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Editorial

We are pleased to bring you our quarterly newsletter covering the latest developments in financial reporting as well as other regulatory updates.

The Companies Act, 2013, has introduced many new reporting requirements for the statutory auditors of companies. One of these relates to section 143(3)(i) of the act, which requires the statutory auditor to additionally state in its audit report whether the company has adequate internal financial controls (IFC) system in place and the operating effectiveness of such controls. The Institute of Chartered Accountants of India (ICAI) has now reissued the long-awaited 'Guidance Note on Audit of Internal Financial Controls over Financial Reporting' (hereinafter guidance note) which provides detailed guidance on this topic. We have analysed key matters covered in the guidance note which may be of interest to the management and others.

Phase 1 companies are getting ready to adopt the new Indian Accounting Standards (Ind AS) beginning 1 April 2016. As part of our continued effort to provide guidance on Ind AS, we have included an overview of certain important aspects related to accounting for business combinations under Ind AS 103. We discuss how the accounting regime for mergers and acquisitions will change for corporate India from the existing Indian generally accepted accounting principles (GAAP) and how this is expected to have a significant impact, especially for companies planning major restructuring of operations, reorganisations or acquisitions.

The Reserve Bank of India (RBI) has recently recommended to the Ministry of Corporate Affairs (MCA) a roadmap for the implementation of Ind AS for banks and non-banking financial companies (NBFCs) from 2018-19 onwards. Our comments and next steps are included in this edition.

We also discuss integrated reporting, which is another important development in a stream of proposed reporting innovations aimed at improving the usefulness of corporate reporting.

This edition includes the salient features of the concept release on potential audit quality indicators (AQI) issued by the Public Company Accounting Oversight Board (PCAOB), which seeks public comment on potential AQIs and may provide new insights on how to evaluate the quality of audits, including how high quality audits may be achieved.

Finally, we have summarised other Indian as well as global regulatory updates.

We hope you find this newsletter informative and of continued interest. We welcome your feedback at pwc.update@in.pwc.com.

Internal financial controls: Guidance from the ICAI is here!

The new Companies Act, 2013, now requires auditors to also opine on whether a company has an adequate internal financial controls (IFC) system in place and the operating effectiveness of such controls. This is in addition to the existing audit opinion on financial statements. While this requirement was originally applicable to financial statements ending 31 March 2015, considering the lack of guidance, this applicability was deferred and is now effective for the year ending 31 March 2016. Due to the deferral of this reporting requirement, the Ministry of Corporate Affairs (MCA) retained the reporting requirement relating to internal controls in certain specific areas under the Companies (Auditor's Report) Order, 2013 (CARO).

Reporting on IFC is undoubtedly a paradigm shift from the reporting required under CARO. The ICAI has now reissued the long-awaited 'Guidance Note on Audit of Internal Financial Controls over Financial Reporting' (guidance note), which provides detailed guidance on this topic.

IFC: Regulatory mandate under Companies Act, 2013

Relevant clauses	Requirement	Applicability
Directors' Responsibility Statement: Sec. 134(5)(e)	Board to confirm that IFCs are adequate and operating effectively	Listed companies
Board report: Rule 8(5) of Companies (Accounts) Rules	Board report to state the details in respect of the adequacy of IFC with reference to the financial statements	All companies
Code for IDs: Sec. 149(8) and Schedule IV	IDs to satisfy themselves on the integrity of financial information and that financial controls are robust and defensible	All companies having IDs
AC terms of reference: Sec. 177	Evaluation of IFC	All companies having an AC
Auditor's report: Sec. 143(3)(i)	Auditors to report if the company has adequate IFC systems and that they are operating effectively (from 2015-16)	All companies

AC – Audit committee ; ID – Independent directors ; CFS – Consolidated financial statements

What do IFC encompass?

The guidance note provides the necessary criteria for maintaining effective IFC for companies. It draws upon the 'Internal Control Components' of Standard on Auditing (SA) 315, 'Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment', which includes the following five required components:

- Control environment
- Entity's risk assessment process
- Control activities
- Information system and communication
- Monitoring of controls

The guidance note explains that for auditor reporting, the term 'IFC' is restricted within the context of the audit of financial statements and relates to internal control over financial reporting only (ICFR). This is also consistent with the practice adopted internationally, e.g. Sarbanes-Oxley (SOX) reporting in the US. This is a relief as it removes unnecessary ambiguity by excluding from the scope operational controls, i.e. those facilitating the effectiveness and efficiency of company's operations, and also differentiates ICFR from enterprise risk management and risk management policies which boards of companies have to maintain.

The guidance note reproduces the definition of the term 'ICFR' from the US Auditing Standard (AS) 5: 'An Audit of Internal Control Over Financial

