in India on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

While Section 44B of the IT Act governs assessees who are engaged in shipping business in India on a regular basis, Section 172 of the IT Act governs assessees who undertake such business in India not on a regular basis i.e. occasional shipping business. Section 172 of the IT Act is a complete code in itself and contains provisions for taxation for the occasional shipping business of non-residents in respect of profits made by them from carriage of passengers, livestock, mail or goods shipped at a port in India.

One of the contentious tax issues adversely impacting the FSC is the controversy revolving around calculation of gross receipts for the purpose of applying a presumptive rate of 7.5 per cent. There exists litigation as to whether the amount of service tax collected from the customers by such non-resident shipping company is to be included in gross receipts for the purpose of calculating tax under presumptive scheme.

The contention of the FSCs for non-inclusion of service tax while computing gross receipts is that service tax is a statutory levy which is required to be deposited with the government and the FSC only acts as an agent of the government with no element of profit. The Central Board of Direct Taxes (CBDT)1 too acknowledges the fact that service tax collected on behalf of the government is not an income of the collector in a circular. While this circular was issued by CBDT by relying on the decision of the Hon’ble Rajasthan High Court in the case of Rajasthan Urban Infrastructure2 and specifically covers cases where payments were made to resident assessees. However, one could draw an analogy from the intention and take a view that tax should not be levied on service tax collected by non-resident shipping companies.

In contrast, tax authorities contend that service tax forms as an integral part of the receipts of an assessees and the element of profit is not the only criteria for inclusion or exclusion of any amount in the aggregate amount received or receivable.

There persists a plethora of judgements in the favour and against the FSC on this subject. The Mumbai Tribunal in the case of China Shipping Container Lines (Hong Kong) Co. Ltd3 has decided the matter against the FSC and held that service tax collected by a FSC should be considered as part of its gross receipts for the purpose of calculating tax under Section 44B of the IT Act. Further, the Mumbai Tribunal failed to follow a favourable order of coordinate bench rendered in the case of Islamic Republic of Iran Shipping Line4 and Orient Overseas Container Lines Ltd5 while the facts remained the same.

The matter of Islamic Republic of Iran Shipping Line and China Shipping is now pending before the Bombay High Court.

Since the matter of China Shipping and Islamic Republic of Iran Shipping Line is now pending before the Bombay High Court, most likely the matter would attain finality only after the decision of the Hon’ble Supreme Court. In the interim period, this uncertainty would result in prolonged litigation before various appellate forums including Tribunals and High Courts. In order to avoid such piling up of litigation and to provide a non-adversarial tax regime, either an appropriate amendment should be brought in the Section or CBDT should come out with a clarification on the matter.

---

1. Circular No. 1/2014 (FNO.275/59/2012-IT(B)) dated 13 January 2014
2. CIT (TD) (Jodhpur vs Rajasthan Urban Infrastructure) (2013) 37 taxmann.com 154 (Jodhpur)
3. China Shipping Container Lines (Hong Kong) Co. Ltd. vs ADIT (2013) 39 taxmann.com 3 (Mumbai Trib.)
4. Islamic Republic of Iran Shipping Lines vs DCIT (2011) 11 taxmann.com 349 (Mumbai Trib.)
5. Orient Overseas Container Line Ltd. vs ADIT (2013) 35 taxmann.com 342 (Mumbai Trib.)
Taxability of shipping income from slot hire

Another most litigative issue faced by the shipping sector is regarding taxability of freight income from slot chartering arrangements.

Slot chartering or code sharing agreements are a regular feature in the shipping industry. It is often seen that due to lack of adequate infrastructure facilities available in India, mother vessels of FSCs do not call Indian ports. However, to tap the Indian EXIM trade, typically, slot arrangements are entered into by FSC, whereby container slots are purchased by them on vessels of other operators, including feeder vessel operators. The crucial question, therefore, arises as to how to interpret the meaning of the term ‘operation of ships’.

The key contention before the judicial authorities, has been whether freight income earned by FSC from slot chartering arrangements tantamount to income from ‘operation of ships’, so as to entitle FSC to the benefit of Article 8 (i.e. shipping income) of the concerned Double Tax Avoidance Agreement (DTAA).

There have been several conflicting judgements on this matter. As such, the principle that emerges from all these decisions is that when the term ‘operation of ships’ is neither defined in the DTAA nor domestic tax laws (at the time the concerned DTAA was executed), only in such an event, commentaries of the Organisation for Economic Co-operation and Development (OECD) Model Convention can be relied upon as an external aid to understand the meaning of the term. Furthermore, it appears that, it will be essential upon FSC to establish a linkage between feeder vessels and their mother vessels in order for them to claim that their freight income is eligible to tax exemption (full or proportionate) in India.

The Bombay High Court had an opportunity to deal with this very issue in the landmark case of M/s Balaji Shipping (UK) Ltd. and concluded that the slot arrangements shall not be taxable in India under Article 9 (i.e. shipping income) of India-U.K. DTAA relying on the writings of the OECD Model commentary. Furthermore, recently Mumbai Tribunal acknowledged that the expression ‘operation of ships’ had to be interpreted in a broader sense of carrying on of shipping activity and a shipping company may carry on such activities qua owner/lessee of a ship or qua charterer of a ship.

To resolve the issue, we will have to watch the space as to how the judicial authorities interprets the term ‘operation of ships’ vis-à-vis slot chartering, especially, considering that requirement of linkage of cargo from feeder vessels to mother vessels has not been mentioned either in OECD commentary or in the commentary of learned authors on international taxation. While, the Indian tonnage tax provisions, as applicable to Indian shipping companies, have specifically explained the term ‘operating ships’ to include slot charter. There seems to be no reason why the same interpretation should not be extended to similar slot charters done by FSC.

To sum up, it would be imperative to analyse the treaty benefits against the ‘substance’ of the agreement between feeder vessel and mother vessel essential to understand the relationship between mother vessel and feeder vessel and analysis of definition of ‘operation of ships’ under the respective tax treaties.

**Taxability of Inland Haulage Charges (IHC) under DTAA**

Charges for inland transportation commonly referred to as IHC are often collected by shipping companies for bringing cargo from a customer’s place (inland) to the port. These charges are essentially in the nature of inlands costs, generally separately disclosed on an invoice.

Taxpayers have been contending that IHC are not only incidental but also closely connected with direct operations of ships in the international traffic and therefore, are covered under the shipping article under DTAA.

The tax authorities have been contesting that the IHC earned by a FSC are not covered within the scope of shipping profits earned by the FSC from operation of ships in international traffic and, thereby treaty benefit are denied on such income.

However, this contentious issue has obtained a clarity in the recent decision of Hon’ble Bombay High Court wherein it has been held that inland transportation, if coupled with the main transportation of further shipping of cargo by the FSC from Indian port to the foreign country, would be an ‘activity directly connected with transportation to the foreign country’.

**Practical difficulties faced by FSC - Cumbersome tax clearance procedures**

The shipping industry in India has been sailing through rough weathers owing to global economic slowdown and falling freight rates. To add to the woes, FSC (especially, those engaged in regular shipping business) are required to comply with time consuming procedural requirements and non-compliance of which adversely impacts their business operations in India.

It is a desperate need of the hour that appropriate amendments are made in the regulations to eliminate or dilute the above practical challenges faced by FSC at the ground level e.g. FSC engaged in ‘regular’ shipping business could be exempted from such clearance procedures viz. obtaining vessel voyage PCC and filing vessel voyage returns, and such a requirement could be restricted only to FSC engaged in ‘occasional’ shipping business. The objective should be to bring the FSC engaged in ‘regular’ shipping business at par with other non-resident companies doing other businesses in India, which are not saddled with onerous compliances for doing business in India.
Different procedures followed by the Income Tax Officers (ITOs) at each port jurisdiction for granting PCC

The CBDT\(^{11}\) has empowered the ITOs to grant an annual No Objection Certificate (NOC) where freight income is not taxable in India under the provisions of the concerned tax treaty. However, it is seen that instead of an annual NOC, another certificate, popularly known as DIT (Double income tax) Relief Certificate, is issued to the FSC.

The DIT Relief Certificate is a certificate similar to an annual NOC and provides that freight income of FSC is fully/partly exempt from tax in India having regard to the specific provisions of the relevant tax treaty. However, unlike in case of an annual NOC, in case of a DIT Relief Certificate, the FSC or their Indian agents do need to obtain vessel voyage PCC before every voyage.

Further, there is no legally prescribed format of the DIT Relief Certificate and, therefore, there is no uniformity in the format of the DIT Relief Certificate issued at different port locations. In some cases, a blanket DIT Relief Certificate is granted which provides that shipping profits of a FSC are exempt from tax in India having regard to specific provisions of relevant tax treaty. In other cases, a list of vessels owned/chartered/pooled by a FSC that are likely to call Indian ports are mentioned and freight income derived only on these vessels is exempted from tax in India. In the latter case, approaching the ITO time and again becomes unavoidable. Different procedures are prevalent at each port jurisdiction for obtaining DIT Relief Certificates, PCCs and filing Vessel Voyage Returns.

Needless to mention that if specific vessels are not included in the DIT Relief Certificate, then freight income derived from carriage of cargo on such vessels can be held to be taxable in India and the FSC may be required to either pay tax or furnish appropriate guarantees till such time vessels are included in the DIT Relief Certificate. The industry is looking forward for exemption/relaxation from the clearance procedure and standardisation of format for details/DIT Relief certificate.

\(^{11}\) Circular No. 732 dated December 20, 1995 issued by the Central Board of Direct Taxes.
Logistics

This article aims to:

- Highlight the accounting challenges faced by freight forwarding agencies, non-vessel operating common carrier agencies and courier companies.
- Provide an overview of the direct tax and indirect tax issues relevant for this sector.
Freight forwards and non-vessel operating common carrier agencies

Sector overview
Freight forwarding activity refers to the services provided by agencies to transport cargo (be it container or bulk cargo) from one location to another (by various modes of transport, i.e. road, rail, air and sea). Freight forwarding agencies may or may not own the assets which are used for the transportation of such cargo. The freight forwards who primarily specialise in container cargo but do not own vessels and book cargo slots with third parties are referred to as Non-Vessel Owning Container Carriers (NVOCC).

There is a growing demand for advanced logistics capabilities (first-mile and last-mile logistics), with an emphasis on door-to-door services from the traditional port-to-port services. The market is also witnessing an increased use of technology to improve internal process efficiency and generate analysis for a deeper understanding of the focus industries and business processes of the customers, in addition to building industry-focussed operational capabilities.

Increased globalisation of Indian suppliers and importers, particularly in retail, e-commerce, pharmaceuticals, automotive and Fast Moving Consumer Goods (FMCG) sector, is expected to drive cross border logistics in the coming years.

Domestic logistics
The roll-out of the Goods and Services Tax (GST) law is expected to be a key enabler to recast the domestic supply chains, which have evolved from being driven by taxation norms to being driven by geographic parameters.

The government has a clear focus on infrastructure development with increased investments in highways, railways and rural roads. The implementation of the Sagarmala project (in July 2018) along with the government’s focus on developing National Waterways as a mode of transport indicates its focus on the maritime sector. Further, the announcements to develop underused airstrips and airports may help drive the aviation sector.

Increase in the outsourcing of logistics services by Indian companies is also expected to drive the domestic logistics sector.

Delhi-NCR, Mumbai and Bengaluru are likely to remain the major hubs for retail distribution centres, while Pune and Chennai are likely to witness a healthy demand for industrial warehousing. The manufacturing sector is expected to continue to remain one of the biggest demand drivers for warehousing in India. The demand for warehousing is also driven by e-commerce, automotive and components, engineering goods, IT and electronics, Fast Moving Consumer Goods (FMCG) and chemicals sectors.

Key accounting issues
Freight forwarding/NVOCC activity differs due to the nature of contracts entered into with customers, especially with reference to the timing of acceptance/delivery of the cargo, import or export shipments, charging of various duties taxes, additional service rendered like custom clearing, etc. Below are the key accounting areas which are relevant for this sub-sector.

Revenue recognition
a. Gross versus net accounting
Freight income is one of the significant items in an invoice billed to a final customer. As such, there can be challenges in respect of accounting of freight cost (cost to be paid to shipping agency), i.e. whether to be recognised at net (billed less cost paid to shipping agency) or gross (gross shown in income and cost of services).

The following features should be considered to determine if a NVOCC carrier is acting as principal or an agent:

- Indicators that an entity is acting as a principal include that it:
  - Bears the customer’s credit risk for the amount receivable from the customer
  - Has discretion in establishing prices (directly or indirectly)
  - Has primary responsibility for providing the services to the customer or for fulfilling the order.

