PwC ReportingPerspectives
April 2018

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Editorial

We are pleased to bring to you the 14th edition of our quarterly newsletter covering the latest developments in financial reporting as well as other regulatory updates.

The Ministry of Corporate Affairs (MCA) notified Ind AS 115, 'Revenue from contracts with customers', on 28 March 2018 as part of the Companies (Indian Accounting Standards) Amendment Rules, 2018. Ind AS 115 is applicable for accounting periods commencing on or after 1 April 2018 for all Ind AS compliant companies. This edition discusses the impact of Ind AS 115 on certain industries.

The enhanced reporting standards, issued by the Institute of Chartered Accountants of India (ICAI), have come into effect for audits of financial periods beginning on or after 1 April 2018. We provide an overview of the Implementation Guide to Standard on Auditing (SA) 701, Communicating Key Audit Matters in the Independent Auditor's Report, issued by the ICAI.

We also discuss the impact of the Payment of Gratuity (Amendment) Act, 2018, notified by the Central Government on 29 March 2018, on Ind AS financial statements for the period ended 31 March 2018.

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

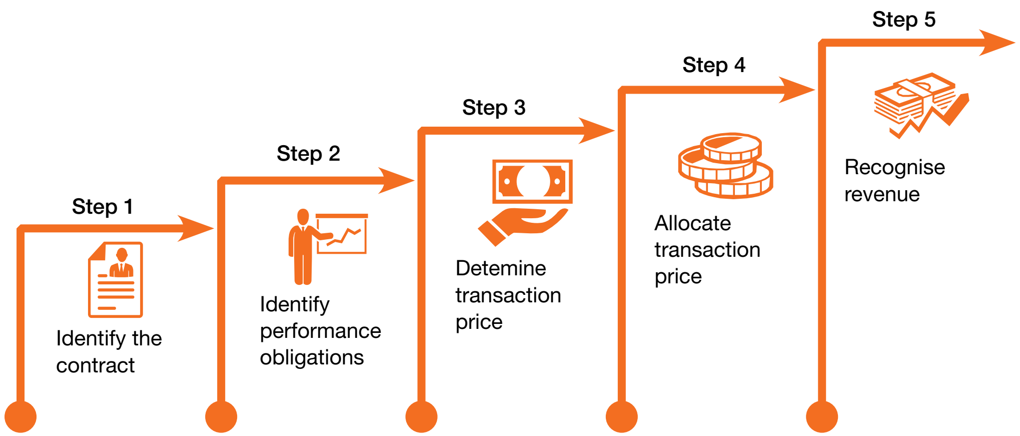
We hope you find this newsletter informative and of continued interest.

We welcome your feedback at pwc.update@in.pwc.com

Industry impact of the new revenue standard – Ind AS 115

The Ministry of Corporate Affairs (MCA) issued the Companies (Indian Accounting Standards) Amendment Rules, 2018, on 28 March 2018. The rules have notified Ind AS 115, 'Revenue from contracts with customers'. Ind AS 115 is largely converged with the International Financial Reporting Standards (IFRS) 15, 'Revenue from contracts with customers', issued by the International Accounting Standards Board (IASB) and ASC 606, 'Revenue from contracts with customers', issued by the Financial Accounting Standards Board (FASB). The new revenue standard is applicable for all Ind AS compliant companies and is effective from accounting periods beginning on or after 1 April 2018.

Five-step revenue model



The core principle of Ind AS 115 is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new standard requires revenue to be recognised upon the transfer of control of goods or services vis-à-vis the transfer of significant risks and rewards. The new revenue standard also introduces a five-step model for recognition of revenue, which might appear simple but requires significant judgement in applying the underlying principles to practice. Application of the new concept of control and the five-step model to complex contractual terms requires a change in the mindset of all the stakeholders.

Our discussions focus on how the new revenue recognition rules may affect the various contractual arrangements and practices prevalent across different industries. With revenue being one of the more important performance measures, the new revenue recognition standard is likely to impact all entities. The standard also provides extensive disclosure requirements. The extent of impact on an entity will vary depending on the current accounting practices.

Retail and consumer products

Retailers commonly offer coupons, rebates issued at the point of sale, free products (buy one get one free), price protection or price matching programmes to their customers. Consumer product companies commonly provide vendor allowances, including volume rebates and cooperative advertising allowances, mark-down allowances (compensation for poor sales levels of vendor merchandise), etc., to their customers. The absence of extensive guidance on the erstwhile revenue standard has led to some diversity in practice in accounting for incentives.

Option to acquire additional goods or services

Retailers often offer customers a right to purchase free or discounted goods or services at future dates together with the initial sale of goods or services (e.g. coupons for additional purchases).

The new revenue standard requires companies to identify all the promised goods or services in a contract and determine whether each promised good or service has to be accounted for as a separate performance obligation. The standard contains extensive guidance with illustrative examples on how to identify different performance obligations.

If an entity grants its customers, as part of a sales transaction, an option to receive additional goods or services in the future free of cost or at a discount, the entity accounts for that option as a separate performance obligation, and, therefore, is required to allocate total consideration between the initial sale and the option to purchase such additional goods or services.

Retailer and consumer product companies will need to closely examine their contracts with customers to evaluate the promises made in them. The evaluation is not restricted to explicit promises in the contract and also includes verbal and implicit promises. If promised goods or services are identified to be separate performance obligations, the costs of fulfilling those goods or services should be presented as cost of sales. Examples of promises that might require careful consideration include training customers' employees, deploying employees to work on-site at the customer's store location, and providing free or significantly discounted products with end customer purchases. In all these instances, entities applying the principles of Ind AS 115 may conclude that such promises constitute a separate performance obligation. Part of the consideration shall be allocated to these separate performance obligations. Accordingly, revenue shall be recognised when the respective performance obligations have been fulfilled.

Customer incentives

Customer incentives can affect the amount and timing of revenue recognition under the new revenue standard. Identification of additional performance obligations can affect the timing of revenue recognition. Incentives can also introduce variability into the transaction price, which can affect the amount of revenue recognised. The new revenue standard includes specific guidance addressing these areas. Under the new revenue standard, variable consideration is required to be estimated and recognised at initial recognition, subject to a constraint. The constraint (variable consideration constraint) requires that the amount of variable consideration is included in the transaction price only to the extent that it is highly probable that there will not be a significant reversal in the amount of cumulative revenue recognised when the uncertainty is resolved.

Example: Variable consideration constraint

A retailer sells a product to a customer for 100 INR on 1 January and agrees to reimburse the customer for the difference between the purchase price and any lower price offered by a certain direct competitor during the three-month period following the sale. The retailer has recent experience with similar promotions of similar products. On a probability weighted basis, the retailer estimates that it will reimburse the customer 5 INR.

How should the retailer account for the potential refund?

Analysis – The consideration expected to be repaid to the customer should be excluded from the revenue and recorded as a liability at the time of sale. If the management, based on its past experience, concludes that it is highly probable that recognising 95 INR would not result in a significant reversal of cumulative revenue upon the resolution of the uncertainty, the retailer would recognise revenue of 95 INR and a refund liability of 5 INR.

Communications

Customers of communication companies often request changes to their service plans. For example, wireless telecom customers might change their existing service plans to upgrade or replace a device; include additional wireless minutes; increase data usage; add incremental, or remove, existing services; or terminate services altogether.

Communications companies often pay commissions to internal sales agents and third-party dealers for connecting new customers to their networks. In practice, there is diversity in accounting for such costs, with some reporting entities recognising these costs as intangible assets while others expense them as incurred.