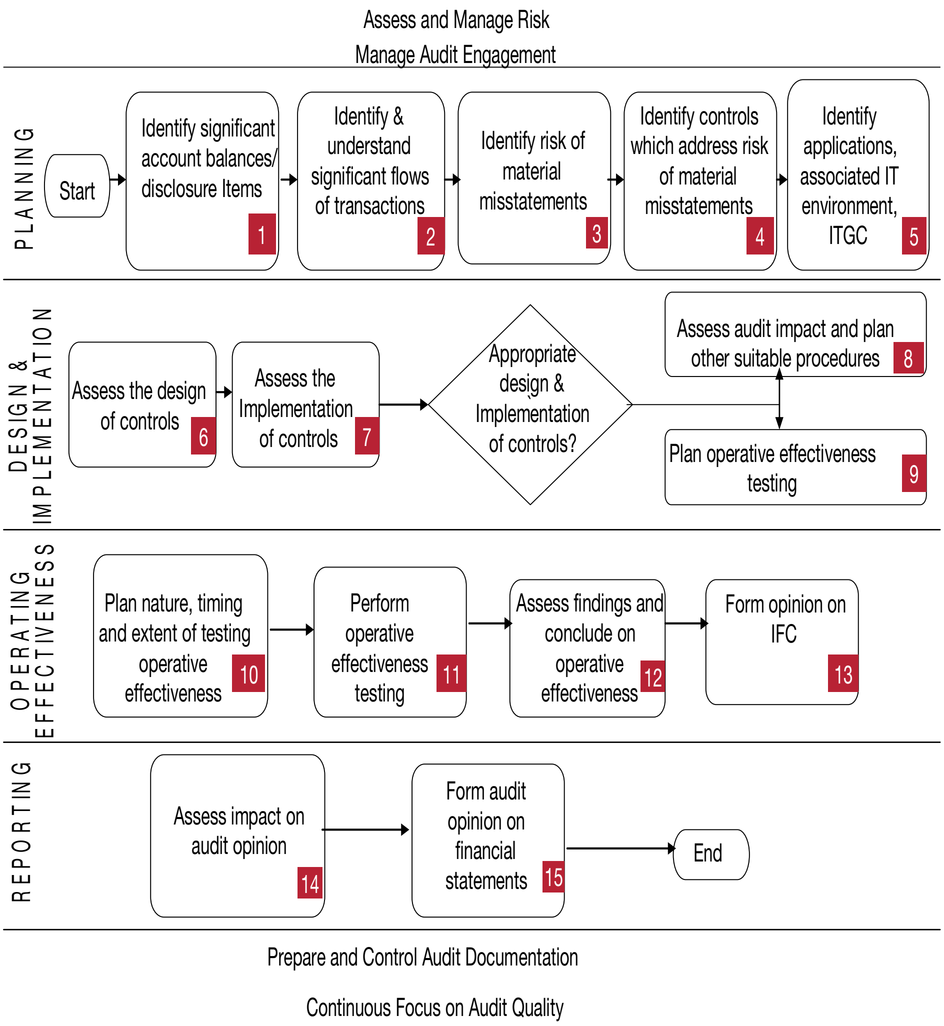
Reporting that is Integrated with An Audit of Financial Statements' issued by the PCAOB:

'A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that:

- *pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;*

- *provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and*
- *provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.*

Building blocks of an ICFR audit



Source: Guidance Note on Audit of Internal Financial Controls over Financial Reporting

To whom does this apply?

The guidance note clarifies that reporting on ICFR by auditors will be applicable to both listed and unlisted companies, including small and one-person companies. This is in line with the requirements of section 143(3)(i) of the Companies Act, 2013. Furthermore, it states that auditors will have to report on ICFR in respect of both stand alone and consolidated financial statements. In respect of consolidated financial statements, it will cover subsidiaries, joint ventures (JVs) and associates of the group, which are companies incorporated in India, since the Companies Act applies to such entities. It is relevant to note that the ICAI has adopted a similar approach with respect to reporting on various clauses in CARO on the consolidated financial statements. Accordingly, auditors of foreign components of an Indian parent are not required to report on ICFR.

When does this apply and for financial statements of which period?

Another aspect which required clarification was whether the comments in the auditor's report should describe the existence and effective operation of ICFR during the period under reporting of the financial statements or as at the balance sheet date.

The guidance note clarifies that auditors will have to report whether a company has an adequate ICFR system in place and whether the same was operating effectively as at the balance sheet date of 31 March 2016. In practice, this will mean that when forming its audit opinion on ICFR, the auditor will surely test transactions during the financial year ending 31 March 2016 and not just as at the balance sheet date, though the extent of testing at or near the balance sheet date may be higher.

If control issues or deficiencies are identified during the interim period and are remediated before the balance sheet date, then the auditor may still be able to express an unqualified opinion on the ICFR. For example, if deficiencies are discovered, the management may have the opportunity to correct and address these deficiencies by implementing new controls before the reporting date. However, sufficient time will need to be allowed to evaluate and test controls, which will again depend on the nature of the control and how frequently it operates. This will be a matter of professional judgement.

This is particularly important for companies for the current year ending 31 March 2016, as it will be the first year when auditor validation of ICFR will be required.

In addition, reporting on ICFR will not apply to interim financial statements, such as quarterly or half-yearly, unless such reporting is required under any other law or regulation.

Integrated audit

Both corporates and auditors in India will need to come to terms with the concept of a combined or an integrated audit, which includes an audit of ICFR over financial reporting and financial statements. The guidance note acknowledges that while the objectives of the audit of ICFR and audit of financial statements are not identical, the auditor now needs to plan and perform work in such a way that it achieves the objectives of both the audits in an integrated manner. In such an audit, the auditor is required to plan and conduct the audit to fulfil the following:

- Obtain sufficient evidence to support the auditor's opinion on the ICFR as of the year end
- Obtain sufficient evidence to support the auditor's control risk assessments for the purposes of the audit of the financial statements

It is relevant to note that any system of internal controls provides only a reasonable assurance on the achievement of the objectives for which it has been established. The guidance note also permits auditors to use the concept of materiality in determining the extent of testing such controls.