- An indicator that an entity is acting as an agent, performing services for compensation or fee basis, which is fixed either in terms of an amount of currency or a percentage of the value of the underlying services provided by the principal.

In this sector, an entity NVOCC operator bears the gross credit risk for non-payment and is obliged to make payments to the shipping line/shipping agency contractually. Further, the NVOCC operator at its own discretion determines the margin and sets the pricing for a particular sector as well as the primary responsibility to ship the goods safely to the destination, irrespective of the fact that many NVOCC operators may have back-to-back arrangements with the shipping line. As such, considering the risk of carriage is with the NVOCC carrier, one may need to book the same at a gross amount.

b. Timing of revenue recognition
In every industry, the timing of revenue recognition is a critical and important judgement exercised by management. In the freight forwarding/NVOCC business, the relevant parameters of risk and rewards need to be analysed based on the type of shipment, i.e. import or export.

Export shipment: Revenue from freight export shipment (ocean/air freight, terminal handling charges, documentation charges, etc.) is normally recognised on the date of sailing/departure 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 key to recognising revenue for 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 each leg of the service, the level of services to be rendered, and the appropriate revenue to be recognised for each respective leg of service.

Import shipment: In the 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 a delivery order) 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 a free-hand shipment (where the business is generated though an agent), in which case, the relevant revenue/commission may be required to be accrued in the books.

Entities typically need to have a robust IT system to capture the 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 year end date (cut off), one may be dependent on IT to generate revenue for deferment for the related projects/shipments.

c. Accounting for pass-through costs

As per the contractual arrangement with the customer, an entity normally incurs certain expenditure on behalf of its customers (which is in the nature of tolls, custom duty, 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 entity (via a customer invoice). Merely invoicing of such reimbursable expenses does not make them eligible to be recorded as revenue and expenses. These are expenses which are incurred by the entity in its role as an agent of the customer and, therefore, it is inappropriate to recognise the gross receipts as income and gross payment as expenses; instead they should be recorded at net in the financial statements.

d. Accounting for rebates/volume discounts

Contract revenue generally comprises the initial amount of revenue agreed in the contract, and variations in contracts account on volume rebates and incentive. Volume rebates, discounts and other incentives are generally accounted for to the extent that it is probable that they may result in revenue, and when they are capable of being reliably measured.

In case of a contractual arrangement with customers where the price is variable and is dependent on the future volumes of business, the entity needs to estimate the volumes based on past experience/history of such arrangements.

Impact of Ind AS on freight forwarding/NVOCC

Revenue recognition – multiple elements

Ind AS 18, Revenue states that it is necessary to apply the revenue recognition criteria to each separately identifiable component of a single transaction in order to reflect the transaction’s substance. A freight forwarding/NVOCC transaction may contain separately identifiable components that may have to be accounted for separately. For example, a typical service includes revenue from export/import ocean freight income, vessel income, export Terminal Handling Charges (THC) income, Multi-modal Transport Operator (MTO) income, export voyage income, documentation charges, etc.

The identification of components within a single arrangement is consistent with the general principles in Ind AS 18 i.e. the requirement that it may be necessary to apply the revenue recognition criteria to the separately identifiable components of a single transaction to reflect the substance of the transaction.

An entity should consider following guidance to separate individual components in a single transactions:

- The component has stand-alone value to the customer; and
- The fair value of the component can be measured reliably.

Ind AS does not define, nor does it provide guidance about application of, the term ‘stand-alone value’. One view is that a delivered element has stand-alone value if a vendor sells the item on a stand-alone basis or the customer could resell it. Another view is that an item has stand-alone value if the customer derives value from that item that is not dependent on receiving other deliverables under the same arrangement.

In practise, both of these interpretations of stand-alone value are acceptable. An entity should choose an accounting policy, to be applied consistently, in determining the definition of stand-alone value. Regardless of the policy applied, the determination of whether a component within an arrangement has stand-alone value to the customer depends on facts and circumstances and requires judgement.

When considering the separation of components in a contract, if the entity sells the different components separately (or has done so in the past), this could be an indicator that separation is necessary for the purposes of revenue recognition, however, it is not a requirement. For example, even if the entity in question does not sell them separately, it may be that the transaction’s components are sold separately by other vendors in the market. In such a situation, the separation of the components may still be appropriate.

In case of the freight forwarding/NVOCC business, if the entity provides a host of landside and offshore services and charges a lump sum fee to the customer, the existence of other vendors in the market who provide similar services on a standalone basis might require the entity to split each element of the transaction at its relative fair value.
Courier industry in India

Sector overview

Courier, express and parcel (CEP) services refer to time bound door-to-door transportation and delivery of documents and parcels, including temperature-controlled logistics, with the potential benefits of continuous amalgamation of information technology and tracking convenience trickled down to the end consumer.

Although, the market is highly fragmented with a majority constituting the unorganised sector, there are only a few prominent players in the organised space.

The key end-use industries include banking, telecommunication, pharmaceuticals, automotive, retail and e-commerce retail.

In our experience, majority of express shipments are B2B shipments, while balance account for B2C and C2C shipments. Further, significant part of the volume is accounted by metro and tier-I cities, however, going forward, the share of tier-II and tier-III cities is expected to grow significantly.

Ind AS – significant areas of impact

Revenue recognition

In the courier industry, customers generally pay for their packages to be transported between two or more cities, either within India only or to a foreign destination. Courier companies operate typically using a ‘hub and spoke’ model wherein all collections from across a particular region are consolidated in a specific hub and then distributed across the country using a network of vehicles/lorries, railways, or through air. Many companies use service centres where parcels for delivery are collected. Given the volume of transactions and the need to maintain high levels of customer satisfaction, it is imperative that companies invest heavily in technology, both at the front end and at the back end, to ensure the complete and accurate capture of data, from hand held scanners to financial systems.

The question that arises is: how can a courier company recognise revenue? Depending upon the mode of delivery used and the distance between the places of origin and destination, a parcel could be in transit from one day (by air) to about 10 days (by road).

AS 9, Revenue Recognition permits service income for a courier company to typically recognise revenue on a ‘completion of service’ basis. Under Ind AS, completed service contract method is not permitted. Therefore, for companies providing services, revenue should be recognised using percentage of completion method. Further, as per Ind AS, when services are performed by indeterminate number of acts over a specified period of time, revenue may be recognised on a straight-line basis over a specified period. Based on the above, courier companies should recognise revenue using percentage of completion method under Ind AS or a straight line basis, if appropriate, based on facts and circumstances each case.

Freight forwarding activity refers to the services provided by agencies to transport cargo (be it container or bulk cargo) from one location to another (by various modes of transport, i.e. road, rail, air and sea). Freight forwarding agencies may or may not own the assets which are used for the transportation of such cargo. The freight forwarders who primarily specialise in container cargo but do not own vessels and book cargo slots with third parties are referred to as Non-Vessel Owning Container Carriers (NVOCC).

There is a growing demand for advanced logistics capabilities (first-mile and last-mile logistics), with an emphasis on door-to-door services from the traditional port-to-port services. The market is also witnessing an increased use of technology to improve internal process efficiency and generate analysis for a deeper understanding of the focus industries and business processes of the customers, in addition to building industry-focussed operational capabilities.

Increased globalisation of Indian suppliers and importers, particularly in retail, e-commerce, pharmaceuticals, automotive and Fast Moving Consumer Goods (FMCG) sector, is expected to drive cross border logistics in the coming years.
These companies operate through different channel partners such as collection centres, franchises, regional partners, etc. The terms of agreement with different channel partners could vary and, hence, one needs to determine which party is acting as the principal and which is the agent in the transaction. Indicators to determine principal and agent depend on defining the primary party responsible for delivery, the one that bears credit risk, the party that has price discretion, etc. The party that is assessed to be the principal for accounting purposes needs to recognise gross revenue and the compensation paid to the channel partner should be recognised as cost.

Lease deposits and straight-lining of lease rent

We have mentioned earlier that courier companies operate through the ‘hub and spoke’ model using a number of service centres across the country. Companies may end up leasing warehouses where hubs are set up for the purpose of temporarily storing the parcel through the delivery chain. These service centres and warehouses are generally leased for a period of four to seven years with a lock-in period of two to three years. Some of the leasing agreements may also have an escalation clause. In such arrangements, where the lease is renewable at the option of the lessee and where it is determined to extend (reasonable certainty at inception that the renewal/extension option will be exercised) and where there is an escalation clause, the lease rent may need to be recognised on a straight-line basis. However, Ind AS has provided a carve-out from IFRS, i.e. if the escalation clause is in line with the expected general inflation so as to compensate the lessor for expected inflationary cost, the increases in rentals shall not be straight-lined.

This could have a significant impact on the statement of profit and loss. Additionally, companies may pay security deposits to the lessor under the leasing agreement. The security deposit could meet the definition of a financial asset and at inception should be recorded at fair value. The difference between fair value and the amount paid shall be recognised as a prepaid rent, to be amortised over the period of the lease. The unwinding of the security deposit as per the effective interest rate method shall be recognised as a finance income over the period of the lease.

Deferred taxes

Under Ind AS, deferred tax is recognised using the balance sheet approach. All adjustments, such as discounting of financial assets and liabilities, may have a corresponding deferred tax impact. An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

- The parent, investor or venturer is able to control the timing of the reversal of the temporary difference
- It is probable that the temporary difference may not be reversed in the foreseeable future.

A burning issue is whether a deferred tax asset needs to be recognised on the indexation of freehold land. While a view is that a deferred tax needs to be created on the indexation of land, we would like to highlight that practices may vary in this area, especially in a situation where management believes that the land may never be sold on a standalone basis, but in a slump sale situation only.

Embedded leases – vehicle lease agreement

Courier companies have arrangements where delivery vehicles can be hired and payments can be made on a daily rate basis or is fixed on a monthly basis. Such agreements are normally enlisted for a period of three to four years, cancellable by either party at a month’s notice. Typically, the agreement could contain details of specific vehicles hired (inter-changeable in case of an accident or breakdown) and may also be branded with the courier company’s logo, etc.

Under Ind AS, such an arrangement, comprising a transaction or a service of related transactions that conveys the right to use an asset in return for payment, is in essence a lease or contains a lease and has to be accounted for under Ind AS 17, Leases.

In substance, such an arrangement could have two parts:

- Leasing of vehicles
- Services provided by the service provider.

Since the company has, under the arrangement, an exclusive right to use all the vehicles of the service provider and payments are fixed with a cancellable clause, this could be in the nature of an operating lease and necessary disclosures should be made in the financial statements, splitting the rentals paid between lease expenses and service charges.

Key direct tax issues

While the transport and logistics sector is witnessing a robust business growth and transformation, the tax issues surrounding the industry have also kept pace with the growth. It may not be incorrect to state that it is the need of the hour to resolve some of the long outstanding tax issues faced by the industry and provide an impetus for further growth.

On the tax front, the transport and logistics sector faces certain challenges such as tax controversies as well as an aggressive stance adopted by tax authorities over the years. The present government has repeatedly affirmed its commitment towards a non-adversarial tax regime and sought to further improve the ease of doing business in India. However, time bound action need to be taken to resolve the legacy tax issues that are plaguing this sector. It is imperative for the government to provide more clarity on outstanding tax issues and help settle the protracted litigation that is pending at various forums including High Courts and the Supreme Court of the country.

The Finance Minister Arun Jaitley in his Budget 2016 speech has laid considerable emphasis on infrastructure, with an increased allocation of funds and overall policy initiatives for the sector. However, from a taxation perspective many issues and expectations were left unanswered.
The previous year’s budget speech announced the reduction of the corporate tax rate from 30 per cent to 25 per cent. However, while in his current year’s budget speech the Finance Minister has laid down a road map for phasing of exemption/tax holidays, no guidance was provided for the reduction of the corporate tax rate to 25 per cent. The government should draw a clear road map for the reduction of corporate tax rate to the globally competitive rate of 25 per cent which could go a long way in boosting investor sentiments.

Phasing out of profit-linked and weighted deductions and exemptions, and a reduction in the accelerated rate of depreciation, has surely shattered the expectations of new entrants in the sector. To satisfy such discontent in the industry, the Finance Act, 2016 provides for a 100 per cent deduction of capital expenditure under Section 35AD of the Income Tax Act, 1961 for a new infrastructural facility which is surely a welcome move. Key proposals, including the commitment to implement General Anti-Avoidance Rule (GAAR) from 1 April 2017, and deferment of the Place of Effective Management (PoEM) for one year, have laid down a road map for industries across.

In today’s troubled times where liquidity rules the roost, it has become even more important that there is an upfront certainty on all costs, including tax costs. Some of the tax issues affecting the transport and logistics sector are elucidated below.