Contract modifications

Ind AS 115 provides extensive guidance on contract modifications. Modifications occur when the parties to the contract approve a modification that creates or changes the enforceable rights and obligations of the parties to the contract. A modification is accounted for as either a separate contract or as part of the existing contract (either prospectively or through a cumulative catch-up adjustment).

A contract modification is treated as a separate contract only if it results in the addition of a distinct performance obligation and the price reflects the standalone selling price of that performance obligation. Otherwise, the modification is accounted for as an adjustment to the original contract.

A company will account for a modification prospectively if the goods or services in the modification are distinct from those transferred before the modification.

A company will account for a modification through a cumulative catch-up adjustment if the goods or services in the modification are not distinct and are part of a single performance obligation that is only partially satisfied when the contract is modified.

A contract modification that only affects the transaction price should be treated as part of the existing contract.

Companies will need to apply judgment in evaluating whether goods or services in the modification are distinct. This may be particularly challenging when there are multiple performance obligations.

Example – Contract modification

A fixed-line communications company enters into a contract with a customer to provide voice and data services for 24 months at a fixed charge of 500 INR per month. After six months, the customer decides to add TV services for an incremental fee of 500 INR per month over the same term. This price is slightly lower than the price charged to customers who purchase only the TV service without voice and data services, which reflects the fact that the customer acquired the TV service as part of a bundle, assuming that there are no other fees or deliverables.

The TV services added by the customer are a distinct performance obligation. These services are being charged at relative standalone selling prices (when adjusted for the selling costs avoided by transacting with an existing customer). The TV services are a new contractual arrangement and there is no impact on the accounting for the existing data and voice services.

While this example is fairly simple, further complexities could arise when modifications provide customers with discounts on new or existing services or the contract period gets extended for all services or additional deliverables (such as equipment). Entities in the communications industry will have to carefully apply the requirements of the new standard to their specific facts and circumstances.

Incremental costs of obtaining a contract

The new revenue standard requires an entity to recognise the incremental costs of obtaining a contract as assets. As a practical expedient, entities are permitted to expense such costs when incurred if the amortisation period is estimated to be less than one year. Subsequently, such contract costs are amortised in a manner consistent with the pattern of transfer of goods or services to the customer.

Accordingly, the new revenue standard could have a significant impact on entities that were charging the incremental costs of obtaining a contract to profit and loss. Such entities will have to modify their systems, processes and controls to identify and monitor incremental acquisition costs. Determination of the amortisation period will require entities to use judgment as the standard requires entities to consider periods beyond the initial contract period (e.g. the renewal of existing contracts and anticipated contracts).

Wireless or network providers may also provide free or heavily discounted handsets to attract customers. Such incentive programmes will not be accounted for as costs to obtain a contract under the new revenue guidance. A handset is a separate performance obligation and the cost of the handset is recognised as an expense when that performance obligation is satisfied (i.e. when the handset is delivered to the customer). Companies should carefully consider subtle differences in their arrangements which could have a significant impact on the recognition and measurement of revenue.

Pharmaceuticals

Companies in the pharmaceutical and life sciences industry often enter into arrangements to develop drugs, either as a supplier of services, a consumer of those services or through execution of licence arrangements.

Licences of intellectual property (IP)

Generally, a licence granted by an entity (the licensor) provides the customer (the licensee) with the right to use, but not to own, the licensor's IP. A common example in the pharmaceutical and life sciences industry is that of an entity who 'out licences' to a customer the IP it developed related to a drug that has not yet received regulatory approval. Often, under the terms of the licence, the licensee can further develop the IP and manufacture and/or sell the resulting commercialised product. The licensor typically receives an upfront fee, milestone payments for specific clinical or other development-based outcomes, and sales-based royalties as consideration for the licence. Some arrangements also include ongoing involvement by the licensor, who might provide R&D and/or manufacturing services relating to the licensed IP.

Accounting for licences could be challenging under the revenue standard. The first step is to determine whether a licence is distinct from other goods and services promised in the contract. For example, licences provided with other services, such as R&D, must be assessed to determine if the licence is distinct as per the guidance in Ind AS 115. If the licence is not distinct, then the licence is combined with other goods or services into a single performance obligation. Revenue is recognised as the licensor satisfies the combined performance obligation.

If it is determined that the licence provided is distinct from other goods and services promised in the contract, the entity needs to determine if the licence provided offers the (1) right to use IP or (2) right to access IP.

Right to use IP: A licence may provide a customer the right to use a company's IP as it exists at the point in time when the licence is granted. For these licences, revenue is recognised at a point in time when control transfers to the licensee and the licence period begins.

Right to access IP: A licence may provide access to a company's IP as it exists throughout the licence period. Licences that provide access are performance obligations satisfied over time and, therefore, revenue is recognised over time.

All of the following conditions must be met for a licence to be regarded as a right to access IP:

- The licensor will undertake (either contractually or based on customary business practice) activities that significantly affect IP to which the customer has rights.
- The licensor's activities do not otherwise transfer goods or services to the customer as they occur.
- The rights granted by the licence directly expose the customer to both positive or negative effects of the licensors activities.

Whether the licence is a perpetual licence or a term licence does not necessarily impact whether revenue should be recognised at a point in time or over time; rather, the terms of the contract, the rights granted to the licensee and any activities the licensor undertakes that significantly impact the IP will impact that determination. Thus, the analysis under the new revenue standard could result in differences in the timing of recognition of revenue.

Sale- or usage-based royalties

It is a common practice for biotech companies to transfer their patent rights to pharmaceutical companies in return for a consideration which is generally based on the sale of products associated with the IP.

Sales- or usage-based royalties received in connection with the licence of IP are subject to a specific exception in the revenue standard. For such licences, the consideration is not included in the transaction price until the customer's subsequent sale or usage occurs, as long as this approach does not result in the acceleration of revenue ahead of the company's performance. This exception is limited to licences of IP, with sales- or usage-based royalties, and does not apply to other royalty arrangements.

In situations when royalties can relate to both a licence of IP and other goods or services, the sales- or usage-based royalty exception only applies when the licence of IP is the predominant item to which the royalty relates.

Engineering and construction

Companies in the engineering and construction industry have historically followed industry-specific guidance to account for revenue. Such guidance specifies accounting treatment for a range of areas specific to long-term contracts, including accounting for contract costs, such as pre-contract costs and costs to fulfil a contract. The new revenue standard will substantially replace all industry-specific guidance.

Example: Applicability of sale- or usage-based royalties

A biotech company enters into an arrangement with a pharma company in which the biotech company agrees to provide the pharma company with a licence to its IP—that is, a drug compound. The biotech company concludes that the license provides the pharma company with the right to use the IP as it exists at the commencement of the license period. In return, the pharma company paid the biotech company an upfront payment of 10 million USD and is required to pay the biotech company an additional 20 million USD in the event that the annual sales of the products associated with the IP of the pharma company exceed 250 million USD.

The 20 million USD sales-based milestone should generally be viewed as a sales-based royalty, given that it is based solely on the pharma company's subsequent sales.

Since the royalty exception applies to this scenario, instead of accounting for this milestone as a variable consideration that would be estimated and included in the transaction price at contract inception (subject to the variable consideration constraint), the milestone would be recognised (1) when the subsequent sales or usage occurs; or (2) full or partial satisfaction of the performance obligation to which some or all of the royalty has been allocated.

Therefore, as the biotech company only had one performance obligation—that is, to transfer the licence to the pharma company, which was transferred at the beginning of the contract, the biotech company should recognise the 20 million USD sales-based milestone when the sales threshold is reached.