Standards on Auditing issued by the ICAI, which now also need to be complied with under the Companies Act, 2013, do not fully address the auditing requirements for reporting on the system of ICFR. The guidance note suggests that the relevant portions of the Standards on Auditing will need to be considered by the auditor when performing an audit of ICFR (e.g. the requirements of SA 230, 'Audit Documentation', when documenting the work performed on ICFR; of SA 315, when understating internal controls). The guidance note essentially provides supplementary procedures that will need to be considered by the auditor for planning, performing and reporting an audit of ICFR.

Reporting

As per the guidance note, auditors will have to issue a qualified or an adverse opinion on ICFR if 'material weaknesses' in the company's ICFR are identified as part of their audit. Material weakness is a deficiency, or a combination of deficiencies, in ICFR over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

A material weakness in ICFR may exist even when the financial statements are not materially misstated. The guidance note also specifies indicators of material weaknesses, such as the following:

- Identification of fraud, whether or not material, on the part of senior management

- Errors observed in previously issued financial statements in the current financial year
- Identification by the auditor of a material misstatement of financial statements that would not have been detected by the company's IFC over financial reporting
- Ineffective oversight of the company's external financial reporting and internal financial controls over financial reporting by the company's audit committee

An adverse opinion will be issued if such matters are pervasive to the financial statements—i.e. they impact various elements, accounts, or items of the financial statements, or a substantial portion of the financial statements. Additionally, significant control deficiencies will have to be reported to the audit committee.

Comparison with international practices

It is interesting to note that the guidance note has similarities with PCAOB Auditing Standard No. 5, which is applied by auditors in the context of SOX reporting in the US. For example, various paragraphs from the US auditing standard have been inserted within the guidance note, including definitions such as significant deficiency and material weakness related to internal controls. Also, in India, auditors are not required to report on the management's assertion of effectiveness on IFC. Reporting under the act will be an independent assessment and assertion by the auditor on the adequacy and effectiveness of the entity's ICFR.

What next?

The guidance note is a fairly comprehensive document covering over 200 pages, with detailed guidance in several areas related to ICFR, such as the internal control components, entity-level controls, information technology controls, understanding and documentation of process flows, including flow charts, use of service organisations and sampling.

Both the management and auditors will have to quickly familiarise themselves with and decipher the details of this guidance note in order to gear up for the year-end reporting on IFC!

Accounting for business combinations under Ind AS 103: Fair value all the way!

Background

Mergers and acquisitions have become increasingly large and complex in today's business environment. Under the current Indian GAAP, such transactions are accounted for under three different accounting standards (AS): Accounting for mergers and amalgamations under AS 14, accounting for acquisition of a group of assets being a business under AS 10, or by preparing consolidated financial statements which include subsidiaries under AS 21. The current Indian GAAP are mainly driven by form and may not truly reflect the underlying substance of such mergers/acquisitions. Furthermore, because of the application of different standards, the accounting consequences for economically similar transactions can significantly vary, thereby lacking consistency and comparability.

Ind AS 103 will fundamentally change the way business combinations, mergers and acquisitions will be accounted for going forward. It is a single comprehensive standard that provides detailed guidance on accounting for business combinations irrespective of the nature, structure or legal form of the transaction. This will clearly bring in uniformity and comparability in accounting for all types of business combinations.

In this article, we analyse certain important aspects related to accounting for business combinations under Ind AS 103 wherein companies, especially those planning major restructuring of operations, reorganisations or acquisitions, should be aware of.

Which transactions are covered within the scope of Ind AS 103?

All transactions or events in which an entity obtains control over one or more 'businesses' are covered under the scope of this standard. Therefore, understanding what constitutes a 'business' is the starting point before any business combination accounting can be done. The next step is to determine whether the investor has obtained control over the 'business'—control is the unilateral power to direct the relevant activities of the investee, i.e. those activities that significantly affect the investee's returns. Under Ind AS, it is only one parent that can control another subsidiary, unlike the case of Indian GAAP, where the same subsidiary could have been potentially consolidated by two parent holding companies.

Accounting for formation of a joint arrangement and acquisition of subsidiaries by an investment entity that are carried at fair value are specifically scoped out of the standard. Similarly, purchase of assets or a group of assets (those sets of assets and activities that do not constitute a 'business') are also scoped out of the standard.

What is a 'business'?

Ind AS 103 defines a business as 'An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants'.

The acquirer will first have to evaluate whether the activities of the acquiree meet the above definition of business. In order to meet this definition, it needs to have inputs (assets and other resources controlled by the acquiree) and processes (i.e. strategic management processes, resource management processes, etc.) which, when applied to the inputs, are capable of producing outputs. In simple terms, the acquiree should have assets and processes which are capable of generating outputs. Outputs can be in various forms, such as cost synergies, profits and dividends.

Let's explore this with an example:

Entity A acquires 100% interest in another entity B. Entity B has only a piece of land and a building but no other activities, employees, etc. Effectively, in this situation, Entity A has only acquired land and a building by acquiring Entity B. Accordingly, in the absence of any processes, the purchase of Entity B will not meet the definition of a 'business' and so this transaction will be scoped out of Ind AS 103. On the other hand, say, Entity B, which owns the land and building, is also operating a hotel in the building comprising inputs (employees and other assets), processes (reservation systems, billing systems, etc.) and regular customers visiting the hotel. In this case, Entity A has effectively acquired an operating business. Such a transaction will be within the scope of Ind AS 103.

This distinction is important because it significantly changes the accounting of the transaction. Acquisition of businesses is accounted for under the acquisition method of accounting prescribed by the requirements of Ind AS 103. On the other hand, accounting for acquisition of assets or a group of assets is less cumbersome and covered by other Ind AS, such as Ind AS 16 on 'property, plant and equipment' or Ind AS 38 on 'intangible assets', as applicable.