**Key Indirect tax issues**

**Levy of service tax on the import of cargo by vessels**

The activity of transportation of goods by an aircraft or a vessel from a place outside India up to the customs station of clearance in India has been kept out of the purview of service tax through the incorporation of the same in a negative list of services which is why these activities are not subject to service tax.

The Union Budget 2016-17 and Finance Act, 2016, levies service tax on ocean freight (inbound cargo) transaction by deleting the same entry from the negative list of services. Thus, service tax may now be applicable on inbound ocean freight transaction.

An abatement of 70 per cent of the value of taxable services is granted by the central government, hence, service tax shall be levied on 30 per cent of the value of ocean freight for inbound cargo, subject to the condition that the tax credit of service tax paid on inputs and capital goods is not availed.

The Ministry of Finance has issued a circular1 which states that in case of foreign shipping lines, the recipient of services will be liable for payment of service tax under the reverse charge mechanism.

The above clarification given in the above circular raises doubt as to whether in the case of a foreign shipping line operating through its agent in India, and having registered with the service tax authorities in India, may be considered as foreign shipping line for the purpose of service tax or not.

In our experience, given the fact that the foreign shipping lines are registered in India with the service tax authorities, they may not be construed as ‘foreign’ shipping lines under the service tax law, and are expected to continue to charge service tax on ocean freight pertaining to inbound cargo.

The Customs Act, 1962 requires that for the valuation of imported goods, the ocean freight paid by the importer should be added to the valuation of imported goods. Thus, in essence, the levy of service tax on an inbound ocean freight transaction may lead to payment of service tax and customs duty on the value of the ocean freight.

To give a partial relief, the circular issued by the indirect tax authorities clarified that the service tax levied on ocean freight shall not form part of customs duty valuation.

The levy of service tax on inbound- ocean freight (imports) may allow the shipping lines to avail tax credit of service tax paid on various input services, which may provide a respite to this industry. However, on the other side, the same may have an adverse impact on various imported goods, which are traded in India, as the service tax paid on ocean freight – inbound cargo may not be eligible as tax credit.

**Classification of ocean freight and non-ocean freight charges**

Shipping lines provide ocean freight, terminal handling and inland haulage services to customers. The amount of consideration for above activities is determined by shipping companies based on the types of activities performed by the shipping lines which are identified in the contracts with customers. Accordingly, various revenue line items could be appearing on the face of invoices issued by shipping lines to their customers, e.g. ocean freight, currency adjustment factor, bunker adjustment factor, emergency risk surcharge, etc.

The ocean freight will be subject to service tax with effect from 1 June 2016. Furthermore, an abatement at the rate of 70 per cent of the value of taxable services has been granted in this regard and, accordingly, only 30 per cent value of ocean freight may be subject to service tax. Thus, a shipping line is essentially required to categories its various streams of revenue in freight and non-freight activities.

The classification of various revenue streams into ocean freight and other freight has always been a matter of interpretation and indirect tax authorities have disputed the classification of the vast nature of income under the heading of ocean freight services. For example, the Currency Adjustment Factor (CAF) is charged by shipping lines for currency fluctuation in the ocean freight and, thus, the same should not be subject to service tax. However, the tax authorities have taken a view that the same does not form part of the freight activities, demanding service tax on the same.

---

Port and Container freight station

This article aims to:

- Provide an overview of accounting issues pertaining to ports and container freight stations.
- Highlight key direct tax and indirect tax issues relating to the sector.
Ports

Service concession arrangement
Ind AS provides guidance on the service concession arrangement which focusses on arrangements in which a private sector entity (the operator) builds or upgrades public service infrastructure. The operator typically receives cash, either from the public sector body that awards the concession (the grantor) or from users, only once the infrastructure is available for use.

This guidance applies to public-to-private service concession arrangements in which the public sector controls or regulates the services provided with the infrastructure and their prices, and controls any significant residual interest in the infrastructure. This guidance does not address all forms of infrastructure service arrangements and does not address accounting by grantors.

In India, certain ports may get covered in this guidance as they may be governed by the Tariff Authority of Major Ports guidelines for their pricing arrangements.

If a port falls in the scope of the service concession arrangement guidance under Ind AS then the following are the implications:

- The operator does not recognise the property, plant and equipment constructed as part of the service concession arrangement in its balance sheet. As per the contractual service agreement, the operator is considered to have a right to use.
- The operator recognises and measures revenue and costs related to the construction or upgrade of infrastructure in accordance with the provisions of Ind AS, during the construction or upgrade period. The consideration may be rights to a financial asset or an intangible asset.
- If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator’s consideration. The consideration received for both the components will be accounted for as per Ind AS.
- Ind AS is likely to affect the operator’s revenue recognition and profit pattern during the period of the arrangement. The change in the profit profile could also impact the timing or ability to pay dividends in certain years during the term of the project. Additionally, the operator’s balance sheet composition is also likely to change, as assets previously classified as fixed assets will be separately classified as financial assets or intangible assets.

The accounting for service concession arrangements under Ind AS is expected to significantly alter some of the key ratios in the financial statements of the operators, which may require a re-negotiation of loan covenants with lenders.

Actions that the management of a port may need to take are as follows:

- Analyse the contractual arrangements with the grantor to determine the appropriate timing and basis for revenue recognition which will have to be split between revenue during the construction period and revenue during the operating period.
- Assess whether the company has have to recognise an intangible or financial asset and assess the impact of derecognising the property, plant and equipment.
- Review the debt covenants with the lenders given that in many cases the fixed assets recognised under the current framework would be offered as security.

Accounting under service concession arrangements could be complex, and may result in the recognition of intangible assets (being the ‘right to use’) and a liability for the payments to the grantor. Where an arrangement is outside the scope of service concession arrangements’ guidance, entities need to consider the requirements of Ind AS 17, Leases relating to the topic ‘determining whether an arrangement contains a lease’.

Container freight station (CFS)

CFS is a location that is designated by carriers for the receiving 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 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 of 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. Generally, revenue from the aforementioned activities are recognised on completion of the respective services.

However, in addition to compliance with the basic revenue recognition criteria as set out in Indian GAAP, one has to also evaluate the following two matters which require a certain degree of judgement:

(a) compliance with laws, and (b) multiple arrangement facilities/composite arrangement.
• 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. Post this date, customs authority have all the rights to auction the goods and have the first claim to the custom duty payable. As such, one needs to carefully examine the following:
  - Ground rent revenue recognition beyond the period of 75 days (especially during the financial closure date i.e. ensuring completeness/cut-off): Since the CFS is governed by customs law, on grounds of prudence, as per industry practice ground rent revenue recognition is generally discontinued once the cargo is not claimed within a period of 75 days. One has to exercise caution in recognising any revenue if the goods are lying unclaimed for a period of more than 75 days. In most cases, revenue is recognised to the extent proceeds are realised from the auction of such unclaimed goods, net of any duties payable.
  - Accounting of surplus customs claims: It is common practice for CFS to auction unclaimed cargo beyond 75 days. The proceeds from the auctioning of unclaimed cargo claim are first used towards the settlement of outstanding dues of customs and later of the CFS’s outstanding dues. In most cases, revenue is recognised to the extent proceeds are realised from the auction of such unclaimed goods, net of any duties payable. In case the proceeds realised are in excess of the dues payable to customs and the dues payable to the CFS, one also needs to evaluate the timing of recognition of the balance excess claim (to be refunded to the consignee).
• 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 arrangements with a customer. To understand when to account separately for performance obligations is a key determination and requires a 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 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 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.

**Key direct tax issues**

**Claiming tax holidays under Section 80-IA of the Income Tax Act, 1961 by the Inland Container Depots (ICD) and Container Freight Station (CFS)**

One of the contentious tax issues adversely impacting the port industry is the debate and ambiguity as to whether the business of developing, operating and/or maintaining ICDs and CFS facilities shall be regarded as ‘inland ports’ and considered as infrastructure facilities eligible for tax incentives under Section 80-IA of the Income Tax Act, 1961 (IT Act).

An ambiguity was created when the government vide Finance Act, 2001 deleted the phrase ‘any other public facility of a similar nature as may be notified by the Board in this behalf in the Official Gazette’ from the definition of infrastructure facility. This amendment has resulted in many a taxpayer being denied the benefits of the said Section. The industry however felt that the amendment in the definition would not impact its claim of considering ICDs/CFS as part of port and more so in the nature of inland port for the purpose of claiming benefits. For this, reliance was placed on CBID Circular No. 793 dated 23 June 2000 as amended by Circular No. 10/2005 dated 16 December 2005 which clarified that the term ‘port’ for the purpose of Section 80-IA includes structures at ports for storage, loading and unloading, etc. If the concerned port authority issues a certificate that said structures (i.e. ICDs/CFS) form part of the port.

The Central Board for Excise and Customs (CBEC)1 and Infrastructure division of Ministry of Commerce and Industry2 clarified to the taxpayer that ICDs/CFSs were inland ports. The taxpayers truly believe that ICDs are inland ports under Explanation (d) of Section 80-IA(4) of the IT Act and hence eligible to claim a deduction under Section 80-IA of the IT Act.

There have been conflicting judgements on this subject. The Hon’ble Delhi High Court in the case of Container Corporation of India Ltd.3 and the Hon’ble Bombay High Court in the case of Continental Warehousing Corporation (Nhava Sheva) Ltd.4 and A. L. Logistics (P) Ltd5 have delivered a landmark judgement in favour of the taxpayer where the court have held that CFSs/ICDs are inland ports under Explanation (d) of Section 80-IA(4) of the IT Act and hence eligible for a tax holiday under Section 80-IA of the IT Act.

Despite the ruling of Delhi and Bombay High Courts, the tax authorities have filed a Special Leave Petition (SLP) against the decision of the High Court which has been admitted by the Apex Court6. Therefore, the Apex Court believes that the matter is a question of law and the industry has to wait for its decision.

**Introduction of a sunset clause in Section 80-IA of the IT Act**

The deduction under Section 80-IA of the IT Act is available to an enterprise carrying on the business of (i) developing or (ii) operating and maintaining or (iii) developing, operating and maintaining any infrastructure facility.

---

1. CBEC Clarification No. F. No. 45024/03/2007 – Cus.IV dated 24 April 2007
2. Office Memorandum No. 16/9/2009 dated 21 May 2009
3. Container Corporation of India Ltd. v. ACIT (ITA No. 1411/2009)
The Finance Act, 2016 has introduced a sunset clause for claiming deduction under Section 80-IA by any enterprise which starts the development or operation and maintenance of the infrastructure facility on or after the 1 April 2017. In the absence of clarity in the Finance Act, the following issues could be the subject matter of litigation in the future:

- Will the new proviso to Section 80-IA of the IT Act apply to enterprises engaging in the developing, operation and maintenance of infrastructure facility on or after the first day of April 2017?
- Which activity/activities performed by the enterprise constitute the start of the development or operation and maintenance of the infrastructure facility?

The above controversy may result in protracted litigation in the near future and thus a clarification on the matter is awaited from the government.

**Deduction of capital expenditure – New infrastructure facility**

The Finance Act, 2016 has extended the benefit of deduction of capital expenditure under Section 35AD of the IT Act to the business of developing or operating and maintaining or developing, operating and maintaining a ‘new infrastructure facility’ from the previous year 2017-18.

The above benefit is surely a welcome move by the government vis-à-vis the disappointment over the phasing out of profit-linked deductions. However, several interpretative issues evolving around the claims of deduction under Section 80-IA of the IT Act by the port sector shall now be faced under Section 35AD of the IT Act as well.

Another worthwhile issue of discussion is on the ambiguity regarding whether or not capital expenditure will include the lease premium paid for land in order to develop infrastructure facility, thus clarity needs to be sought before one can claim such a huge quantum of deduction under this Section.

**Key indirect tax issues**

**Changes in the Foreign Trade Policy (2015-2020)**

Ports provide services to shipping lines, importer/exporter, etc. Generally, the consideration for port services is denominated in foreign exchange, as the Reserve Bank of India (RBI) guidelines permit receipt of consideration by ports from overseas customers/shipping lines in convertible foreign exchange. However, due to restrictions levied by the Tariff Authority for Major Ports (TAMP), ports are permitted to receive amounts in INR only.

Considering the above fact, payments received by ports in INR was given the status of deemed receipt in foreign exchange under the Foreign Trade Policy (FTP) till 2014. Accordingly, ports were eligible for export incentives under the Served from India Scheme (SFIS) and Export Promotion Capital Goods (EPCG) schemes.