Set-up and mobilisation costs

Set-up and mobilisation costs are direct costs typically incurred at a contract's inception to enable a company to fulfil its obligations under the contract. Mobilisation costs are a type of set-up cost incurred to move equipment or resources to prepare to provide the future services in an arrangement. Examples of set-up and mobilisation costs in the engineering and construction industry include:

- Temporary facilities for a construction project that are established on the customer's property, and the related requirements for such facilities, if any, as spelled out in the contract. Examples of such costs include:
  - Offices
  - Construction parking areas
  - Access roads
  - Utilities
- Moving equipment and people

The new revenue standard refers to such set-up and mobilisation costs as 'cost to fulfil a contract'. If the costs incurred to fulfil a contract are not within the scope of another standard (e.g. Ind AS 2, 'Inventories', Ind AS 16, 'Property, plant and equipment' or Ind AS 38, 'Intangible assets'), an entity shall recognise as asset the costs incurred to fulfil a contract if those costs meet all of the following criteria: (a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify; (b) the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and (c) the costs are expected to be recovered.

Entities in the engineering and construction industry will need to evaluate whether such costs incurred are for providing a service or preparing an entity to provide a promised service. All costs related to satisfied performance obligations and costs related to inefficiencies (i.e. abnormal costs of materials, labour or other costs to fulfil) are expensed as incurred.

Direct costs of fulfilling a contract are capitalised under the revenue standard if they are not within the scope of other standards, relate directly to a contract, generate or enhance resources that will be used to satisfy future performance obligations, and are expected to be recovered.

Example: Costs to fulfil and acquire contracts

A contractor enters into a construction contract with a customer to build an oil refinery on the customer's land. The contractor determines that the contract has a single performance obligation to build the refinery. The contractor recognises revenue over time for the performance obligation to build the refinery. At the beginning of the contract, the contractor incurs certain mobilisation costs amounting to 1 million USD and bid costs of 100,000 USD. The contractor has concluded that such costs should not be accounted for in accordance with other standards (e.g. inventory, fixed assets or intangible assets). The contractor expects that construction performance will occur evenly over a two-year period.

The contractor will need to exercise judgment to determine whether the mobilisation costs:

- represent costs to fulfill a contract and qualify for capitalisation as an asset to be amortised over the contract term or;
- relate to mobilisation activities that transfer a service to the customer and should be reflected in the measure of progress as incurred. This would be the case if the mobilisation activities are either:
    - Distinct and represent a separate performance obligation; or
    - Are part of a combined performance obligation when such activities represent an input to form an overall output.

If the contractor determines that the mobilisation activities are a part of a combined performance obligation and it is using the cost-to-cost method of measuring progress, it will incorporate such costs in its measurement of progress towards completion.

If the contractor determines that the mobilisation activities (i.e. moving equipment and people) are not providing distinct goods or services or are part of a combined performance obligation, the mobilisation costs would be capitalised as costs to fulfil a contract if they (a) relate directly to the contract; (b) enhance resources that will be used to satisfy future performance; and (c) are expected to be recovered. Judgment may be required to determine the goods or services to which the asset relates. Capitalised costs might relate to an entire contract or could relate only to specific performance obligations within a contract. The contractor should apply an amortisation method that is consistent with the pattern of transfer of goods or services to the customer. An asset related to a performance obligation satisfied over time should be amortised using a method consistent with the method used to measure progress and recognise revenue (i.e. an input or output method). Straight-line amortisation may be appropriate if goods or services are transferred to the customer rateably throughout the contract, but not if the goods or services do not transfer rateably.

Assuming that mobilisation costs are capitalised, 500,000 USD would be amortised at the end of year one (coinciding with 50% control transfer using a cost-to-cost method).

The accounting for bid costs is determined by whether such costs are chargeable to the customer, regardless of whether the contract is won. Amounts that relate to a contract that are explicitly chargeable to a customer are receivable if a company's right to reimbursement is unconditional. Costs that are not recoverable from the customer should be expensed as incurred.

Contract assets and liabilities

Existing construction contract guidance requires a contractor to record an asset for amounts recoverable from customers (Ind AS) when revenue is recognised but not billed. The unbilled accounts receivable are transferred to trade receivables when the invoice is submitted to the customer. Under the new revenue standard, if a contractor delivers services to a customer before the customer pays consideration, the contractor should record either a contract asset or a receivable depending on the nature of the contractor's right to consideration for its performance.

The transfer from a contract asset to an accounts receivable balance (when the contractor has a right to payment) may not coincide with the timing of submitting the invoice (as would be required under the existing guidance, under which a receivable typically arises upon invoicing). Under the new revenue standard, a receivable is recorded when a company has the unconditional right to the consideration. A receivable is recognised at that time since payment from the customer is contingent only upon the passage of time. Under the revenue standard, engineering and construction companies will need to evaluate the appropriate balance sheet classification in instances where an entity has incurred costs and has the right to payment (right to invoice) but has not yet submitted the invoice to the customer (e.g. delays in invoicing due to billing cycles).

Disclosures

Regardless of the changes to recognition and measurement of revenue, detailed quantitative and qualitative disclosure requirements are included in the new revenue standard that cover a range of topics, including the significant judgments made when measuring and recognising revenue. The disclosure requirements are extensive and will require entities to obtain data and information that may not have previously been captured within an organisation's information systems. Engineering and construction companies will need to ensure that their existing processes and controls are amended to capture the necessary information. The disclosures include:

- Qualitative and quantitative information about performance obligations;
- Reconciliations of contract balances; and
- Significant judgments and changes in judgments made in applying the guidance to contracts with customers.

Automotive industry

The value chain in the automotive industry generally includes suppliers, original equipment manufacturers (OEMs) and their financing affiliates. Ind AS 115 is expected to have an impact on the amount of revenue recognised by each of the parties. The discussion below specifically focuses on tooling arrangements, free maintenance services and warranties offered by OEMs.

Tooling arrangements between suppliers and OEMs

It is common for suppliers to enter into contracts with their OEMs for the construction and sale of tools and to supply parts which are manufactured using the tools. These two contracts may be entered into at the same time. Title of the tools transfer to OEMs prior to the production and supply of the parts in accordance with the supply contract. A number of questions arise regarding the classification and recognition of such contracts in the context of Ind AS 115.

The current revenue standard requires contracts to be combined when two or more transactions are linked and a combination is necessary to reflect the commercial substance of the transactions (commonly referred to as linked transactions). Ind AS 115 requires two or more contracts to be combined and accounted for as a single contract if they are entered into at or near the same time; contracts are negotiated with a single commercial objective, consideration for one contract depends on the price or performance of other contract and goods and services performed are a single performance obligation. If the consideration for the sale of a tool is recovered by the supplier along with the sale of the parts then both the contracts are negotiated with a single commercial objective and their pricing is related. The supplier therefore combines the contract for the sale of tools with the contract for the sale of parts.

Ind AS 115 requires entities to account for goods or services separately if the customer can benefit from goods or services either on their own or together with other resources readily available to the customer and the entity's promise to transfer goods or services is separable from other promises in the contract. Tools and the parts are supplied at different times and the OEM can benefit by taking the tools to another supplier for the manufacture of parts. Accordingly, the tool and the subsequent production of parts appear to be separable. The supplier shall recognise revenue for each performance obligation when the control of the respective tool and individual part is transferred to the OEM.

If an entity concludes that the contract for the sale of tools and the contract for sale of parts are combined, the transaction price is required to be allocated to tools and parts based on their relative standalone selling prices. Allocation of consideration to each performance obligation is required irrespective of how the contract is structured. For example, if the tooling contract is structured to earn a lower margin, the allocation would result in a part of the margin on the sale of parts being moved to the sale of tools.