This is quite fundamental because acquisition of businesses results in goodwill or negative goodwill, which is absent in the case of acquisition of assets or a group of assets.

How will assets and liabilities be recorded by the acquirer under the acquisition method of accounting for business combinations?

Ind AS 103 requires the mandatory use of the acquisition method of accounting for business combination. The pooling of interest method of accounting for mergers and acquisitions under the current Indian GAAP will no longer be permitted under Ind AS other than in the case of transactions between entities under common control.

Essentially, under the acquisition method of accounting, all assets acquired (subject to certain exceptions) and liabilities assumed on the date of acquisition of control of the acquired business will be recorded at their fair values. Entities will also need to identify any previously unrecognised intangible assets of the acquiree. This will result in recognition of not only higher amounts, but also of additional items of intangible assets, which, under the Indian GAAP, generally get subsumed within goodwill. Examples of intangibles include customer relationships, patents, brands and in-process research. Recognition of such intangibles will consequently also increase the reported amortisation expense in the acquirer's consolidated financial statements.

It is also important to note that purchase price allocations can become a complex and time-consuming exercise, requiring the timely involvement of experts.

How is goodwill or bargain purchase (negative goodwill) determined in a business combination and what is its accounting treatment?

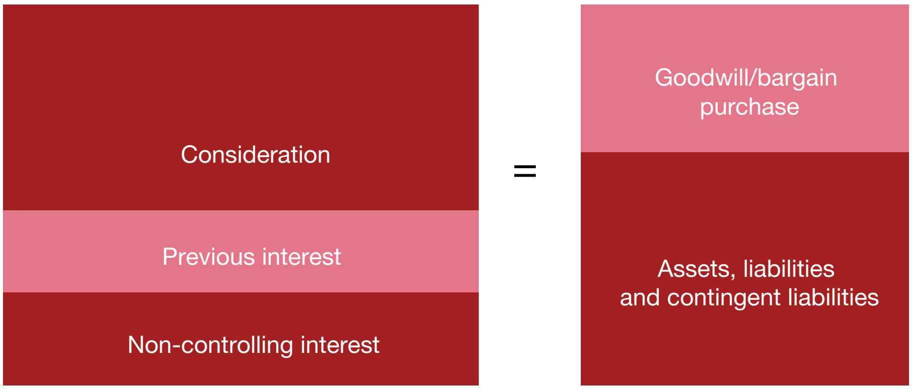
Goodwill is determined as the excess of (a) over (b) below:

- The aggregate of the following:
  - 'Consideration' transferred by the acquirer
  - Amount of any non-controlling interest (NCI)
  - Acquisition date fair value of the previously held interest in the acquiree in the case of a business combination achieved in stages
- The fair value of the acquisition date net assets acquired

Under the current Indian GAAP, there is diversity in practice with respect to goodwill accounting. Goodwill arising on amalgamation is amortised, whereas goodwill on the acquisition of subsidiaries in the consolidated financial statements is not amortised. Under Ind AS, goodwill will not be amortised but, at a minimum, tested for impairment annually, irrespective of whether there are any indicators of impairment. This is another significant change compared to the current Indian GAAP, where impairment testing is performed when indicators exist. Besides accounting implications, from a tax perspective, non-amortisation of goodwill can potentially increase the amounts of minimum alternate tax (MAT) profits and, consequently, MAT liabilities under the Ind AS regime.

Bargain purchase gain (negative goodwill) refers to a situation where the consideration transferred by the acquirer is less than its share of fair value of net assets acquired. This is expected to be an unusual situation and to occur rarely in circumstances such as a distress or forced sale. Companies will need to exercise caution when faced with such a situation and reassess whether they have properly recognised all the assets and liabilities, including their amounts. Only when there is clear evidence that the business combination is a bargain purchase, the acquirer recognises the resulting gain in other comprehensive income on the acquisition date and accumulates the same in equity as a capital reserve. In the absence of clear evidence, the difference is directly recognised in equity as part of the capital reserve. This is also a specific deviation from the International Financial Reporting Standards (IFRS), which requires the bargain purchase gain to be recorded in the statement of profit and loss.

Principles of Ind AS 103: 'double column approach



What happens when control is acquired in stages, i.e. step acquisitions?

Often it is noted that control over subsidiaries is acquired in stages, for example, where an entity initially acquires, say, 40% equity interest in an entity, making it an associate and thereafter acquires additional, say, 50% interest, thereby gaining control. Under Ind AS 103, the interest held in a subsidiary before control is acquired (in this example the previous 40% interest) is fair valued on the date when control is acquired. The difference between the carrying value of such previously held interest in the acquiree and its fair value on the date when control is obtained is recognised in the profit and loss account. In the above example, the acquirer will have to fair value its previously held interest of 40% in the acquiree on the date it acquires the additional 50% interest, and the difference between such fair value and the carrying value of the 40% interest will be recorded in the statement of profit and loss as unrealised gain/loss. Again, this is a big shift from what we do today under Indian GAAP, which is essentially based on a cost accumulation method for control achieved in stages.

Where an additional interest is acquired in an entity which is already controlled (in the above example, say, if the investor acquires the balance 10% stake at a later date), the transactions is accounted as an equity transaction. In such cases, the difference between the consideration paid and the reduction in the non-controlling interest (NCI) is charged directly against the parent's equity.

How is consideration measured in a business combination?