However, the Ministry of Commerce and Industry introduced new FTP provisions (2015-2020) effective from 1 April 2015, whereby the special privilege given to the port sector (construing the receipt of amount in INR as equivalent to deemed receipt of foreign exchange) was withdrawn.

As per the amended FTP provisions, the benefit is currently available only if the consideration is received in convertible foreign exchange. Further, the FTP stated that government shall notify the ‘list of services eligible for receipt of amount in INR’.

After a period of one year, in the month of May 2016, the Ministry of Commerce and Industry notified the above list and included port services in the same, which enables the port sector to leverage potential benefits under the above schemes.

Furthermore, till 2014 the port sector was eligible for incentives at the rate of 10 per cent on services under the earlier SFIS scheme. However, under the FTP 2015-2020 provisions, the fiscal incentive has been reduced from 10 per cent to 5 per cent, shrinking the benefits available to the port sector. This means that port services are construed at par with consulting or other services that do not involve major infrastructure costs. Construction/development of a port requires huge infrastructural costs as opposed to consulting services and, thus, port services should be eligible to receive a higher amount of incentive and get incentives at an earlier rate, i.e. as specified by the FTP till 2014.

**Taxability of construction contracts pertaining to ports**

Prior to 2015, construction services provided to port/airports, etc. were exempt from the levy of service tax. However, the exemption has been withdrawn from 1 April 2015 with regards to services by way of construction, erection, commissioning, or installation of original works pertaining to an airport or a port. Accordingly, there is a huge increase in the cost of new construction projects. Furthermore, the service tax paid on such construction services are not eligible as CENVAT Credit to the port sector and, hence, the same forms part of the overall project cost.

Considering that construction of ports is a very expensive proposition with a long gestation period, payment of service tax at 14.5 per cent or at 15 per cent from 1 June 2016 could be an additional expenditure, discouraging project developers in undertaking construction activities at ports.

It was expected that as part of the ‘Ease of Doing Business’ initiative by Government of India, the exemption from service tax on construction of a port might be revisited and preferably restored as available prior to 1 March 2015.

The Union Budget 2016-17 has reintroduced the exemption only to the extent of contracts executed prior to 1 April 2015, subject to the prescribed conditions. The service tax paid on the contract during the above period is proposed to be refunded by the government. However, it appears that the refund of service tax might be limited to the incremental taxes paid to the government and not the entire service tax charged by the contractor to the port.

Thus, the new contracts are still covered under the service tax net, increasing the overall project cost.
This article aims to:
- Provide an overview of the accounting issues while entities use rail as a mode of transportation of materials.
- Summarise key direct and indirect tax issues affecting entities using rail as a mode of transportation.
Entities into heavy metal and mining industry and construction sectors use railways as the mode of transportation for materials from project site/factories to destination. In this regard, entities spend on the following types of cost which are explained in the given article.

**Railway sidings**
Railway sidings usually connect through a railway track or to other sidings which could be used for loading and unloading material from/to factory/project sites.

Many companies in India use railways for transportation of materials to their site. In this regard, separate railway tracks could be linked to the site wherever it is located.

Costs which are directly attributable for construction of such railway sidings are generally paid by the entity requiring railway sidings. An entity may incur expenditure such as commissioning costs, payment to railway authorities for construction of railway sidings, etc. Such expenditure could be recorded as tangible fixed assets if they meet the recognition criteria under Ind AS 16, *Property, Plant and Equipment*.

For such assets, the indicative useful life as provided in Schedule III is 15 years.

**Registration fees**
Entities may also enter into long-term arrangements with railways for use of Indian railway tracks.

In this respect, entities may pay licence/registration fees (right to use) to the Ministry of Railways for approval of movement of rakes/container trains on Indian railway tracks.

Ind AS 38, *Intangible Assets* would be applied to determine whether such registration fees would meet the definition of an intangible asset and can be recognised in the balance sheet.

**Enabling assets**
Certain entities incur expenditure on items which are not owned by them. This expenditure is often incurred to facilitate the construction/development of the project or used as a mode of transportation of materials. While the expenditure is incurred by entities on these assets but these assets are often constructed on land owned by the government. Entities may have exclusive rights to use these assets or companies can use the assets along with the general public. These items are generally referred to as ‘enabling assets’.

The moot issue in accounting for these items (which are necessary for the construction of the plant/operations of the entity but are not owned or controlled by the entity) is that these costs may not meet the definition of an asset.

In order to recognise the expenditure as an asset, the following two conditions must be satisfied:

i. The entity must have control over the asset, and

ii. Future economic benefits must flow to the entity from these assets.

An indicator of control of an item of a fixed asset would be that the entity can restrict the access of others to the benefits derived from the asset.

Therefore, in cases where the assets are available for general public use, the expenditure incurred by an entity on such ‘enabling assets’ cannot be capitalised as a separate tangible or intangible asset even though the economic benefits are expected to flow to the entity. However, an entity should also analyse the conditions given in Ind AS 16 along with its facts and circumstances before it capitalises the enabling assets.
Recently, the Ind AS Transition Facilitation Group (ITFG) of the Institute of Chartered Accountants of India (ICAI) held its second meeting on 12 April 2016 and has issued its second bulletin (Bulletin 2) on 10 May 2016 which provides guidance on six issues relating to the application of Ind AS. Enabling assets was one the topic that ITFG discussed and opined that the expenditure incurred on construction of assets on land not owned by an entity should be capitalised based on the principles of Ind AS 16 after consideration of facts and circumstances of each case.

In the cases, where an entity can restrict the access to others i.e. track is not available for public issue and the economic benefits is expected to flow to the entity, in that case the entity could meet the definition of ‘control’ and the said expenditure incurred could be capitalised.

**Key direct tax issues**

The railway sector is yet to be privatised in India, thus keeping the stakeholders free from litigative trouble. However, many taxpayers hold indirect nexus with the railway industry including the developers and contractor of the rail infrastructure.

**Developer versus contractor**

An ambiguity exists in the industry whether the railway contractors shall be eligible for deduction under Section 80-IA of the Income-tax Act, 1961 (IT Act). Many contractors carrying on the construction of rail over bridges, foot over bridges, railway station buildings, etc. on behalf of Indian Railways claim the benefit of deduction under Section 80-IA of the IT Act considering that ‘rail system’ is included in the definition of ‘infrastructure facility’ under Section 80-IA(4) of the IT Act.

The tax authorities, however, contend that for the purpose of claiming the benefit of deduction under Section 80-IA of the IT Act, the taxpayer shall develop or operate and maintain or develop, operate and maintain an infrastructure facility which includes a ‘rail system’. The Central Board of Direct Taxes should provide appropriate clarifications in order to avoid frivolous litigation on this matter.

**Section 43B of the IT Act to include payments made to Indian Railways**

The Finance Act, 2016 has introduced an amendment in the Section 43B of the IT Act with a view to safeguard the interests of the Indian Railways. To ensure the prompt payment of dues to Railways for use of its assets, payments made to the Indian Railways shall be disallowed if not paid before the due date of filing the return of income.

**Indirect tax issue**

**Railway haulage charges**

To boost the railway sector, the government has allowed private participation and, following which private Container Train Operators (CTO) have been allowed to obtain licenses to run container trains on Indian Railways routes.

CTOs executed agreements with the Indian Railways which clearly required the private players to bring their own wagons, and pay haulage charges to Indian Railways for the transportation of containers. These haulage charges are subject to service tax, according to which Indian Railways charges service tax at an applicable rate, i.e. after 70 per cent abatement.

The service tax authorities have initiated an enquiry and alleged that the haulage amount charged by Indian Railways are not in the nature of transport of goods by rail services and the same is in nature of support services provided by the government. The support services provided by the government are subject to service tax on the haulage amount under a reverse charge mechanism (i.e. recipient of services will be liable for payment of service tax), under which show-cause notices are issued to CTOs demanding the payment of the tax despite the fact that the same has been already charged by Indian Railways as forward charges.

To ignite this matter, in the Finance Act, 2015, the abatement of 70 per cent as applicable to CTOs, was subjected to the condition that CENVAT credit of service tax paid on input services will not be eligible. Thus, CTOs were essentially required to charge service tax at full rate, without abatement. This had an impact on the competitiveness of the sector as transport of containers by rail was subject to a full rate of service tax, whereas other modes of transport were still subject to a lower rate of service tax.

To remove all these anomalies, the Finance Act, 2016, made suitable amendments stating that haulage charges by the Indian Railways will be subject to service tax as forward charges. Furthermore, CTOs will be eligible to take the credit of the service tax charged by Indian Railways and opt for the abatement of 60 per cent. Thus, transport of containers by rail gain an equal status with other modes of transport.
Aviation

This article aims to:
- Highlight key accounting issues pertaining to the aviation sector.
- Summarise key direct tax issues.
The airline industry is capital intensive, with a significant portion of an airline’s assets invested in property, plant and equipment. The acquisition of an aircraft and related fixed assets, whether taken on lease or purchased, represent the single most critical channel of investment for all airlines. Acquisition of assets can be structured under a variety of terms which may offer potential for disparate accounting treatment.

Below are some of the key accounting issues impacting the aviation sector.

**Aircraft cost**

Ind AS 16 *Property, Plant and Equipment* sets out the accounting treatment and disclosure requirements for property, plants and equipment. The cost of a property, plant and equipment includes all expenditures applicable to its acquisition. These include the manufacturer’s sales price, sales or use tax, duty, freight costs and the costs of any additions or modifications that qualify for capitalisation. In addition, borrowing cost is directly attributable to the acquisition needs to be capitalised as part of cost of the asset.

Ind AS 16 requires major components of assets to be capitalised and appropriate depreciation policies applied to each identified component. An aircraft generally comprises a number of components, which include:

- Airframe
- Engines
- Buyer-Furnished Equipment (BFE)
- Modified In-flight Entertainment (IFE)
- Rotables.

Although these components are accounted separately, the financial statements continue to disclose them as a line item aircraft in the financial statements. Generally, in relation to the purchase of an aircraft, the following issues arise, which may require detailed consideration.

**Option payments**

In order to purchase a new aircraft, the practise is that airlines pay an upfront deposit to the aircraft manufacturers. These deposits are generally referred to as ‘options’ and have an exercise period attached with them within which an airline has to exercise its decision to purchase an aircraft. These deposits help airlines keep the aircraft acquisition capacity as flexible as possible, and also help establish a position in the aircraft manufacturer’s production queue. As and when an airline exercises these options i.e. purchases an aircraft then these options (deposits) are capitalised as part of the aircraft cost. In certain cases, the options may expire i.e. an airline may not purchase an aircraft, or the option period lapses then the deposit should be charged off to the statement of profit and loss.

**Manufacturing incentives**

We have generally observed that certain airlines acquire aircrafts under sales and leaseback model. Additionally, airlines may negotiate the purchase price and other incentives with aircraft manufacturers whereby, as an inducement to purchase a particular manufacturer’s aircraft, engine, parts, or other flight equipment, a manufacturer may grant incentives to an airline. These incentives generally form a significant component of aircraft acquisition agreements and can take many forms, such as:

- Cash incentives received along with the purchase of an aircraft
- Incentives in the form of spare parts, tools, or other equipment received along with the purchase of an aircraft
- Incentives in the form of services such as flight crew training, maintenance, advertising, promotions, aircraft financing, etc. received along with the purchase of an aircraft.

In substance, these incentives can be broadly classified into cash and non-cash incentives.

An airline should consider facts and circumstances relating to its case and if the substance of the incentives represent discount against the aircraft purchase price then in case of owned and finance leased aircraft, both the categories of incentives are set off against the cost of an aircraft. While a cash incentive is directly set off against the cost of the aircraft, if the aircraft manufacturer provides non-cash incentive to the airline, the fair value of the non-cash incentive would be recognised as an asset, to the extent it represents a service not yet rendered, with an offsetting reduction in the purchase price of the aircraft. The asset would be charged to the statement of profit and loss as the incentive is utilised. Similarly, in case the sale and lease back results in an operating lease, an airline would need to ascertain the fair value of the aircraft. If, the fair value of the aircraft is lower than the sales price, then the difference would be treated as a compensation for higher lease rentals to be paid in future and therefore the cash incentives should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If, however, it is clear that the transaction is established at fair value, the cash incentives should be recognised immediately, since in that case the future lease rentals represent fair rents. In the case of non-cash incentive, an airline should defer and recognise the incentives in proportion to the lease payments over the period for which the asset is expected to be used.

**Aircraft modification**

It is common for certain types of expenditures, such as cost of replacing seats, cost of replacing inflight entertainment systems, etc. have to be incurred a number of times throughout an aircraft’s life. Such modification costs should be capitalised as it is probable that future economic benefits associated with such items may flow to the entity and the cost of such items can be reliably measured. However, it is imperative to distinguish modification expenditures from expenditure on regular repairs and maintenance, the latter of which are expensed off to the statement of profit and loss.