Ind AS 115 may also impact the timing of recognition of revenue. Tools constructed by the suppliers are generally specific to OEM requirements and can be used in the manufacture of parts for a specific model. Tools have no alternative use. Further, the OEM is obligated to reimburse the supplier for its costs of construction to date plus a reasonable profit margin if the OEM cancels the contract. The supplier would need to evaluate if the construction of tools creates or enhances an asset for the OEM and if the OEM controls the asset as it is created. If this condition is met, the supplier concludes that the performance obligation to deliver the tool is satisfied over time.

Contract modifications

As discussed earlier, Ind AS 115 provides extensive guidance on contract modifications. Any modification that promises distinct goods or services and the price of the contract increases by an amount of consideration that reflects the standalone selling price of the additional promised goods or services is accounted for as a separate contract. Let's understand this with an example in respect of arrangements between OEMs, suppliers and dealers in the automotive industry.

Example: Accounting for free maintenance as a performance obligation or incentive

Consider the example of an OEM which sells vehicles to dealers. The OEM announces a three-year free maintenance service on each vehicle sold. The promotion also applies to all vehicles with the dealer at no additional charge. The OEM recognises revenue upon the sale of vehicles to the dealer. With respect to new sales, free maintenance is a separate performance obligation and a portion of the total consideration should be allocated to it. With respect to vehicles already with the dealer, the answer depends on whether the dealer had a valid expectation that the OEM would offer such additional promotional services. The offer for free maintenance would be a performance obligation if it were part of the contract between the OEM and the dealer, whether the offer was explicit in the contract or implied by the OEM's prior business practices. The conclusion may vary based on individual facts and circumstances. For example, the OEM could conclude that the dealer did not have a reasonable expectation for certain items (such as free maintenance) if they are offered for the first time, on a limited basis, and with no anticipation of repeating the offer.

Warranties

The new guidance is similar to the current accounting for warranties. There may, however, be some situations where the accounting for warranties could result in revenue deferral; for example, when the entity's warranty provides a service to the customer, in addition to the promise that the product complies with the specifications in the contract. Entities would then need to separate the service component as a separate performance obligation, defer revenue related to the service and recognise it as the service is provided.

Under the new guidance, OEMs that offer extended warranties are required to allocate the consideration to the sale of a vehicle and extended the warranty based on relative standalone selling prices. Entities cannot consider the prices explicitly specified in the contract for each distinct performance obligation.

Industrial products

There are a wide range of entities which operate in the industrial products space, including industrial manufacturing, metals, chemicals, etc. The new revenue standard will affect the amount and timing of recognition of revenue in this industry, considering complex contractual arrangements and prevalent commercial practices.

Synthetic free on board (FOB) contracts

It is a common practice for entities to replace or credit the customer for lost or damaged goods even when the delivery terms are FOB shipping point. Under the current revenue recognition rules, revenue is generally recognised when the product is received by the customer because risks and rewards of ownership have not been substantially transferred at the point of shipment. The timing of revenue recognition for such arrangements might change under the 'control-based' model introduced under Ind AS 115.

For example, if at the point of shipment, the customer has the legal title, ability to redirect and sell goods in transit, or the right to payment, then entities may need to evaluate whether control is transferred under the new revenue standard and therefore whether revenue should be recognised at the point of shipment. This is a judgmental matter requiring evaluation of transfer of control based on an entity's specific facts and circumstances and contracts with their customers.

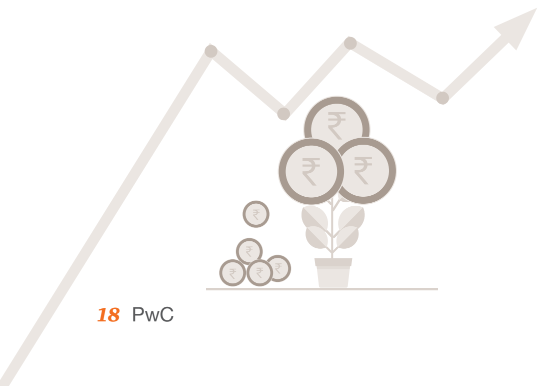
In these situations, recognition of revenue at the point of shipment may also result in additional performance obligations being identified for shipping and risk of loss in-transit.

Bill-and-hold arrangements

Some entities in the industrial products industry have bill-and-hold arrangements with their customers in which the company bills the customer for a product but does not deliver the product until a later date. The new revenue standard focuses on when control of the goods transfer to the customer to determine when revenue should be recognised. For a customer to have obtained control of a product in a bill-and-hold arrangement, the following criteria must be met:

1. the reason for the arrangement is substantive;
2. the product has been identified separately as belonging to the customer;
3. the product is ready for delivery in accordance with the terms of the arrangement; and
4. the company does not have the ability to use the product or sell the product to another customer.

Let's understand with an example how the new revenue standard may have an impact on bill-and-hold arrangements.



Example: Bill-and-hold arrangements

Entity A orders pipes from Entity B. Entity A requests the arrangement to be on a bill-and-hold basis because of frequent changes to the timeline for developing remote gas fields and long lead times needed for the delivery of drilling equipment and supplies. Entity B has a history of bill-and-hold transactions with Entity A. The pipes are separately warehoused by Entity B and are ready for shipment. Entity B cannot utilise the pipes or direct the pipes to another customer once the pipes are in the warehouse. The terms of the arrangement require Entity A to remit payments within a period of 30 days of the pipes being placed in the warehouse.

Entity B shall recognise revenue from the sale of pipes only when control over the inventory of pipes have been transferred to Entity A.

Entity A has requested for the sale to be structured as a bill-and-hold arrangement, which suggests that the reason for bill-and-hold sales is substantive. Entity B is not permitted to use the pipes to fulfil other customer orders and the pipes are ready for immediate shipment at the request of Entity A.

All the above conditions must be satisfied for an entity to recognise revenue from the sale of products pending shipment.

The following conditions, including 'buyer must have taken title to the goods and accepted billing', 'probability that the delivery will take place', 'acknowledgement from the buyer with regard to the deferred delivery terms' and 'payment terms are not unusual', which were part of Ind AS 18, have not been included in the evaluation of transfer of control model under Ind AS 115.

Software and technology

Revenue recognition within the software industry has historically been complex. Accounting for software products and services is expected to be one of the areas most impacted by the new revenue standard. Due to the lack of industry-specific guidance, in the current Generally Accepted Accounting Principles (GAAP), recognition of revenue involved significant judgement and there has been diversity in practice in the application of the revenue recognition principles in the industry.

Identification of multiple elements in a contract

Software arrangements typically comprise multiple goods and services such as software licences, unspecified or specified future updates or upgrades/ enhancements, specified or unspecified additional software products, exchange and platform transfer rights, post-contract customer support (PCS), installation and other professional services.

The goods or services promised in a contract with a customer may be explicitly stated in the arrangement or implied by the software vendor's customary business practices. The new revenue standard requires companies to consider whether the customer has a valid expectation that the vendor will provide goods or services when it is not explicitly stated. If the customer has a valid expectation, he/she would view those promises as part of the goods or services in the contract.

Promised goods or services must be distinct to be accounted for as a separate performance obligation when there are multiple promises in a contract. Goods or services are distinct if (1) the customer can benefit from goods or services either on their own or together with other readily available sources (i.e. it is capable of being distinct) and (2) if goods or services are separately identifiable from the other promises in the contract (i.e. distinct in the context of the contract). Identifying different performance obligations in a software contract requires significant judgement.

Example: Determination of multiple performance obligations

Entity A contracts with a customer for perpetual software licences, installation services, unspecified software updates and technical support for two years. The installation services include significant customisation of the software to interface with customer data sources. The updates and technical support are not critical to maintaining the ongoing utility of the software.