Consideration transferred in a business

combination is measured at fair value. It is calculated as the sum of the acquisition date fair values of the assets transferred by the acquirer; the liabilities assumed by the acquirer and the equity interests issued by the acquirer. Examples of consideration are cash, other assets, a business or a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options, warrants, etc. The overriding principle is that all forms of consideration are measured at fair value on the date when control is obtained over the acquiree.

How are transaction costs related to a business combination accounted for?

Acquisition related costs are not part of the consideration paid by the buyer to the seller for the acquired business. Instead, these are costs incurred for separate services received by the company. Accordingly, they are not accounted for as a part of the business combination, but treated as separate transactions and expensed in the period in which the costs were incurred. Examples of such costs are consultancy and legal charges, costs related to investment bankers, valuation experts and other third parties. This is a significant difference from the current Indian GAAP where transaction costs are included as part of the cost of acquisition/ consideration paid and therefore included in the determination of goodwill.

What is contingent consideration and how is it accounted for in a business combination?

Many business combinations contain provisions which require the buyer to make additional payments to the seller in the future based on the occurrence of specific events such as the acquired business reaching a particular threshold of revenues, earnings before interest, taxes, depreciation and amortisation (EBIDTA) or other milestones. This is commonly referred to as contingent consideration. Ind AS 103 requires the contingent consideration to be measured at fair value on the date of acquisition and is recognised as a part of the consideration. Accordingly, it affects the goodwill recognised at the date of the business combination.

Contingent consideration is treated as a 'liability' or 'equity' depending on the manner in which it is settled. Liability classified contingent consideration is subsequently fair valued at each reporting date, and the difference is recorded in the income statement. On the other hand, equity classified contingent consideration is not subsequently remeasured. The difference between the settlement value and the initial fair value is recorded in the equity in such cases.

Under the current Indian GAAP, there is no specific guidance to account for contingent consideration. There is diversity in the practice whereby some may have estimated and recorded the amount of such a contingent consideration at the date of acquisition, while others may have accounted for it based on the actual settlement. Additionally, under the current Indian GAAP, some companies may have accounted for the change in the estimate of the contingent consideration as an adjustment to the cost of acquisition, while others may have charged it to the profit and loss account. Now Ind AS 103 makes this accounting consistent as discussed above.

In practice, we have observed that the payment of contingent consideration also gets linked to the continued employment of the selling shareholders of the acquired entity in the combined entity for a specific period of time. Termination of employment services of the selling shareholders result in forfeiture of such contingent consideration payments. Under Ind AS, in such circumstances, the contingent consideration is recorded as compensation expense in the profit and loss and not capitalised as part of cost of acquisition. Companies entering into such types of earn-out arrangements should carefully evaluate the terms of such contracts as this can have a significant impact on its financial statements going forward.

Mergers approved under high court schemes

Presently, under Indian GAAP, accounting for mergers occurs from an 'appointed date' even though the scheme becomes effective upon approval of the high court and submission of the court order with the Registrar of Companies (RoC). This effective date is generally much later than the appointed date. In such a scenario, the assets and liabilities are recorded from the appointed date, including the calculation of the resultant goodwill/ capital reserve. Going forward, under Ind AS, this may need to change. Ind AS 103 requires business combination accounting to be done on the date when the entity obtains control over the acquiree. In a court scheme, it is likely that the date, when the control passes to the acquirer, will be the date when the high court approves the scheme, resulting in acquisition accounting from this date and not the appointed date. As more guidance evolves in this area, companies planning such mergers and reorganisations should carefully evaluate their court schemes keeping in mind the requirements of Ind AS 103.

What are the common control business combinations and how are they accounted for?

Common control transactions are business combinations between entities that are ultimately controlled by the same parent, both before and after the combination, e.g. fellow subsidiaries. Under IFRS, there exists an accounting policy choice where such transactions are recorded either at the predecessor's carrying values (historical basis) or at fair values of the acquired assets and liabilities. However, under Ind AS 103, specific guidance has been included in the standard (Appendix C of Ind AS 103) requiring such common control business combinations to be recorded using the pooling of interest method. This means that all the assets and liabilities will be recorded at their pre-combination carrying values, and there will be no goodwill arising on such transactions. This will be a significant change from the current practice and can also have consequential tax implications.

Summary

As summarised in this article, Ind AS 103 introduces several new concepts and will significantly impact the way business combinations, mergers and reorganisations are accounted for going forward. Finance, legal, tax, business and commercial teams will have to closely interact and evaluate the implications of this new standard while planning such transactions.

Currently, all listed companies desirous of undertaking a scheme of arrangement are required to obtain a no-objection letter from the stock exchange(s) before filing such schemes with any court or tribunal. The Companies Act, 2013, has introduced a requirement that no compromise or arrangement should be sanctioned by the tribunal unless a certificate by the company's auditor is filed with the tribunal to the effect that the accounting treatment, if any, proposed in the scheme of compromise or arrangement is in conformity with the prescribed accounting standards. However, the above requirement has not been made effective yet. Once it becomes effective, it will bring in the same level of compliance by unlisted companies as previously introduced by the Securities and Exchange Board of India (SEBI) for listed entities.

Ind AS for banks and non-banking financial companies (NBFCs)

MCA's notification dated 16 February 2015 made Ind AS applicable for certain categories of companies. However, it specifically excluded NBFCs, banking companies and insurance companies. Furthermore, these entities are not permitted to apply Ind AS voluntarily.