For an operating lease aircraft, one needs to deliberate on how modifications should be treated. In many circumstances, these modifications are treated as leasehold improvements, which are capitalised and depreciated over their useful life or the remaining period of the lease, whichever is shorter.
**Used aircrafts**

Used aircrafts are acquired in various conditions and at various stages between their overhauls. The cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. Therefore, costs incurred by an airline for items such as interiors, painting, customer service equipment, and initial maintenance costs, etc. to bring the aircraft to a condition of being capable of entering service should be capitalised.

However, once an aircraft is placed into service, any subsequent costs may have to be analysed, to determine whether they meet the criteria for capitalisation.

**Componentisation**

To apply the ‘component approach’, it is necessary to identify various significant parts of property, plant and equipment which have a different useful lives from the remaining parts. Determination of significant components requires a careful assessment of the facts and circumstances. This assessment includes, at a minimum:

- Comparison of the cost allocated to the item to the total cost of the aggregated property, plant and equipment
- Consideration of the potential impact of componentisation on the depreciation expense.

An aircraft generally comprises a number of components that may be replaced independently as part of a modification before the aircraft reaches the end of its useful life. However, it is vital to note that identification of significant parts and their useful lives is a matter of judgement and should be decided on a case-to-case basis. It is not merely an accounting exercise. It would help if technical experts are involved to determine significant parts of an asset.

**Aircraft maintenance, major inspection and overhaul**

Maintenance requirements are dictated by the highly sophisticated nature of the industry’s equipment. The airlines establish repair and overhaul cycles for each airframe and engine part in an effort to prevent potential hazards and to ensure transportation safety. The timing and extent of maintenance procedures are determined by individual airlines using studies based on actual experience, which demonstrate airworthiness to the regulatory agencies, e.g. the Directorate General of Civil Aviation.

An airline’s maintenance programme includes two general categories - line maintenance, and component overhaul and maintenance checks.

Line maintenance consists of routine daily and weekly scheduled maintenance inspections and checks, including pre-flight, daily, overnight and weekly checks, and any diagnostics and routine repairs. Some or all of these activities may be outsourced by the airline to a third-party provider. The line maintenance cost is expensed off as they would not qualify for capitalisation.

Component overhaul and maintenance checks involve the repair of major parts, including engines, landing gear, avionics, etc. that are either repaired in-house or sent to third-party maintenance repair stations. They encompass all inspections or replacements of major parts, which the regulatory agencies require at specific maximum periodic intervals to recertify that those part are completely airworthy.

Component overhaul and maintenance checks can be considered as a major inspection or overhaul cost and could be treated as a separate part of the asset, if they are significant component of the cost of an aircraft and meet the requirements of Ind AS 16. The components may not physical components of an aircraft.

At the time of purchase of an aircraft, the entity should identify a major inspection or overhaul cost as a separate component which is depreciated separately over the period till the next major inspection or overhaul. Upon the next major inspection or overhaul, the cost of a new major inspection or overhaul is added to the gross block of the asset and any residual amount pertaining to the previous inspection or overhaul is de-recognised.

For example, C Limited runs an airline and has just acquired a new aircraft for USD40 million. The useful life of the aircraft is 20 years, but it will be inspected every three years and a major overhaul will be carried out. At the date of acquisition, the major overhaul cost for similar aircrafts that are three years old is approximately USD6 million. Therefore, the cost of the overhaul component for accounting purposes is USD6 million and this amount would be depreciated over the three years to the next overhaul. The remaining carrying amount, which may need to be split into further components is USD34 million. Any additional components will be depreciated over their own estimated useful lives.

Entities transitioning to Ind AS may have identified an element relating to the inspection/overhaul as a separate component of its aircraft asset then it would have been depreciated using the component approach.
Impairment

The airline industry is capital intensive, with a significant portion of an airline's assets typically invested in property, plant and equipment such as aircraft and related infrastructure and support assets. While capital investment is high, earnings have historically been volatile. Certain impairment indicators, which are peculiar to an airline are:

- Disposal or planned disposal of an entire fleet or a major portion of a fleet
- Management's intention to permanently ground a fleet (or a major portion of a fleet) that is currently operating
- Adverse changes in the way the aircraft are being used, affecting cash flows (for example, significant reductions in fleet-wide aircraft utilisation rates)
- Permanent and significant declines in fleet fair values
- Regulatory changes and requirements that affect an airline's ability to operate its aircraft, etc.

Impairment testing should be performed on the smallest group of assets that work together to generate independent cash flows (i.e. Cash Generating Units - CGU). Determining the appropriate asset group to use as a basis for impairment testing requires significant judgement. Generally, entities group aircrafts on the basis of aircraft fleet type or allocating aircrafts to route groups or assessing economic interdependencies. It may not be appropriate to consider a standalone aircraft as a CGU as it is generally not practical to evaluate cash flows at this level due to the interchangeability of aircraft in an airline's operations, unless the aircraft is not interchangeable with other aircraft in the airline's fleet. Different airlines' circumstances are expected to be critical factors in determining the asset groupings for impairment testing.

Hedging of fuel

The airline industry is exposed to significant volatility in the price of fuel. However, unlike many global airlines, the Indian airlines may not have robust risk management policies that include the use of derivative financial instruments to hedge the exposures emanating from volatility in the price of fuel.

Under Ind AS 109, Financial Instruments an entity may hedge the price risk on a forecasted purchase of jet fuel using the hedge accounting requirements in the standards. If hedge accounting is followed then effective portion of changes in fair value of the hedging instrument is recognised in Other Comprehensive Income. The ineffective portion of the gain or loss on the hedging instrument is recognised immediately in profit or loss. On actual purchase of the jet fuel, any accumulated amount in the Other Comprehensive Income is removed and included in the initial cost of the jet fuel.

Key direct tax issues

The Indian airline sector has been perennially facing tax controversies on several accounts leading to an unstable tax regime for the industry.

Depreciation on aircrafts at a higher rate

The airline industry is facing disputes on a higher rate of depreciation on aircrafts of 40 per cent. Tax authorities contend that in the absence of a specific mention of aircrafts in 'aeroplanes-aero engines' in the present depreciation table, an aircraft would be eligible for depreciation at the general category of 15 per cent based on the judgements of the Supreme Court and the Bombay High Court.

However, in light of the recent judicial rulings in the case of SRC Aviation (P) Ltd, the Delhi High Court held that in the depreciation table ‘aeroplane-aero engine’ cannot be given a restrictive interpretation so as to include aero engines since ‘aircraft’ is a broader term and it includes the term ‘aeroplane’. Accordingly, the court held that aircrafts shall be entitled to a higher rate of depreciation at 40 per cent. A similar ruling has been delivered by the Delhi Tribunal in the case of M/s A.R. Airways Pvt. Ltd.

Withholding tax on tickets at the concessional price provided by airlines to travel agents

It is an industry practice wherein the airlines generally sell their tickets through agents who sell the same to end customers. The tickets are typically sold at a discount to travel agents who further sell it to retailers and/or end subscribers at the market price. The tax characterisation of the margin left with an agent as well as the applicability of the tax withholding obligations is at the core of the tax controversy in types of transactions.

The airlines consider the transaction between airlines and its agents on a principal to principal basis, hence the difference in the price is characterised as a discount and not commission. Since the transaction is not characterised as commission, it would not be subject to withholding tax provision. The said view has been supported by the ruling of the Bombay High Court in the case of Qatar Airways.

On the other hand, tax authorities have adopted a contrary position regarding the sale of tickets through agents. They believe that a discount given to the distributors is in the nature of commission and therefore, should be subject to tax withholding under Section 194H of the Income Tax Act, 1961 (IT Act). There have been several conflicting judgements on this matter. However, the most point of consideration is that the cash discounts provided to travel agents are not related to any services rendered by them (selling tickets), i.e. the amount of cash discount is paid for upfront, in advance, for sale of tickets and bears no relation to the services of the agent for the principal.
There is an urgent need to resolve the controversy and end protracted litigation over this matter. This is expected to help in preventing a compliance challenge for airline players and might also address the cash flow issue at the agents’ end.

**Withholding tax on payment of Passenger Service Fee (PSE)**

Another issue adversely impacting airlines is regarding Tax Deducted at Source (TDS) compliances in respect of payment of PSE made by them to the Airport Authority of India (AAI) which is a statutory liability of an airline.

PSE is levied under Rule 88 of the Indian Aircraft Rules, 1937 which is collected by the airlines from embarking passengers. It has two components, namely, the security component and facilitation component. PSE is collected by an airline and transferred to AAI or an airport operator.

Tax authorities have been issuing notices to the airlines for non-deduction of tax under Section 194-I, 194C and 194J of IT Act with respect to the payment of PSE. The airlines are contending that withholding should not be applicable since they act as collecting agents on behalf of AAI/airport operators for PSE and there is no contract between airline companies and AAI/airport operators. Since airline are only collecting PSE from the passengers on behalf of airport operators and paying the same to them, no liability to deduct tax under the IT Act should arise.

The Mumbai Tribunal\(^2\) has held that such PSE charges paid by the airline on behalf of the customer does not attract TDS under section 194-I of the IT Act.

**Withholding tax on payment of landing/take off/parking charges**

Rate of TDS on landing/take off/parking charges paid by the airlines to the airport authorities has also been a vexing issue.\(^6\)

In many of these cases, the airlines contend that the payments are compensation for work done by the AAI for providing facilities as mandated under the International Civil Aviation Organisation (ICAO) guidelines at the airport and, accordingly, tax is deductible under Section 194C of the IT Act at the rate of 2 per cent. However, the tax authorities contend that the charges are for use of land, thus, in the nature of rent and liable to withholding at 10 per cent.

There have been several conflicting judgements on this matter. However, the contentious issue of characterisation of landing and parking charges as rent has been put to rest by the recent Supreme
Court Ruling in the case of Japan Airlines Co. Ltd where the Supreme Court held that TDS shall be deducted at 2 per cent under Section 194C of the IT Act since the said charges are not for use of land but for services which cannot be termed as rent.

Leasing of an aircraft
Sale and lease back of aircraft is one of the way of acquiring aircrafts by the airlines. Earlier, the benefit of Section 10(15A) was available in IT Act which exempted the income of foreign vendors offering aircrafts on lease. However, this benefit was withdrawn by the government from 1 April 2007 onwards. However, the benefit of tax treaties can still be availed in this respect. For instance, India has favourable tax treaties with Ireland and Belgium in this regard where the leasing of aircrafts is not within the ambit of a royalty definition.

Permanent Establishment (PE) for inventory placed at the aviation premises
Foreign vendors provide critical components vide a local pool without which the aircrafts would be on ground. Due to the critical nature of the components the same would be maintained in the airline’s premises. These components are made available as serviceable part within a few hours of the corresponding component fitted on the aircraft becoming unserviceable.

The local pool is owned by a foreign vendor, but is under the possession and control of an airline in India. The tax authorities have contested that income generated for a foreign vendor from granting the right to use spare parts/components shall be taxed in India as business income since the foreign vendor creates a PE in India.

It is pertinent to note that for mitigating the PE risk, the airline needs to demonstrate control over the leased stock and reliance can be placed in respect of the case law relating to Airline Rotables Limited vs. JDIT (131 TTJ 385).

7. ACIT v. Jet Airways (India) Ltd. [2013] 40 taxmann.com 178 (Mum.- Trib)
8. CIT v. Singapore Airlines Ltd. [2012] 24 taxmann.com 200 (Mad.)
Leisure

This article aims to:
– Summarise the accounting issues that impact the leisure sector.
Key accounting issues for the hotel industry

A typical business structure of a hotel consists of either of the following models:

- Owned hotel
- Managed hotel
- Leased licensed hotel, and
- Ownership and franchise affiliation.

In order to facilitate uniformity in accounting of some of the peculiar features of a hotel and to provide clarity on various aspects of accounting, the Institute of Chartered Accountants of India issued a guidance note on audit in hotel industry in 2011. We have discussed a few key accounting concepts that the industry encounters including impact of transition to Ind AS in this article.

Revenue recognition

The sources of revenue will differ depending upon the business structure. In case of owned hotel structure, key sources of revenue include room revenue, food and beverages revenue from restaurants, minibars and banquets, membership fees and other ancillary services such as communication revenue, car hire, health club, spa, housekeeping and laundry services.

In case of a managed hotel structure, there is a clear separation of ownership from its management. The day-to-day operations of the hotel are managed by an enterprise which specialises in the management of hotels and is not the owner of the hotel. Such an enterprise earns the management fees which is its operating income.