In accordance with the principles of Ind AS 115, goods or services in a contract are distinct only when customers can benefit from specified goods or services and the goods and services are separately identified from other promises in the contract. The evaluation needs to consider the customer's perspective.

A software licence is not distinct from installation services because installation services significantly customise a software. A software licence and installation services are inputs into a combined output, which is a promise to deliver customised software. Accordingly, Entity A is likely to conclude that the software licence and installation services are not distinct.

Updates and technical support are not critical to maintaining the ongoing utility of the software. A customer can benefit from the software even without significant updates and technical support. Accordingly, updates and technical support are to be recognised as separate performance obligations.

Licences of IP

Recognition of revenue in respect of licences of IP under the new revenue standard has been discussed earlier. Let's now understand how the new requirements apply to licences of IPs within the software industry.

Example: Right to use vs right to access IP

Entity A provides a fixed-term software licence to Entity B. Entity B can download the software using a unique digital key and use it on its own server. The software is functional when it is transferred to Entity B. Entity B also purchases PCS with the software licence. There is no expectation for Entity A to undertake any activities other than PCS. Entity B can benefit from the software licence on its own.

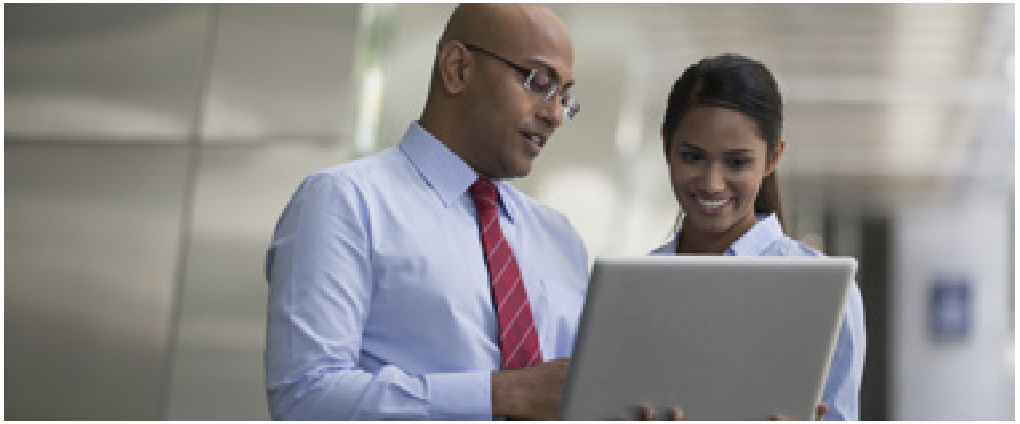
PCS is not considered an 'activity' that affects IP because it is a separate performance obligation. The IP has significant standalone functionalities and Entity A is not expected to perform any activities that affect the functionality of the software license. The three-point criteria required for the right to access IP over time are not met. The licence is a right to use IP. Accordingly, Entity A will recognise revenue at a point in time when Entity B is able to use and benefit from the licence.

Entertainment and media (E&M)

The E&M industry comprises diverse sub-sectors, including filmed entertainment, television and cable broadcast, data services, advertising, music, video games and publishing. Our discussion is intended to highlight implications of the new revenue standard on common accounting matters identified in this industry.

Licence of IP

Licences for IPs in the E&M industry are very common. As discussed earlier, determination of whether the licence provides a right to use IP or a right to access IP may have significant impact on the timing and pattern of revenue of recognition. Let's understand how the guidance in the new revenue standard is likely to impact the timing of recognition of revenue relating to licences of IP.



Barter transactions

Example: Right to use IP vs right to access IP

Entity A is the creator of a new cartoon show on television. Entity A grants a 3-year licence to a retailer for the use of the cartoon characters on consumer products. The retailer is required to use the latest image of the characters from the television show. There are no other goods or services provided to the retailer in the arrangement. The retailer expects that Entity A will continue to produce the show, develop the characters and perform marketing to enhance awareness of the characters. The retailer may start selling merchandise with the characters once the show airs on television.

Entity A's continued production and marketing of the show and development of characters indicates that Entity A will undertake activities that will significantly affect the IP. The retailer is directly exposed to any positive or negative effects of Entity A's activities, as the retailer is required to use the latest images that could be more or less positively received. The activities of Entity A are not separate performance obligations since they do not transfer goods or services to the retailer separate from the licence. Accordingly, the licence meets all the three conditions to be classified as a right to access IP, with revenue to be recognised over the three-year licence period.

Several E&M sub-sectors engage in barter transactions, typically exchanging advertising for advertising or exchange of goods or services. Ind AS 115 could change how transaction prices are measured in some situations in the absence of specific guidance. Under Ind AS 18, revenue is not recognised on the exchange of similar goods or services; for example, exchange of advertising services on the same medium. However, if the medium of advertising exchanged is dissimilar in nature, revenue is recognised as fair value of the advertising supplied. In case of other barter transactions (i.e. other than advertising for advertising) revenue is recognised at fair value of goods or services received or given, whichever is more reliably measurable.

Under the new standard, revenue is required to be measured at fair value of the cash and non-cash consideration received or promised by the customer. Variable consideration constraint is applicable when the fair value of non-cash consideration varies only for reasons other than the form of consideration. Judgment may be necessary to determine the fair value of goods or services exchanged (e.g. advertising) when a limited market exists.

Producers and distributors of TV and film IP often license their programmes or films to TV stations and cable networks (broadcasters) for consideration that includes a fixed cash amount and the right to monetise advertising spots to be aired with the content (barter). Under the new revenue standards, the question arises as to whether the advertising time received should be accounted for as non-cash consideration, which would require the producer to measure the advertising spots at fair value at contract inception. Under this view, the producer would record:

- Licensing revenue for both the cash consideration and the fair value of the advertising spots when the content is delivered to the broadcaster.
- Advertising revenue (and corresponding cost of sales) for the subsequent sale of the advertising spots to advertisers.

Key takeaways

Ind AS 115 contains extensive guidance and illustrative examples which provide much-needed guidance for preparers to apply the revenue recognition principles in the standard. Entities should carefully evaluate the terms of arrangement and past business practices with customers. The application of the new standard may result in a change from the current recognition and measurement practices. However, the extent of impact would vary based on the industry and current accounting practices followed.

Additionally, the new standard may impact an entity's budgeting and reporting process, IT systems, internal control systems, and employee KPIs, including tax implications in many circumstances.

Since Ind AS 115 is already applicable from accounting periods beginning on or after 1 April 2018, entities should focus on effectively completing their transition and implementation processes and timely communication with their stakeholders.

Including key audit matters in an audit report

Introduction

The enhanced reporting standards issued by the Institute of Chartered Accountants of India (ICAI) come into effect for audits of financial periods beginning on or after 1 April 2018. These enhanced reporting standards envisage the inclusion of key audit matters (KAMs) in the audit report. In this respect, guidance has been provided by the Auditing and Assurance Standards Board of the ICAI in its Implementation Guide to Standard on Auditing (SA) 701, Communicating Key Audit Matters in the Independent Auditor's Report.

KAMs are those items that, in the auditors' professional judgement, are most significant to the audit. KAMs are selected from matters communicated with those charged with governance.

Communicating KAMs does not constitute a separate opinion on individual matters and is in the context of the auditor's opinion on financial statements as a whole.

Communicating KAMs in the auditor's report is not:

- a substitute for disclosures in the financial statements that the applicable financial reporting framework requires the management to make, or that are otherwise necessary to achieve fair presentation;
- a substitute for expressing a modified opinion when required by the circumstances of a specific audit in accordance with SA 705 (Revised);
- a substitute for reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern;
- a separate opinion on individual matters.