The good news is that RBI recently issued its Fourth Bi-monthly Monetary Policy statement on 29 September 2015 recommending to the MCA a roadmap for the implementation of IND AS for banks and NBFCs from 2018-19. As per the statement, RBI has constituted a Working Group (Chairman: Sudarshan Sen) for the implementation of Ind AS. The report of the Working Group will be available on the RBI website by end of October 2015 to seek public comments. This surely is a positive and welcome development demonstrating India's commitment towards the adoption of Ind AS.

One of the most significant Ind AS that will impact banks and NBFCs is the new IFRS 9 on financial instruments. Though this standard applies to all entities; financial institutions in particular are expected to be affected the most from the new requirements of the expected credit loss (ECL) impairment model. This new impairment model for financial assets seeks to address the criticisms of the incurred loss model and will result in recognition of impairment losses earlier. Assessing the impact of IFRS 9 will take a significant amount of time and resources, especially to implement the changes in a systematic manner, taking into consideration the impact on data, systems and financial models.

India has decided to early adopt the new IFRS 9 on financial instruments by notifying Ind AS 109: Financial Instruments, though IFRS 9 is globally mandatory for financial periods beginning 1 January 2018. Accordingly, the roadmap recommended by RBI is well timed with the effective date of IFRS 9 globally. This will help the Indian financial sector to learn from global experience and align its financial reporting with rest of the world.

It is now for the insurance regulator—Insurance Regulatory and Development Authority to come up with an Ind AS roadmap for companies in this sector.

Integrated reporting: A new corporate reporting model

Background

We are quite familiar with the term 'financial reporting', and used to reading board and management reports which form a part of the annual report. However, the latest buzzword in the area of reporting is 'integrated reporting'. There is active discussion on this topic and it is also on the radar of various regulators and stakeholders. Here is how an integrated report is defined:

An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term.

Corporate reporting norms have been evolving with increasing expectations from various stakeholders, including investors, government and regulators. Stakeholders intending to assess the appropriateness of corporate behaviour find it increasingly difficult to navigate through lengthy annual reports. Moreover, key messages can get lost in these reports due to immaterial or repetitive disclosures. Corporate reports are already more complex and heavily regulated than earlier. Over the last decade, corporate reporting has received a lot of attention and there have been considerable changes in the extent of reporting sought with the objective of ensuring transparency.

Recent changes will ensure transparency in reports:

- *Convergence with IFRS, i.e. notification of Ind-AS and its application in a phased manner*
- *Focus on reporting of non-financial components, for example, disclosure for not incurring expenditure on corporate social responsibility (CSR) initiatives*
- *Increasing momentum for sustainability reporting*

Corporates have also started realising the need to have a fundamental change in reporting wherein the focus is not just on the financial capital but also on demonstrating the value created by the entity while operating within its economic, social and environmental system. The intended change requires a deeper understanding of all the building blocks of the business value creation process. This will enable corporates to develop a reporting model that will give an insightful picture of its performance, and sufficient information to assess the quality and sustainability of that performance.

With this objective, companies are increasingly revisiting their annual reports to see how they can make improvements in their reporting structure within the existing legal and regulatory requirements. Some of the questions they can consider asking themselves include the following:

- How does the outcome of the stakeholder dialogue link up with the company's strategy and risk?
- How does it connect to the key value drivers and performance, and how will these factors ultimately impact the company?

How is integrated reporting different?

Integrated reporting is achieved when it shows how governance connects with remuneration and risk, when strategy is designed to exploit a changing market environment, and when strategic priorities align with key resources, relationships and key performance indicators.

So, what else is different about 'integrated reporting'?

Certain key differences with regard to the current model are given in the following table:

	Current model	Integrated reporting/future model
Focus	Past, financial	Future, connected and strategic
Timeframe	Short term	Short, medium and long term
Detail	Long and complex	Concise and material
Compliance	Rule bound	Responsive to circumstances
Presentation	Paper based	Technology based
Thinking	Silos	Integrated
Stewardship	Financial capital	All capital (human, intellectual, social, natural, etc.)

Source: International Integrated Reporting Council (IIRC)

Types of capital

Finance capital, intellectual capital, human capital, natural capital, manufactured capital, social and relationship capital

The capitals are stocks of value that are increased, decreased or transformed through the activities and outputs of the organisation.

What needs to be done?

Corporates need to embed the approach of integrated thinking throughout their decision-making process to identify how the organisation uses and affects its important capitals, as well as the trade-offs between the capitals and in its value creation process. Boards should always meet with an agenda item on the capitals used and affected, as well as the ongoing relationships with stakeholders.

In order to plan and prepare for a quality integrated report, organisations should strive at ensuring participation and consensus at leadership and governance levels. Accountability for the preparation of the report should be fixed with clarity around the processes which in turn will be dependent on the organisational size and structure. Efforts should be made to ensure that the report provides insight into the nature and quality of the organisation's relationships with its key stakeholders.

Determining materiality is one of the cornerstones of an effective integrated report and immaterial information should be avoided. Accordingly, only matters that substantively affect the organisation's ability to create value should be reported on. In determining whether matters are material, consideration should be given to all aspects of the organisation–strategy, governance, performance, prospects, and the important capitals.