There may be an arrangement wherein one party having specialisation in hotel operations takes the hotel on lease which is owned by others for an annual lease rent or licence fees. The rent/fee can be either a lump sum amount or a combination of minimum guaranteed fees and additional fees paid as a fixed percentage of revenue or profit.

Under franchisee affiliation, the owners of the hotel make a contract with another enterprise running a chain of well-known hotels for the use of name and reservation system. The fees contractually arranged between the parties may be fixed or dependent upon the revenue generated from operations.

Room revenue

Room revenue generally constitutes around 50 to 65 per cent of the total revenue of a hotel which keeps varying depending upon the seasonality and occupancy factors, followed by food and beverages revenue and other components.

Revenue is accounted for under AS 9, Revenue Recognition wherein revenue is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method. In the context of room revenue, the income is accounted proportionately over the period of stay of the guest.

Revenue from food and beverages

Revenue from food and beverages entails serving food to guests in the restaurant either to those staying in the hotel or coming from outside. This component constitutes around 25 to 35 per cent of total revenue of a hotel. The hotel has a pre-determined rate card for food items and the revenue is recognised at a point in time when the food is served to the guest.

Revenue from membership fees

In case of revenue from membership fees, since it is stipulated for a specified period of time, revenue is recognised on straight-line basis unless there is evidence that some other method better represents the pattern of performance.

Other services such as banquets, car hire, health club, spa, housekeeping, etc. are accounted for as and when these services are rendered.

Hotels may charge the composite rate from the guests comprising the room rent and the meals. In such a case, it is required to apportion such composite amount charged into room rent and charges for food on equitable and seasonal basis applied consistently.

Key impact areas under Ind AS

Under the Ind AS on revenue, when an arrangement includes more than one component, it is necessary to account for the revenue attributable to each component separately either on their relative fair value basis or fair value of the undelivered components (residual value method), separation would generally be considered if the conditions mentioned below are present:

- The component has a standalone value to the customer; and
- The fair value of the component can be measured reliably

Where a hotel offers the composite rate to the guest, for example the composite charge agreed in respect of banquet service which includes hall hire charges and the charge for food and beverages. Under the relative fair value method, the total consideration is allocated to hall hire charges and food and beverages based on the ratio of the fair values of the components relative to each other. For example, the fair value of hall rent for a day is INR10,000 and that of food and beverages is INR500 per person. Assuming the total agreed consideration for a set of 25 people is INR20,000 for a day, 44 per cent of the consideration i.e. INR8,800 will be allocated to hall hire charges and the balance to the food and beverages revenue under the relative fair value method.
Customer loyalty programmes

Under the Indian GAAP, the Technical Guide on Accounting Issues in the Retail Sector (guide) provides guidance on customer loyalty programmes. It mentions that currently in India both ‘deferment model’ and ‘provision model’ are prevalent. The deferment model is based on IFRIC 13, Customer Loyalty Programmes and is similar to the guidance in Ind AS. In this model, when a hotel grants loyalty points with the purchase of hotel services i.e. frequent visitors for hotel stay or restaurants, the loyalty points are separated from the concerned hotel services and accounted for as a separate performance obligation. Under the provision model, sale of service is treated as a single element transaction and revenue is recognised for the entire transaction at the time of initial sale. However, since further cost is expected to be incurred with regard to the obligation to provide free/discounted services, a provision is recognised towards cost of such free/discounted services at the time of initial sale.

Under Ind AS, award credits and other loyalty programmes are considered as a separate component of the initial sale transaction. The fair value of the award credits/points is estimated and separated from the initial sale. Such income is deferred and is recognised subsequently when the award credits/points are utilised.

Investment property

Another critical accounting area of difference between the current GAAP and Ind AS is classification of a property into fixed asset or investment property. Under the Indian GAAP, the following accounting standards may be relevant for a hotel from the perspective of classification of a property:

- AS 10, Accounting for Fixed Assets: This standard defines a fixed asset as, an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

- AS 13, Accounting for Investments: This standard defines investments as assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. It defines an investment property as, an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

The Schedule III of the Companies Act, 2013 lays down the disclosures, wherein fixed assets and investment property are required to be disclosed separately under non-current assets and inventory under current assets.

Under Ind AS, Ind AS 40 is the standard that deals with the accounting and reporting of investment properties. An investment property comprises land or building held for earning rentals or for capital appreciation or both. Land and building used in the production or supply of goods or services, or for administrative purposes is classified as property, plant and equipment and not investment property. Similarly, property held for sale in the ordinary course of business is classified as inventory and not investment property. The investment property classification would apply to property either owned by the company or obtained under a finance lease; but not to a property obtained under an operating lease.

Determining whether a property is an investment property depends on the use of the property rather than the type of entity that holds the property. In some cases, a company provides ancillary services to the occupants of a property it holds. A company treats such a property as an investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building. In other cases, the services provided could be significant. For example, if a company owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel may not qualify as an investment property. In certain instances, it may be difficult to determine whether ancillary services are so significant that a property does not qualify as an investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract. The terms of such contracts vary widely. At one end of the spectrum, the owner’s position may, in substance, be that of a passive investor. At the other end of the spectrum, the owner may simply have outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

In the context of a hotel, one is likely to come across a dual use property scenario wherein a portion of the building is leased out to apparel stores, for example. Thus if the portion could be sold or leased out separately under finance lease, the same is classified as investment property with the residual part being classified as property plant and equipment. In a case where the portion of the property could not be sold or leased out separately, the entire property could be classified as an investment property unless portion held for own use is insignificant.

In terms of recognition and measurement, Ind AS 40 states that the investment property should be initially recognised at cost and subsequent measurement would be under the cost model. The standard also mandates disclosure of the fair value of investment property even though the cost model is followed.
Goods and Services Tax

This article aims to:
- Provide an overview on the expected challenges on implementation of Goods and Services Tax (GST) in the transport and logistics sector.
Supply chain
Currently, owing to multiple and differential state-level taxes, companies in India have set up several warehouses, servicing various parts of the country; in some cases, one per state has been established to minimise the intra-state movement and associated taxation. This is highly inefficient as it leads to higher unit and inventory carrying cost.

GST is proposed to merge various central and state level taxes and is expected to provide a level playing field to the industry, which may obviate the need for multiple warehouses in the respective states. As a result, it is expected that it could lead to a significant reorganisation of warehousing space in India, with large hubs being developed in key locations, coupled with smaller warehouses nearer to production or consumption centres.

This reorganisation is likely to lead a significant investment in modern warehousing infrastructure and is expected to be the largest driver for the warehousing industry.

Shipping lines
Shipping lines provide transportation of goods by vessel services to their customers. India is expected to have dual GST and, accordingly, each transaction is expected to be subject to the same, i.e. central GST and state GST.

The levy of state GST shall be determined based on the ‘place of supply’ rules. In case of a transaction involving transportation services, the ‘place of supply’ could possibly be based on any of the three parameters - place of origin, place of destination, and the location of the customer.

Irrespective of the parameter, on which the final ‘place of supply’ is determined, shipping lines are likely to be required to configure their IT systems to cater to the legal requirements and pay GST in the appropriate state.

At present, shipping lines consider ocean freight, Terminal Handling Charges (THC) and Inland Haulage Charges (IHC) as three separate components and determine the taxability of the transaction accordingly.

In the GST regime, this may lead to three different places of provision of services and, accordingly, a single consignment may involve three different state’s GST.

The levy of varying GST rates in different states is likely to increase the complexity of levying the tax on respective transactions.

Thus, the determination of the situs and the place of supply of services could be a key challenge for the shipping and logistics sector.

Currently, the service sector is subject to service tax, wherein the assessee can choose the option of taking centralised registration, and discharge service tax liability at one centralised office.

However, based on the draft GST framework, the shipping line/logistics sector is expected to be required to take state GST registration under the respective state laws and comply with compliance requirement of multiple states. This shall lead to an increase in tax compliance for shipping lines.

Advent of an organised logistics and transport sector
Due to the current state VAT/CST levy on inter-state transactions, the logistics and distribution chain is tax driven. Availability of credits under the GST regime is expected to lead to emergence of the organised logistics sector, since the tax compliances and tax cost may not be the criteria to decide/structure the supply chain.

Further, the players in the unorganised sectors too may be expected to consolidate the business to improve their service levels if they are to grow in the competitive landscape. The post-GST regime is in fact likely to offer many more unseen opportunities for unorganised players, who intend to tie up/collaborate with existing large players. This is expected to lead to greater efficiencies, better use of technology and more cost advantages to both logistic sector as well as end users.

Conclusion
The sector envisages revamping of the current business models and various benefits under the GST regime. The deferral of GST implementation has been impacting the readiness of logistics service providers and end users.

As India prepares for a transition to the next level of logistics growth path, regulatory policies need to evolve well ahead of the introduction. Further, on account of the delay in implementation of GST, it is critical to gauge the advantages to the industry at large and what the various stakeholders may be specifically losing out on.
The Securities and Exchange Board of India (SEBI) through an announcement dated 21 April 2016 issued Frequently Asked Questions (FAQs) on SEBI (Delisting of Equity Shares) Regulations, 2009. The FAQs offers a simplistic explanation/clarification of terms/concepts related to the above regulations. Some of the important explanations/clarifications are as follows:

- **Definition of term ‘delisting’ of securities:** ‘Delisting’ of securities has been defined as removal of securities of a listed company from a stock exchange.
- **Difference between voluntary delisting and compulsory delisting:** In voluntary delisting, a company decides on its own to remove its securities from a stock exchange whereas in a compulsory delisting, the securities of a company are removed from a stock exchange as a penal measure for not making submissions/complying with various requirements set out in the listing agreement within the time frames prescribed.
- **Provision of exit opportunity to investors in case of delisting of a company:** The SEBI (Delisting of Securities) Regulations, 2009 provide an exit mechanism to the existing shareholders in the following manner:
  - **Voluntary delisting whereby the exit price is determined through the reverse book building process:**
    The floor price is calculated in accordance with the regulations and the shareholders need to make a bid at a price either on or above the floor price. The exit price would be decided on the basis of bidding by the public shareholders. If the exit price so determined is acceptable to the promoter, the promoter pays that price to the investors and the investors can exit. Those investors who do not participate in the reverse book building process have an option to offer their shares for sale to the promoters. The promoters are under an obligation to accept the shares at the same exit price.
  - **Voluntary delisting for a small company:**
    Any company with paid up capital of less than INR10 crore and net worth less than INR25 crore, whose equity shares have not been frequently traded on any recognised stock exchange for a period of one year and has not been suspended for any non-compliance in the preceding one year would not be required to follow the reverse book building process. In such cases, the promoter decides the exit price in consultation with the merchant banker.
- **A company which delists its equity shares from a recognised stock exchange but continues to remain listed on another recognised stock exchange would not be required to provide an exit opportunity to its shareholders provided the equity shares remain listed on any recognised stock exchange which has nationwide trading terminals.
- **Clarification on merchant banker’s role:** A merchant banker appointed to carry out due-diligence on behalf of the company in terms of Regulation 8(1A) of the Delisting Regulations can also act as a manager to the offer.
- **Computation of reference date:** Reference date for computing the floor price would be the date on which the recognised stock exchanges were notified of the board meeting in which the delisting proposal would be considered.

(Source: SEBI announcement dated 21 April 2016)
Framework proposed by the MAT-Ind AS Committee

Background

The Ministry of Corporate Affairs (MCA) through its notification dated 16 February 2015 issued a road map for implementation of Ind AS by companies other than banking companies, insurance companies and Non-Banking Financial Companies (NBFCs) in two phases i.e. for accounting periods commencing on 1 April 2016 and 1 April 2017 based on certain prescribed thresholds. Subsequently, on 18 January 2016 and 30 March 2016, the MCA notified Ind AS road map for banks, insurers and NBFCs.

While adopting the Ind AS, one of the biggest challenges faced by the corporate sector is how this change in financial reporting would impact taxable income. In response, on 31 March 2015, the Ministry of Finance (MOF) issued 10 Income Computation and Disclosure Standards (ICDS), operationalising a new framework for computation of taxable income by all assessee (in relation to their income under the heads ‘Profits and Gains of Business or Profession’ and ‘Income from Other Sources’). While the ICDS are expected to fill some gaps in the current taxation set up by bringing in consistency and clarity in computation of taxable income and providing stability in tax treatments of various items, there is still some uncertainty on the levy of MAT for companies that would compute their book profits under Ind AS.

Therefore, on 8 June 2015, the Central Board of Direct Taxes (CBDT) formed the MAT-Ind AS Committee (the Committee) to suggest a framework for computation of book profit for the purpose of levy of MAT under Section 115JB of the Income-tax Act, 1961 (the IT Act) for Ind AS compliant companies in the year of adoption and thereafter.