In this section, we take a look at the guidance provided in the Implementation Guide in respect of the new standard. However, it remains the responsibility of the management, with the oversight of those charged with governance, to communicate relevant information to users about an entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework.

Applicability

The new reporting standard SA 701 is applicable for audits of financial statements for periods beginning on or after 1 April 2018. SA 701 mandatorily applies to audits of complete sets of general purpose financial statements of listed entities for periods beginning on or after 1 April 2018. SA 701 is applicable on the audit of unlisted entities under the following circumstances:

- When the auditor decides to communicate KAMs in the auditor's report, or
- When the auditor is required, by law or regulation, to communicate KAMs in the auditor's report.

Determining KAMs

A funnel approach may be adopted to determine which matters are required to be reported as KAMs in the auditor's report. The starting point would be the matters that are communicated to those charged with governance, filtered for those matters that required significant auditor attention and then finally filtered for matters of significance in the audit, which then would be the KAM for inclusion in the auditor's report.

Step 1: Matters communicated with those charged with governance

Some of the matters that are routinely communicated with those charged with governance include:

- Auditor's responsibilities in relation to the audit of financial statements.
- Planned scope and timing of the audit, including significant risks identified:
  - Plan for addressing the significant risks of material misstatement, whether due to fraud or error
  - Plan to address areas of higher assessed risks of material misstatement
  - Approach towards internal control relevant to the audit
  - Application of materiality
  - Nature and extent of specialised knowledge, including use of an auditor's expert
  - Where SA 701 applies, preliminary views about matters that may be areas of significant audit attention and therefore may be KAMs.
- Significant findings from the audit:
  - Where SA 701 applies, this would be relevant to determine matters that required significant auditor attention and therefore may be KAMs.
- Auditor independence

Reference may be made to SA 260 (Revised) in this regard for listing of matters that are required to be communicated to those charged with governance.

Step 2: Matters that required significant auditor attention

Matters that required significant auditor attention primarily relate to matters that pose challenges to the auditor in forming an opinion or obtaining evidence that in his judgement was sufficient and appropriate under the circumstances. The auditor shall take into account the following in this regard:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with Para 5 of SA 315. Some points to be considered are:
  - SA 260 (Revised) requires communication of significant risks to those charged with governance and plans for addressing the same.
  - Significant risks require special audit consideration and are often areas that require significant auditor attention.
  - Exceptions for considering KAMs could be the presumed significant fraud risks – revenue recognition and management override of controls.
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period. Some points to be considered are:
  - Those that had a significant effect on financial statements or the audit. For example, significant transactions with related parties, significant transactions outside the normal course of business, unusual transactions.
  - Significant economic, accounting, regulatory, industry or other developments that impacted the management's assumptions and judgements.

Step 3: Matters that were of most significance in the audit of the current period

When determining matters that were of most significance in an audit, some points to be considered include:

- Areas where the auditor had more in-depth, frequent or robust interactions with those charged with governance on more difficult and complex matters.

For example, the auditor may have had more in-depth, frequent or robust interactions with those charged with governance on more difficult and complex matters such as the determination of certain accounting estimates that were the subject of significant auditor or management judgment.

- Other factors to be considered are:
  - Importance of the matter to intended users of the financial statements and its materiality
  - Nature of the accounting policy compared to other entities within its industry
  - Nature and materiality of corrected and uncorrected misstatements (when uncorrected misstatements exceed thresholds, it would qualify for modification [including internal financial control over financial reporting (ICFR)], in which case it will not be a KAM)
  - Nature and extent of audit effort required, including the need for specialised knowledge and consultations outside the engagement team
  - Nature and severity of difficulties in applying the audit procedures, evaluating results of those procedures and obtaining relevant and reliable evidence

For example, an auditor may experience significant difficulties in matters such as:

- Significant delays in management providing required information
- Unnecessarily brief time within which to complete the audit
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence
- Unavailability of expected information
- Restrictions imposed on the auditor by the management
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification in the auditor's opinion:

- Severity of control deficiencies
- Impact on several related areas (e.g. long-term contracts – impact on revenue recognition, litigation, contingencies etc.)

Determining which, and how many, of those matters that required significant auditor attention were of most significance in the audit is a matter of professional judgment. The number of KAMs to be included in the auditor's report may be affected by the size and complexity of the entity, the nature of its business and environment, and the facts and circumstances of the audit. In general, the greater the number of matters initially determined to be KAMs, the more the auditor needs to reconsider whether each of these matters meets the definition of a KAM. Lengthy lists of KAMs are contrary to the notion of such matters being those of most significance in the audit.

Communicating KAMs

A separate section with the 'KAM' is to be included in the auditor's report. The section on KAM shall explicitly state:

- KAMs are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period; and
- These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

An illustrative paragraph on KAMs:

KAMs are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each KAM in accordance with SA 701.]

Placement of KAMs in the audit report

Generally, the KAMs section is required to be placed after the 'basis for opinion' paragraph and before the 'management responsibility' paragraph.

In case the 'material uncertainty relating to going concern' section is required as per the revised SA 570, the KAM section is placed after that section.

Further, regarding the placement of the KAM section, paragraph A16 of the revised SA 706 indicates:

When the KAMs section is presented in the auditor's report, an 'emphasis of matter' paragraph may be presented either directly before or after the KAMs section, based on the auditor's judgment as to the relative significance of the information included in the 'emphasis of matter' paragraph. The auditor may also add further context to the heading 'emphasis of matter', such as 'emphasis of matter – subsequent event', to differentiate the 'emphasis of matter' paragraph from the individual matters described in the KAMs section.

Interplay between the 'emphasis of matter' paragraph and KAM

When SA 701 applies, the use of 'emphasis of matter' paragraphs is not a substitute for a description of individual KAMs. In other words, when a matter has been determined to be a KAM, the auditor is required to include the matter in the auditor's report in accordance with SA 701. The auditor should not use the 'emphasis of matter' paragraph or an 'other matter' paragraph as a substitute for reporting the matter as a KAM.

Further, matters that are determined to be KAMs in accordance with SA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a KAM in accordance with SA 701, the auditor may wish to highlight or draw further attention to its relative importance. The auditor may do so by presenting the matter more prominently than other matters in the KAMs section (e.g. as the first matter) or by including additional information in the description of the KAM to indicate the importance of the matter to users' understanding of the financial statements.

There may be a matter that is not determined to be a KAM in accordance with SA 701 (i.e. because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g. a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an 'emphasis of matter' paragraph in the auditor's report in accordance with SA 706 (Revised).

For example, when the auditor concludes in accordance with SA 570 (Revised) that no material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor may nevertheless determine that one or more matters relating to this conclusion arising from the auditor's work effort under SA 570(Revised) are KAMs. In such circumstances, the auditor's description of such KAMs in the auditor's report could include aspects of the identified events or conditions disclosed in the financial statements, such as substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements, and related mitigating factors.

In summary

Inclusion of KAMs in the audit report provides greater transparency about the audit performed by the auditor. It aids the users to understand the entity better, and provides an insight into areas of significant management judgement in the audited financial statements. To accomplish this, auditors must make sure that the information is as entity-specific as possible, and related to the facts and circumstances of the audit of the current period.

Payment of Gratuity (Amendment) Act, 2018[1]

Background

On 29 March 2018, the Central Government notified the Payment of Gratuity (Amendment) Act, 2018, (the Act). The Act increases the ceiling of the amount of gratuity payable to employees from 10 lakh INR to 20 lakh INR. Under the Act, gratuity is payable on termination of employment upon an employee completing at least five years of continuous service.