Recent initiatives

The work of the International Integrated Reporting Committee (IIRC) and corporate chambers has resulted in rising awareness around the need for change and providing mechanisms to achieve this by experimenting with the structure and content of reporting. Some of the recent initiatives are:

- The CII-ITC Reporting Lab which brings management and investors together to innovate and shape reporting to better meet their needs.
- Market leaders are taking voluntary initiatives and have started structuring their reports around the new reporting model. They plan to innovate across all corporate reporting and take stock of its environmental, social and economic impact.
- In one of the recent speeches of the President of the Institute of Chartered Accountants of India (ICAI), the importance of an integrated report was acknowledged. It was also mentioned that the ICAI has taken up a project to study the framework of integrated reporting and explore the possibility of making it applicable to Indian companies.

The primary purpose of an integrated report is to explain to providers of financial capital how an organisation creates value over time. An integrated report benefits all stakeholders interested in an organisation's ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policymakers.

The ability of an organisation to create value for itself enables financial returns to the providers of financial capital. This is interrelated with the value the organisation creates for stakeholders and society at large through a wide range of activities, interactions and relationships. When these are material to the organisation's ability to create value for itself, they are included in the integrated report.

Source: IIRC

Measuring quality in audits

On 1 July 2015, PCAOB issued a concept release to seek the public's viewpoints on potential AQIs that may provide new insights on how to evaluate the quality of audits and how high quality audits are achieved.

Why was the concept release issued?

The PCAOB commented that audit quality should be the most significant driver in the public company audit market. Currently, there is minimal publicly available information regarding indicators of audit quality at individual auditing firms. Consequently, it is difficult to determine whether audit committees, who ultimately select the auditor and management, are focussed and have the tools that are useful in assessing audit quality that will contribute to making the initial auditor selection and subsequent auditor retention evaluation processes more informed and meaningful.

The PCAOB, as part of its responsibility to improve audit quality, issued a concept release seeking the public's comments on 28 possible AQIs and whether this information will be useful for audit committees, audit firms, investors and regulators.

How does it matter?

As per section 177 of the Companies Act, 2013, audit committees in India are required to recommend the auditor's appointment/reappointment to the board of directors and also review and monitor the auditor's performance. The PCAOB concept release, although intended for public companies in the US, can provide useful information to audit committees in India in discharging its functions.

What are the AQIs?

The concept release recommends a framework of 28 possible AQIs for evaluating audit quality. These 28 AQIs are based on an audit firm's audit professionals, audit process and audit results. These are discussed below:

The goal of the AQI project is to improve the ability of persons to evaluate the quality of audits in which they are involved or the ones they rely on and to enhance discussions among interested parties.

Audit quality should be the most significant driver in the public company audit market influencing auditor selection and retention.

Audit professionals: Measures relating to (i) availability of resources, (ii) competence, and (iii) focus.

Availability	1. Staffing leverage 2. Partner workload 3. Manager and staff workload 4. Technical accounting and auditing resources 5. Persons with specialised skill and knowledge
Competence	6. Experience of audit personnel 7. Industry expertise of audit personnel 8. Turnover of audit personnel 9. Amount of audit work centralised at service centres 10. Training hours per audit professional
Focus	11. Audit hours and risk areas 12. Allocation of audit hours to phases of the audit

Audit process: Measures relating to an audit firm's (i) tone at the top and leadership, (ii) incentives, (iii) independence, (iv) attention to infrastructure, and (v) record of monitoring and remediation of identified matters impacting audit quality.

Tone at the top	13. Results of independent survey of firm personnel
Incentives	14. Quality ratings and compensation 15. Audit fees, effort and client risk
Independence	16. Compliance with independence requirements
Infrastructure	17. Investment in infrastructure supporting quality auditing
Monitoring and remediation	18. Audit firms' internal quality review results 19. PCAOB inspection results 20. Technical competency testing

Audit results: Measures relating to (i) financial statements, (ii) ICFR, (iii) going concern reporting, (iv) communications between auditors and audit committees, and (v) enforcement and litigation.

Financial statements	21.Frequency and impact of financial statement restatements for errors 22. Fraud and other financial reporting misconduct 23. Inferring audit quality from measures of financial reporting quality
Internal control	24.Timely reporting of internal control weaknesses
Going concern	25.Timely reporting of going concern issues
Communications between auditor and audit committee	26. Results of independent surveys of audit committee member
Enforcement and litigation	27.Trends in PCAOB and SEC enforcement proceedings 28. Trends in private litigation

The concept release illustrates how each possible AQI can be calculated at both the engagement level and the audit firm level to meet various stakeholders' needs. The PCAOB emphasised that the indicators have inherent limitations. They are not intended to provide scores or grades for audits and will require the context to be understood and evaluated.

The concept release also seeks comments on how AQI data should be obtained and distributed, whether auditors should be required to provide AQIs, or whether providing the information should be voluntary, which audits and audit firms should be subject to AQI reporting.

The above AQIs will enhance focus on audit quality. AQIs will facilitate audit committees in making more informed and transparent decisions on auditor selection/retention. AQIs will also assist audit committees and auditors in identifying the factors relevant to the performance of a quality audit.

Conclusion

The PCAOB has emphasised that auditor selection and retention should be based on the 'audit quality'. The AQIs suggested by PCAOB measure quality in terms of an audit firm's audit professionals, audit process and audit results. The AQIs will provide useful information to the board of directors and audit committees to discharge their responsibilities towards the auditor selection/retention and review, and montior auditors performance in a more informed and transperent manner.

Recent technical updates

Companies Act, 2013

Alterations to Schedule III of the Companies Act, 2013: Regarding MSME disclosures

The central government has now restored the disclosures relating to micro and small enterprises as defined under the Micro, Small and Medium Enterprises Development (MSMED) Act 2006, in Schedule III of the Companies Act, 2013. While these disclosures were specifically covered under Schedule VI of the Companies Act, 1956, they were not included in Schedule III earlier.