New development

On 18 March 2016, the Committee formed by the CBDT issued a report (the report) proposing a framework for computation of book profit for the purposes of levy of MAT under Section 115JB of the IT Act for Ind AS compliant companies in the year of adoption and thereafter.

Overview of the Committee’s report

Clarifications sought by the Committee from the Ministry of Corporate Affairs (MCA)

The Committee observed that the adjustments currently provided under section 115JB of the IT Act are of a nature that seek to compute the realised profit before tax that would be available for appropriation/distribution, based on the provisions of the companies law. This indicates that there is an implicit relation between the distributable profits available for payment of dividend and the tax base for levying MAT.

The Companies Act, 2013 (2013 Act) permits the declaration of dividend out of the profits of the current year or the earlier year. In addition, if these profits are inadequate, dividend can also be declared out of free reserves. While free reserves are accumulated profits of the earlier years transferred to reserves, and exclude unrealised gains, notional gains or revaluation of assets, or any change in the carrying amount of an asset or liability recognised in equity, (including surplus in the statement of profit and loss on measurement of the asset or liability at fair value), the net profit and net Other Comprehensive Income (OCI) under Ind AS may include significant notional/unrealised gains or losses. This indicates that there is no restriction on distribution of profit from notional/unrealised gains included in the net profit or net OCI of the current or earlier year, resulting in a differential treatment of such unrealised gains or losses as compared to those in accumulated reserves.

The computation of distributable profit under the 2013 Act is also different to the computation of profit for determining managerial remuneration (which excludes changes in the carrying amount of an asset or a liability in equity, including surplus in the statement of profit and loss on its measurement at fair value).

In view of these differing requirements, the Committee, on 27 July 2015, sought clarity/guidance from the MCA on the following issues, before it could recommend a framework for computation of book profits for the purpose of levy of MAT.

- The underlying principles for the differential treatment for unrealised gains and losses included in the net profit and net OCI for the current and earlier year, and those included in accumulated reserves.
- Proposed guidance for calculating distributable surplus or computing the profit base for managerial remuneration under the 2013 Act (by excluding the notional/unrealised gains) to ensure uniformity in application by Ind AS compliant companies.
- The treatment of notional/unrealised losses for the computation of free reserves, as the current definition provides for exclusion of notional/unrealised gains but is silent on the treatment of such notional/unrealised losses.
- Any change in law being considered by MCA for avoiding the complex computations involved in determining profits (for distribution or managerial remuneration) after excluding unrealised/notional gains or losses.
Clarifications issued by MCA

The MCA through an office memorandum dated 11 January 2016 provided clarity on the above issues after consultation with the Institute of Chartered Accountants of India (ICAI). This memorandum listed certain items (components of OCI as per Schedule III of the 2013 Act), which are notional/unrealised gains and are to be excluded for the purpose of arriving at distributable profits for payment of dividend as well as for calculation of profit for managerial remuneration. It further suggested that the Committee may consider extending this principle for determining book profits for levy of MAT. The components of OCI listed by the MCA are as per Table 1 below.

**Table 1: Notional/unrealised gains to be excluded from computation of book profits**

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Name of component</th>
<th>Ind AS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Changes in revaluation surplus.</td>
<td>Ind AS 16, Ind AS 38</td>
</tr>
<tr>
<td>2</td>
<td>Remeasurements of defined benefit plans.</td>
<td>Ind AS 19</td>
</tr>
<tr>
<td>3</td>
<td>Gains and losses arising from translating the financial statements of a foreign operation.</td>
<td>Ind AS 21</td>
</tr>
<tr>
<td>4</td>
<td>Gains and losses from investments in equity instruments designated at fair value.</td>
<td>Ind AS 109</td>
</tr>
<tr>
<td>5</td>
<td>Gains and losses on financial assets measured at fair value.</td>
<td>Ind AS 109</td>
</tr>
<tr>
<td>6</td>
<td>The effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income.</td>
<td>Paragraph 5.75 of Ind AS 109</td>
</tr>
<tr>
<td>7</td>
<td>For particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability’s credit risk.</td>
<td>Ind AS 109</td>
</tr>
<tr>
<td>8</td>
<td>Changes in the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value.</td>
<td>Chapter 6 of Ind AS 109</td>
</tr>
<tr>
<td>9</td>
<td>Changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument when excluding it from the designation of that financial instrument as the hedging instrument.</td>
<td>Chapter 6 of Ind AS 109</td>
</tr>
</tbody>
</table>
Recommendations of the Committee

The Committee has made the following recommendations:

- Since current year profits are available for distribution as dividends and considering the implicit relation between distributable profits under the 2013 Act and the tax base for levying MAT, no further adjustments should be made to the net profits (excluding net other comprehensive income (OCI)) of Ind AS compliant companies, other than those already specified under Section 115JB of the IT Act.

- The current year’s net profits (excluding net OCI) under Ind AS may include a significant amount of notional/unrealised gains or losses, for example, gains or losses on fair valuation of derivative instruments or those on fair valuation of investments that are classified and measured at ‘fair value through profit or loss’. The Committee stated that the requirements for additional adjustments under Section 115JB may be considered at a later stage if the MCA prescribes any further adjustments to current year’s profits for computing distributable profits.

- Under Ind AS, the net OCI includes certain items that will permanently be recorded in reserves and hence never reclassified to the statement of profit and loss included in the computation of book profits. These items should be included in book profits for MAT purposes at an appropriate point of time.

The Committee provided an illustrative list of such items along with the recommended treatment for MAT as (see Table 2 below):

Table 2: Illustrative list of items included in OCI and recommended MAT treatment

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Items</th>
<th>Recommended treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Changes in revaluation surplus (Ind AS 16 and Ind AS 38).</td>
<td>To be included in book profits at the time of realisation/ disposal/retirement</td>
</tr>
<tr>
<td>2</td>
<td>Remeasurements of defined benefit plans (Ind AS 19).</td>
<td>To be included in book profits every year as the</td>
</tr>
<tr>
<td>3</td>
<td>Gains and losses from investments in equity instruments designated at fair value through other comprehensive income (Ind AS 109).</td>
<td>To be included in book profits at the time of realisation.</td>
</tr>
</tbody>
</table>

Adjustments on first-time adoption of Ind AS

Ind AS compliant companies are required to record adjustments relating to first-time adoption of Ind AS in retained earnings/reserves at the date of transition to Ind AS. Several of these adjustments may subsequently never be reclassified to the statement of profit and loss included in the computation of book profits. In this regard, the Committee recommended that the adjustments are categorised as follows:

- Category I: Those adjustments recorded in reserves and which would subsequently be reclassified to the statement of profit and loss, should be included in book profits in the year in which these are reclassified to the statement of profit and loss. These include, for example, adjustments relating to recognition of a cash flow hedging reserve based on the fair value change in derivatives that are designated as hedging instruments in a cash flow hedge relationship. This amount would be subsequently reclassified to the statement of profit and loss when the hedged item affects profit and loss.

- Category II: Those adjustments recorded in net OCI and which would never be subsequently reclassified to the statement of profit and loss should be included in book profits as per Table 2 above. These include changes in revaluation surplus, remeasurements of defined benefit plans, and gains and losses from investments in equity instruments at fair value through OCI.

- Category III: All other adjustments recorded in retained earnings and which would otherwise never subsequently be reclassified to the statement of profit and loss should be included in book profits in the year of first time adoption of Ind AS. These could include adjustments relating to availing the deemed cost exemption or revaluation of property, plant and equipment and fair value adjustments relating to transition date measurement of investments in equity instruments that are classified as ‘fair value through profit or loss’, straight-line adjustment of operating lease rentals, share based payment expense, etc.

- Section 115JB already provides for certain adjustments for computation of book profit. The above adjustments would therefore be subject to the existing provisions of Section 115JB (e.g. the amount set aside as provision for diminution in the value of any asset is required to be added to book profits and accordingly would not be included in any of the adjustments mentioned above).
Next steps

Approach towards computation of MAT

While the ICDS issued in context of computation of taxable income by all assesses ensured horizontal equity, the approach for computation of MAT outlined in the Committee report may not result in either horizontal equity or tax neutrality.

Given that a company may not be required to pay MAT in all years, the approach of subjecting transition adjustments on date of transition may result in an outflow (including outflows on account of time value of money) of tax without any subsequent benefit (except for MAT credit set off with tax on 'Profits and gains on business or profession' and 'Income from other sources').

The companies should also consider the impact of this report on their expected advance tax payment in the current financial year.

(Source: Report by CBDT, dated 18 March 2016 and KPMG in India's IFRS Notes: Framework proposed by the MAT-Ind AS Committee, dated 10 May 2016)

The ICAI issues a Guidance Note on Accounting for Real Estate Transactions

The Institute of Chartered Accountants of India (ICAI) through an announcement dated 10 May 2016 issued the Guidance Note on Accounting for Real Estate Transactions (GN).

This GN should be applied to all projects in real estate by entities to whom Ind AS are applicable. The objective of this GN is to recommend the accounting treatment by entities dealing in real estate as sellers or developers.

The GN covers all forms of transactions in real estate. An illustrative list of transactions which are covered by the GN is as under:

- Sale of plots of land (including lease of land on finance lease under Ind AS 17, Leases) without any development.
- Sale of plots of land (including lease of land on finance lease under Ind AS 17) with development including development in the form of common facilities like laying of roads, drainage lines and water pipelines, electrical lines, sewage tanks, water storage tanks, sports facilities, gymnasium, club house, landscaping etc.
- Development and sale of residential and commercial units, row houses, independent houses, with or without an undivided share in land.
- Acquisition, utilisation and transfer of development rights.
- Redevelopment of existing buildings and structures.
- Joint development agreements for any of the above activities.

However, real estate transactions of the nature covered by Ind AS 16, Property, Plant and Equipment, Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, Ind AS 38, Intangible Assets and Ind AS 40, Investment Property are outside the scope of this GN.

The GN primarily provides guidance on application of percentage of completion method where it is appropriate to apply this method as such transactions and activities of real estate have the same economic substance as construction contracts. For this purpose, the GN draws upon the principles enunciated in AS 11, Construction Contracts. In respect of transactions of real estate which are in substance similar to delivery of goods principles enunciated in Ind AS 18, Revenue, are applied.

The accounting prescribed in the GN is at variance to the guidance provided under IFRS. Hence, this area is a carve-out from IFRS.

(Source: ICAI Guidance Note on Accounting for Real Estate Transactions dated 10 May 2016)

Guidance Note on CARO 2016

Background

Section 143(11) of the 2013 Act requires that the auditor’s report of specified class of companies should include a statement on the prescribed matters. These reporting requirements have been prescribed under the Companies (Auditor’s Report) Order, 2015 (CARO 2015) issued by the MCA on 10 April 2015.

Further with the aim to amend CARO 2015, on 9 February 2016 MCA issued Draft Companies (Auditor’s Report) Order, 2016 (CARO 2016) based on recommendations of the committee formed for this purpose.

New development

Based on recommendation made by the committee and suggestion received from stakeholders on Draft CARO 2016, on 31 March 2016 MCA issued CARO 2016 to supersede CARO 2015.

The CARO 2016 contains several new reporting requirements which were not there in the earlier Orders i.e. CARO 2003 and CARO 2015. Therefore for providing appropriate guidance on CARO 2016, ICAI on 23 April 2016, issued Guidance Note (GN) on CARO 2016.

Applicability

Every report made by the auditor under Section 143 of the 2013 Act for FY commencing on or after 1 April 2015 would include CARO 2016. It would be applicable to every company (except companies that are excluded, see below), including a foreign company as defined under Section 2(42) of the 2013 Act.

The CARO 2016 would not be applicable to the auditor’s report on consolidated financial statements.
Companies exempted under the CARO – 2016

The following table highlights the class of companies whose auditors are exempted to comment on matters prescribed under the CARO 2016 (in comparison to CARO 2015):

<table>
<thead>
<tr>
<th>Companies not covered under CARO 2016</th>
<th>Companies not covered under CARO 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking company as defined under Section 5(c) of the Banking Regulation Act, 1949</td>
<td>Banking company as defined under Section 5(c) of the Banking Regulation Act, 1949</td>
</tr>
<tr>
<td>Insurance company as defined under the Insurance Act, 1938</td>
<td>Insurance company as defined under the Insurance Act, 1938</td>
</tr>
<tr>
<td>Companies incorporated with charitable objects, etc. i.e. companies licensed to operate under Section 8 of 2013 Act</td>
<td>Companies incorporated with charitable objects, etc. i.e. companies licensed to operate under Section 8 of 2013 Act</td>
</tr>
<tr>
<td>One person company as defined under Section 2(62) of the 2013</td>
<td>One person company as defined under Section 2(62) of the 2013</td>
</tr>
<tr>
<td>Gains and losses on financial assets measured at fair value.</td>
<td>Ind AS 109</td>
</tr>
<tr>
<td>The effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income.</td>
<td>Paragraph 5.75 of Ind AS 109</td>
</tr>
<tr>
<td>For particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability’s credit risk.</td>
<td>Ind AS 109</td>
</tr>
<tr>
<td>Changes in the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value.</td>
<td>Chapter 6 of Ind AS 109</td>
</tr>
<tr>
<td>Changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument when excluding it from the designation of that financial instrument as the hedging instrument.</td>
<td>Chapter 6 of Ind AS 109</td>
</tr>
</tbody>
</table>

Matters included in CARO 2016

As compared to CARO 2015, the reporting requirements under CARO 2016 have increased. The following table provides the reporting requirements in three sections:

- New requirements
- Requirements that have been carried forward with certain modifications
- Requirements that have been deleted as compared to CARO 2015.

Along with the reporting requirements, the table provides the guidance as stated in GN.
### New requirements

#### Fixed assets

Whether title deeds of immovable properties are held in the name of the company. If not, provide details thereof.

**Clarification in GN** – The GN clarifies that the auditor is required to identify immovable properties and verify the title deeds of such immovable properties for reporting purpose. Since the CARO 2016 is silent as to what constitutes title deeds, GN clarifies that title deeds means a legal deed or document constituting evidence of a right, especially to the legal ownership of the immovable property.

#### Loans and investments

In respect of loans, investments, guarantees and security whether provisions of Section 185 and 186 of the 2013 Act have been complied with. If not, provide details thereof.

**Clarification in GN** – The clause requires auditors to report on compliance of Section 185 of the 2013 Act. The GN clarifies that the auditor should report the nature of non-compliance, the maximum amount outstanding during the year and the amount outstanding as at the balance sheet date in respect of

(i) the directors, and

(ii) persons in whom directors are interested (should also specify the relationship with the director concerned).

#### Managerial remuneration

Whether managerial remuneration has been paid/provided in accordance with the requisite approvals mandated by the provisions of Section 197 read with Schedule V of the 2013 Act? If not, state the amount involved and steps taken by the company for securing refund of the same.

**Clarification in GN** – The reporting under this clause would not be required for private companies, since Section 197 is applicable only to public companies. The reporting under this clause should incorporate details relating to payment made to director/whole time director/managing director/manager, amount paid/provided in excess of the limits prescribed, amount due for recovery as at balance sheet date and steps taken to secure the recovery of the amount.

#### Nidhi company

Whether the Nidhi company has complied with the net owned fund to deposits in the ratio of 1:20 to meet the liability and whether the Nidhi company is maintaining 10 per cent unencumbered term deposits as specified in Nidhi Rules, 2014 to meet out the liability.

**Clarification in GN** – The Nidhi Rules, 2014 prescribe the requirements for minimum number of members, net owned funds and requirement to invest in unencumbered term deposits with scheduled commercial banks. The GN clarifies that an auditor is required to comment on the compliance of this clause by stating the amount of shortfall and actual ratio of net owned funds to the deposits. Also required to provide the amount of shortfall in case unencumbered term deposits falls short of 10 per cent.

#### Related party transactions

Whether all transactions with related parties are in compliance with Section 177 and 188 of the 2013 Act where applicable and the details have been disclosed in the financial statements, etc. as required by the accounting standards.

**Clarification in GN** – This clause requires auditors to verify the compliance of Section 177 and 188 and also to ensure that disclosures required by Accounting Standard (AS) i.e. AS 18, Related Party Disclosures are disclosed in the financial statements. CARO 2016 aligns the disclosure requirements in the clause relating to related parties under 188 and 177 of the 2013 Act to the disclosures required by the applicable accounting standards.

#### Preferential allotment/private placement

Whether the company has made any preferential allotment/private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of Section 42 of the 2013 Act have been complied with and the amount raised has been used for the purposes for which the funds were raised. If not, provide details in respect of the amount involved and nature of non-compliance.
### New requirements (cont.)

#### Non-cash transactions

Whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether provisions of Section 192 of the 2013 Act have been complied with.

#### Non-Banking Financial Company (NBFCs)

Whether the company is required to be registered under Section 45 IA (relating to requirement of registration and net owned fund for NBFCs) of the Reserve Bank of India (RBI) Act, 1934 and if so whether the registration has been obtained.

**Clarification in GN** – The auditor is required to examine whether the company is engaged in financing business which attracts the requirement of registration. The auditor should also examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the NBFCs.

#### Requirements that have been carried forward with certain modifications

#### Inventory

Whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

**Deleted requirement**

- Are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business
- Whether the company is maintaining proper records of inventory.

**Clarification in GN** – The GN clarifies that physical verification of inventory is the responsibility of the management and reasonable intervals should be determined based on circumstances of each case. The periodicity of the physical verification of inventories should be determined based on nature of inventories, their location and the feasibility of conducting a physical verification.

#### Granting of loans to certain parties

Whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships (LLPs) or other parties covered in the register maintained under Section 189 of the 2013 Act which relates to register of contracts or arrangements in which directors are interested. If so,

- Whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest
- Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipt are regular
- If the amount is overdue, state the total amount overdue for more than 90 days, and whether reasonable steps have been taken by the company for recovery of the principal and interest.

**New requirement**

- It relates to reporting in respect to loans granted to LLPs.
- Whether the terms and conditions are prejudicial to the company's interest and limit of overdue for more than 90 days inserted instead of threshold limit of INR1 lakh of overdue amount.

**Clarification in GN** – The GN provides that the auditor is required to disclose the requisite information in his/her report in respect of all the parties covered in the register maintained under Section 189 of the 2013 Act irrespective of the period to which such loan relates. Also there is no stipulation regarding the loan being given in cash or in kind, therefore, an auditor is expected to disclose the requisite information as specified in his/her report in respect of all kind of loans whether long term or short term, whether given in cash or in kind to the parties covered in the register maintained.

Also an auditor is expected to examine loan agreements/mutually agreed letter of arrangement, as the case may be, to determine whether schedule of repayment of principal and payment of interest has been stipulated at the time of sanction. Further GN clarifies that in case of non-stipulation, the auditor should state the fact and may report that he is unable to make specific comment on the regularity of repayment of principal and payment of interest, in such cases.
### Requirements that have been carried forward with certain modification (cont.)

#### Default in repayment of dues

Whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, government or dues to debenture holder?

If yes, the period and amount of default to be reported (in case of banks, financial institutions and government lender wise details to be provided).

**New requirement**

It relates to reporting in relation to loans or borrowing from government and requirement of lender-wise details of period and amount of default to banks, financial institutions and government.

**Clarification in GN** – The GN provides what should constitute ‘government’ and it should not include government company/public sector undertaking/boards/authority/corporation and foreign government. It also clarifies that lender wise details is to be provided in case of banks, financial institutions and government only and not in respect of individual debenture holders.

#### Application of term loans/initial public offer/further public offer

Whether moneys raised by way of initial public offer/further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised.

If not, the details together with delays/default and subsequent rectification, if any, as may be applicable, be reported.

**New requirement**

It increases the scope to public issue and further public offer (including debt instruments). Earlier it was restricted to term loans only.

**Clarification in GN** – The GN provides that in case the company has made an initial public offer/further public offer (including debt instruments) the auditor is required to report upon the disclosure of end-use of the money by the management in the financial statements. The auditor is also required to state whether he/she has verified the disclosure made by the management in this regard.

Further GN provides that there is no legal requirement under the 2013 Act to disclose the end use of money raised by initial public offer/further public offer (including debt instruments) in the financial statements. However, companies make such a disclosure in the board’s report. The requirement of this clause envisages that the companies should disclose the end use of money raised in the financial statements by way of notes and the auditor should verify the same.

#### Fraud reporting

Whether any fraud by the company or any fraud on the company by its officers/employees has been noticed or reported during the year? If yes, the nature and the amount involved should be indicated.

**New requirement**

It is restricted to officers and employees of the company.

**Clarification in GN** – The GN clarifies that the reporting under this clause does not require the auditor to discover such frauds. The scope of auditor’s inquiry under this clause is restricted to frauds “noticed or reported” during the year. The use of the words “noticed or reported” indicates that the management of the company should have the knowledge about the frauds by the company or on the company by its officer and employees that have occurred during the period covered by the auditor’s report. Further it has been clarified that the auditor is not relieved from his responsibility to consider fraud and error in an audit of financial statements.
Requirements that have been deleted as compared to CARO 2015

Internal control system

Is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control system.

Deposit of statutory dues

Whether the amount required to be transferred to Investor Education and Protection Fund (IEPF) in accordance with relevant provisions of the Companies Act, 1956 (1 of 1956) and rules made thereunder has been transferred to such fund within time.

Accumulated losses and incurrence of cash losses

Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than 50 per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year.

Guarantee for loans taken by others from banks or financial institutions

Whether the company has given any guarantee for loans taken by others from banks or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.

(Source: MCA notification dated 30 March 2016 and ICAI Guidance Note on CARO 2016 dated 23 April 2016)

Ind AS Transition Facilitation Group issues clarifications Bulletin 2 (ITFG Bulletin 2)

The Ind AS Transition Facilitation Group (ITFG) of ICAI held its second meeting on 12 April 2016 and has issued its second bulletin (Bulletin 2) on 10 May 2016 which provides guidance on six issues relating to the application of Ind AS. These issues relate to topics such as:

- Application of the option (under Ind AS 101, First-time Adoption India Accounting Standards) to continue with the accounting policy under para 46A of AS 11, The Effects of Changes in Foreign Exchange Rates, would be available for those long-term foreign currency loans which were taken before the beginning of the first Ind AS reporting period.
- The balance of balance of Foreign Currency Monetary Item Translation Difference Account (FCMITDA) should be amortised over the balance period of such long term liability and be routed through profit or loss and not through Other Comprehensive Income (OCI).
- Upfront cost/processing fee incurred for a foreign currency loan may have been initially charged to the statement of profit and loss. However, on first-time application of Ind AS, the principles of Ind AS 109, Financial Instruments should be applied.
- In case of an Indian subsidiary of a foreign parent, the net worth of the foreign parent should not be considered as the basis for determining whether Indian subsidiary is required to comply with Ind AS or not.
- All Indian companies should determine the date of transition to Ind AS per the requirements of the Ind AS 101, voluntary selection of transition date is not permitted.
- In case where spare parts are recognised as property, plant and equipment in accordance with criteria under Ind AS 16, Property, Plant and Equipment, then depreciation on such item should begin from the date when the asset is available for use.
- The expenditure incurred on construction of assets on land not owned by a company should be capitalised based on the principles of Ind AS 16 after consideration of facts and circumstances of each case.

Companies should consider the interpretations issued by ITFG while transitioning to Ind AS.

(Source: ICAI - ITFG clarification Bulletin 2 dated 10 May 2016)
KPMG in India’s IFRS institute

KPMG in India is pleased to re-launch its IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

IFRS Notes
Framework proposed by the MAT-Ind AS Committee

10 May 2016
Background
On 8 June 2015, the Central Board of Direct Taxes (CBDT) formed the MAT-Ind AS Committee (the Committee) to suggest a framework for computation of book profit for the purpose of levy of MAT under Section 115JB of the Income-tax Act, 1961 (the IT Act) for Ind AS compliant companies in the year of adoption and thereafter.

New developments
On 18 March 2016, the Committee formed by the CBDT issued a report (the report) proposing a framework for computation of book profit for the purposes of levy of MAT under Section 115JB of the IT Act for Ind AS compliant companies in the year of adoption and thereafter.

This issue of IFRS Notes provides an overview of the report.

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

MCA approves changes to the existing Accounting Standards
13 May 2016
Background
On 16 February 2016, the Ministry of Corporate Affairs (MCA) issued the draft Companies (Accounting Standards) Amendment Rules, 2016 to upgrade Accounting Standards (ASs), as notified under Companies (Accounting Standards) Rules, 2006, in order to align them with Ind AS.

New developments
On 30 March 2016, MCA issued the Companies (Accounting Standards) Amendment Rules, 2016 to amend existing accounting standards applicable for companies not covered in phase I of Ind AS corporate road map.

This issue of First Notes aims to provide an overview of these amendments.

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

Previous editions are available to download from:
www.kpmg.com/in

Follow us on:
kpmg.com/in/socialmedia

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Printed in India. (057_NEW0116)