The Companies (Accounts) Second Amendment Rules, 2015

This amendment essentially draws on Ind AS with respect to preparation of financial statements. The definition of Indian Accounting Standards (Ind AS) has now been included in the Rules. The Rules specifically state that the financial statements shall be in the form specified in Schedule II of the Act and comply with the AS or Ind AS. Items in the financial statements shall follow the definition and other requirements of AS or Ind AS. Also, the consolidated financial statements will need to be filed along with Form AOC-4 CFS.

Clarification with regard to circulation and filing of financial statement under relevant provisions of the Companies Act, 2013

MCA has clarified that a company holding a general meeting after giving a shorter notice as provided under section 101 of the Act may also circulate financial statements (to be laid/considered in the same general meeting) at such shorter notice.

In consultation with ICAI, it is also clarified that in case of a foreign subsidiary, which is not required to get its accounts audited as per the legal requirements prevalent in the country of its incorporation and which does not get such accounts audited, the holding/parent Indian may place/file such unaudited accounts to comply with requirements of section 136(1) and 137(1) as applicable. These, however, will need to be translated in English if the original accounts are not in English. Furthermore, the format of accounts of foreign subsidiaries should be, as far as possible, in accordance with requirements under the Companies Act, 2013. In case this is not possible, a statement indicating the reasons for the deviation may be placed/filed along with such accounts.

SEBI

SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

SEBI has notified 'Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015' (hereinafter referred to as 'Regulations'). These Regulations will become effective on the 19th day from the date of the notification in the official gazette, i.e. 1 December 2015, except the regulation relating to disclosure of class of shareholders and conditions for reclassification.

Guidance Note on SEBI (Prohibition of Insider Trading) Regulations, 2015

SEBI has provided guidance to remove difficulties in the interpretation or application of the provisions of SEBI (Prohibition of Insider Trading) Regulations, 2015, which was issued on 15 January 2015 and came into effect on 15 May 2015.

ICAI

Quality Review Board: A Report on Audit Quality Review Findings (2012-15)

The Quality Review Board has brought out 'A Report on Audit Quality Review Findings (2012-15)' providing an analysis and summary of observations made by the technical reviewers in review reports completed during the financial years 2012-15. The report is accessible at: http://www.qrbca.in/wp-content/uploads/2015/07/qrb28179.pdf.

Global updates

IFRS

IASB proposes clarifications to IFRS 15

The International Accounting Standards Board (IASB) has proposed amendments to IFRS 15 in some of the areas discussed by the Transition Resource Group (TRG). These areas include accounting for licences, principal versus agent guidance and practical expedients on transition. The proposed amendments differ from those suggested by the Financial Accounting Standards Board (FASB). These areas were previously discussed by the TRG and subsequently at joint meetings with FASB. Some of the issues were jointly deliberated, but the proposed changes are not the same as those proposed by FASB. The revenue standards might therefore diverge before the 2018 effective date. However, the proposals are subject to the board's due process requirements which include a period for public comment that closes on 28 October 2015.

IASB issues Exposure Draft (ED) on pensions

The IASB has proposed narrow scope amendments to IAS 19 and International Financial Reporting Interpretations Committee (IFRIC) interpretation 14 to clarify how the recognition of changes that take place during the year impacts the income statement. The proposals also expand the guidance in IFRIC 14.

IFRIC 14 has proved difficult since it was issued in 2007. Divergent views on how it should be interpreted have evolved and at least one regulator has been looking hard at how entities have been applying it. Even before this, IFRIC 14 accounting for asset ceiling was one of the most challenging aspects of IAS 19. When IAS 19 was revised in 2011, incorporating IFRIC 14 into the standard (as is the normal practice with interpretations) was put in the 'too difficult' box. The current ED amends IFRIC 14 rather than incorporating it into the standard.

The comment period for these proposals closes on 19 October 2015. Although the changes to IFRIC 14 may impact relatively few preparers, when they do, the impact can be very significant, moving from a balance sheet asset position to recognising an additional liability.

US generally accepted auditing standards (GAAS)/ GAAP

FASB proposes clarification to principal vs agent guidance in revenue recognition standard

On 31 August 2015 FASB issued a proposed Accounting Standards Update (ASU) to clarify the implementation guidance on principal versus agent considerations contained in the new revenue recognition standard. Stakeholders are encouraged to review and provide comment on the proposal by 15 October 2015.

FASB issues a final standard to simplify the measurement of inventory

On 22 July 2015, FASB issued ASU 2015-11, 'Simplifying the Measurement of Inventory', which requires that inventory within the scope of the guidance be measured at the lower of cost and net realisable value. Inventory measured using last in, first out (LIFO) and the retail inventory method (RIM) are not impacted by the new guidance.

The amendments in this update do not apply to inventory measured using LIFO and RIM. Feedback from preparers during the exposure period highlighted certain implementation issues affecting companies using these measurement bases that may have resulted in significant transition costs compared to limited benefits. Based on this feedback, the board decided to exclude inventory measured using LIFO and RIM from the scope of the guidance.

The new guidance will be effective for public business entities in fiscal years beginning after 15 December 2016, including interim periods within those years (i.e., in the first quarter of 2017 for calendar year end companies). For entities other than public business entities, the amendments are effective for fiscal years beginning after 15 December 2016, and interim periods within fiscal years beginning after 15 December 2017. Prospective application is required. Early adoption is permitted as of the beginning of an interim or annual reporting period.

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