Impact on the financial statements for the quarter or year ended 31 March 2018

Many entities may have provided for gratuity benefit to its employees limited to the 10 lakh INR ceiling specified under the Payment of Gratuity Act, 1972. Gratuity is classified and recognised as a post-employment defined benefit obligation. The amendment is a positive past service cost which results in increase in the gratuity obligation.

Paragraph 8 to Ind AS 19, ‘Employee benefits’ defines past service cost as the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment or a curtailment.

An entity shall recognise past service cost as an expense when the plan amendment occurs.

The amendment has been notified by the Central Government before the period ended 31 March 2018. The amendment will increase the amount of gratuity benefit payable to employees, and accordingly meets the definition of a past service cost. Consequently, the entire amount relating to such past service cost shall be recognised immediately in the Statement of Profit or Loss in the quarter or year ended 31 March 2018. Unlike Indian GAAP, unvested past service cost shall not be spread over a future service period under Ind AS.

Before determining the amount of past service cost, an entity shall re-measure the net defined benefit liability/(asset) using the current fair value of plan assets and current actuarial assumptions (including current market interest rates and other current market prices) reflecting the benefits offered under the plan before the amendment.

Disclosure requirements

Disclosure of the reconciliation of defined benefit obligation required in accordance with paragraphs 140 and 141 of Ind AS 19 shall separately disclose the impact of the past service cost resulting from the increase in gratuity ceiling limit on the amount of defined benefit obligation.

1. http://egazette.nic.in/WriteReadData/2018/184299.pdf

Key takeaways

Companies should carefully evaluate the impact of the amendment as they gear up for the quarterly or year-end 31 March 2018 reporting. The impact of the amendment may vary depending on the existing terms of the gratuity benefit offered by entities to their employees. Early engagement with actuarial experts is encouraged.

Recent technical updates

Institute of Chartered Accountants of India (ICAI)

Educational Material on Ind AS 103, 'Business combinations'[2]

The Ind AS Implementation Committee of the ICAI has issued educational material on Ind AS 103. This educational material contains a summary of Ind AS 103, discusses the key requirements of the standard and includes frequently asked questions on issues that are expected to be encountered while implementing the standard.

Ind AS Transition Facilitation Group (ITFG) Bulletin 13:

The ITFG issued its 13th bulletin to address certain issues received from preparers and other stakeholders. The clarifications are summarised below:

1. Dividend distribution tax (DDT) on dividend payable on preference shares classified as liability in accordance with Ind AS 32, 'Financial instruments': Presentation will be treated as borrowing cost eligible for capitalisation under Ind AS 23, 'Borrowing costs'.
2. Ind AS 109, 'Financial instruments' does not provide any specific accounting for the beneficiary of a financial guarantee. A personal guarantee provided by a director to the lenders of a company, without any premium or fees, is not required to be accounted by the company, i.e. the beneficiary. The fair value of the borrowing is expected to be the face value of the loan proceeds received considering the unit of account as being the guaranteed loan.
3. The disclosure specified in paragraph 34 of Ind AS 108, 'Operating segments', relating to information about the extent of reliance on major customers also applies to an entity with a single reportable segment.
4. A company which carries on the activity of a non-banking financial company (NBFC) but is not registered with the Reserve Bank of India (RBI) shall also comply with Ind AS as per the Ind AS roadmap for NBFCs.
5. Ind AS and Ind AS Schedule III do not permit classification of expenses by function. Further, disclosure of operating profit would result in a change in the format of the Statement of Profit or Loss as prescribed by Ind AS Schedule III. Accordingly, it may not be appropriate to present operating profit measure as a sub-total on the face of the Statement of Profit or Loss. Entities may provide such additional information in the financial statements.
6. Modification gain or loss arising on renegotiation of terms of borrowings should be recognised in the profit or loss of the period in which the renegotiation has contractually taken place.
7. A deemed disposal of a parent's equity interest in a subsidiary without loss of control (e.g. when another investor invests in the equity of the subsidiary thereby reducing the parent's ownership percentage) has no accounting impact in the separate financial statements of the parent. In the consolidated financial statements of the parent, such deemed disposal is accounted as an 'equity transaction'. No gain or loss is recognised in profit or loss.
8. Market risk disclosures relating to foreign exchange risk, required by Ind AS 107, 'Financial instruments: Disclosures', shall also be provided in respect of exchange differences capitalised with the cost of the asset as per paragraph D13AA of Ind AS 101, 'First-time adoption of Indian Accounting Standards'.

2. https://resource.cdn.icai.org/49531indas39251.pdf

9. Impact of DDT paid by a partly owned subsidiary in the consolidated financial statements of the parent:
    a. Where no dividend is declared by the parent company: In consolidated financial statements, dividend income earned by the parent from the subsidiary and the equivalent amount recorded by the subsidiary in its equity shall be eliminated. DDT paid by the subsidiary attributable to the parent's share of dividend (which is eliminated in the consolidated financial statements) shall be charged to the consolidated Statement of Profit or Loss as 'tax expense'. Dividend paid by the subsidiary to non-controlling interests (NCIs) along with the attributable DDT thereon would be recorded in the consolidated statement of changes in equity as a reduction in NCI balance.
    b. Where dividend is declared by the parent company: DDT paid by the subsidiary claimed as set-off against the DDT liability of the parent under tax laws shall be recognised in the consolidated statement of changes in equity. DDT not claimed/utilised as set-off shall be charged to the consolidated Statement of Profit or Loss as 'tax expense'. Accounting of dividend paid by the subsidiary to NCI and DDT thereon shall be as per 9(a) above.
10. DDT paid by an associate is not allowed as set off against the DDT liability of the investor under tax laws. Accordingly, investor's share of DDT paid by the associate would be accounted by the investor by crediting its investment in the associate and recording a corresponding debit adjustment towards its share of profit or loss from the associate.
11. Debentures compulsorily convertible into a fixed number of equity shares (CCDs) with mandatory interest payment are classified as compound financial instruments from the issuer's perspective. Such a compound financial instrument is required to be separated into two components, i.e. financial liability and equity. When allocating the initial carrying amount of the compound instrument into financial liability and equity, an entity first determines the fair value of the liability component. The fair value of the financial liability is determined with reference to the fair value of a similar stand-alone debt instrument. The amount allocated to the equity component is the residual amount after deducting the fair value of the financial liability component from the fair value of the entire compound instrument. The above principle would also apply to CCDs issued at off-market coupon.

Our PwC Reporting InBrief on ITFG 13 can be accessed here:
https://www.pwc.in/publications/2018/pwc-reporting-reporting-inbrief-inbrief-ind-as-transition-facilitation-group-itfg-clarification-bulletin-13.html

ITFG Bulletin 14:

The ITFG issued its 14th bulletin to address certain issues received from preparers and other stakeholders. The clarifications are summarised below:

1. Loan processing fees are considered an integral part of the effective interest rate (EIR) of a borrowing. Where such borrowing is in connection with the construction or acquisition of a qualifying asset, processing fees to the extent amortised as per the EIR method shall be capitalised as part of the cost of the asset till the period of capitalisation permitted under Ind AS 23, 'Borrowing costs'.
2. Accounting for site restoration cost in the case of leasehold land depends on whether the lease is a finance or an operating lease.
   a. If the lease is determined to be a finance lease, the present value of the estimated restoration costs shall be capitalised on initial recognition along with the property, plant and equipment (PP&E) and a corresponding liability shall be recognised. PP&E along with the capitalised restoration costs shall be depreciated over the estimated useful life.
   b. If the lease is determined to be an operating lease, the present value of the estimated restoration costs to remove the leasehold structure or improvement shall be capitalised with the leasehold structure or improvement and depreciated over the lease term or the estimated useful life of the structure or improvement, whichever is lower.
3. Where advances received from customers for supply of goods or services constitute a significant financing component, the entity shall adjust the consideration (including advance payments) for the effects of time value of money.
4. Preference shares which are redeemable or convertible at issuer's option with discretionary dividend shall be classified as equity provided the conversion option is substantive. This is because the issuer has the ability to avoid making cash payment or settling the instrument through issue of a variable number of its own shares.
5. A court or National Company Law Tribunal (NCLT) order approving a scheme of amalgamation involving entities under common control with retrospective effect, subsequent to the balance sheet, is an adjusting subsequent event.
6. Financial instruments which are held as stock-in-trade shall be recognised and measured in accordance with Ind AS 109, 'Financial instruments'. Disclosures in accordance with Ind AS 107, 'Financial instruments: Disclosures' shall also be provided in respect of such financial instruments.
7. Where an entity upon transition elects to apply fair value as the deemed cost of the PP&E or Ind AS 16, 'Property, plant and equipment' retrospectively and subsequently measures the PP&E based on the revaluation model as per Ind AS 16, then any revaluation surplus recognised in accordance with previous Indian GAAP shall be transferred to retained earnings or another category of equity. Revaluation gain or loss as determined as per Ind AS 16 shall be recognised on the date of transition to Ind AS in equity as revaluation reserve. Any subsequent changes in revaluation after the date of transition to Ind AS shall be recognised in other comprehensive income.

Our PwC Reporting InBrief on ITFG 14 can be accessed here:
https://www.pwc.in/publications/2018/pwc-reportinginbrief-ind-as-transition-facilitation-group-itfg-clarification-bulletin-14.html

ITFG Bulletin 15:

The ITFG issued its 15th bulletin to address certain issues received from preparers and other stakeholders. The clarifications are summarised below:

- In determining the fair value of the liability component of a compound financial instrument with an equity conversion option, all the contractually determined future cash flows under the instrument shall be discounted at the market rate of interest prevailing at the time of issue. The discount rate shall be comparable to the instrument with respect to currency, time period, credit status and cash flows, but without the equity conversion option.
- Non-cumulative mandatorily redeemable preference share where payment of dividend is at the discretion of the issuer is a compound financial instrument. On initial recognition, fair value of the liability component is determined by discounting the eventual redemption amount using a market rate of interest. The residual amount represents the equity component. Furthermore, discretionary dividends will be recognised when they are declared and are attributable to the equity component.
- Incentives receivable under a government scheme is a financial asset to be recognised in accordance with Ind AS 109, 'Financial instruments', provided an entity has complied with the conditions attached to the scheme. An understanding between the government and the entity that on complying with the stipulated conditions under the scheme, the entity will be granted incentives constitutes a 'contract' in accordance with Ind AS 32, 'Financial instruments, presentation'.
- Applicability of Ind AS to an entity having net worth less than 250 crores INR as on 31 March 2017 in the following scenarios:
  - The entity began the process of listing at the beginning of financial year 2017–18 and gets listed as at the end of the year: It shall be required to prepare its financial statements in accordance with Ind AS from 2017-18.
  - The entity is de-listed during the financial year 2017-18: It shall prepare its financial statements in accordance with Ind AS since it was listed as at the beginning of the year.
  - The entity began the process of listing during the financial year 2017–18 and may or may not get listed by the year end: It shall comply with Ind AS from that financial year, irrespective of whether the listing is completed by the year end.
  - The entity issues debentures which were listed during financial year 2017-18. These debentures were delisted during the same financial year. The entity would not be required to comply with Ind AS since the entity did not have the status of a listed entity both at the beginning and at the end of the year.
- From the time a Non-Banking Finance Company (NBFC) ceases to carry on the activities of an NBFC, it shall determine the applicability of Ind AS following the roadmap as applicable to a non-NBFC company. The roadmap applicable to a non-NBFC company shall be followed even if the entity's application for termination of membership is in the process with the Securities and Exchange Board of India (SEBI).

- If an entity has not taken exemption under Ind AS 101, 'First-time adoption of Indian Accounting Standards' of not restating past business combinations, the entity will be required to retrospectively apply the requirements of Ind AS 103, 'Business combinations'. The requirements of Appendix C to Ind AS 103 shall also be applied retrospectively to past business combinations under common control.
- Interest-free refundable security deposits shall be discounted and measured at their present value on initial recognition. Rate of interest to be used for the purpose of discounting shall be determined considering the prevailing market rate of interest for a similar instrument with a similar credit rating.
- A lessor shall recognise land held under finance lease in the balance sheet and present it as a receivable at an amount equal to the net investment in the lease. If the entire lease rentals are received upfront there will be no receivable.
- Amounts outstanding towards retired partners' capital in a partnership firm are in the nature of financial liabilities repayable on demand. Such amounts outstanding are not required to be discounted both on initial recognition and subsequent measurement.
- Investors (other than the parent) and fellow subsidiaries of an entity would not be required to mandatorily adopt Ind AS for their statutory reporting, merely because the entity meets the net worth or the listing criteria in the Ind AS roadmap and is therefore required to prepare its financial statements in accordance with Ind AS.

Our PwC Reporting InBrief on ITFG 15 can be accessed here:
https://www.pwc.in/publications/2018/pwc-reportinginbrief-ind-as-transition-facilitation-group-itfg-clarification-bulletin-15.html

Standard on Auditing (SA) 299 (Revised) Joint Audit of Financial Statements[3]

The Auditing and Assurance Standards Board of ICAI has issued SA 299 (Revised). This SA is effective for audits of financial statements for periods beginning on or after 1 April 2018. The standard deals with the special considerations in audits carried out by joint auditors.

3. https://resource.cdn.icai.org/49657aasb39352.pdf

Ministry of Corporate Affairs (MCA)

Companies (Indian Accounting Standards) Amendment Rules, 2018

The MCA issued the Companies (Indian Accounting Standards) Amendment Rules, 2018, on 28 March 2018. The rules have brought in the following key amendments to Ind AS:

- New revenue standard Ind AS 115 has been notified which supersedes Ind AS 11, 'Construction contracts' and Ind AS 18, 'Revenue'.
- Appendix B, 'Foreign currency transactions and advance consideration' to Ind AS 21, 'The effects of changes in foreign exchange rates' has been notified. The appendix clarifies that the date of the transaction, for the purpose of determining the exchange rate to use on initial recognition of the asset, expense or income, should be the date on which an entity initially recognises the non-monetary asset or liability arising from the advance consideration.
- Amendment to Ind AS 40, 'Investment property', clarifying when assets are transferred to, or from, investment properties. The amendment clarifies that to transfer to, or from, investment properties, there must be a change in use supported by evidence. A change in intention in isolation is not enough to support a transfer.
- Amendments to Ind AS 12, 'Income taxes', clarifying the requirements for recognising deferred tax assets on unrealised losses. The amendments clarify the accounting for deferred tax where an asset is measured at fair value and that fair value is below the asset's tax base. They also clarify certain other aspects of accounting for deferred tax assets. These amendments only clarify the existing guidance of Ind AS 12 and do not change the underlying principles for recognition of deferred tax assets.
- An Amendment to Ind AS 28, 'Investments in associates and joint ventures' and Ind AS 112, 'Disclosure of interests in other entities' clarifying that:
    - Disclosures requirement of Ind AS 112 is applicable to interest in entities classified as held for sale except for summarised financial information (para B17 of Ind AS 112).
    - The option available with venture capital organisations, mutual funds, unit trusts and similar entities to measure their investments in associates or joint ventures at fair value through profit or loss (FVTPL) is available for each investment in an associate or joint venture.
- Consequential amendments to other Ind AS due to notification of Ind AS 115 and other amendments discussed above.

Our PwC Reporting InBrief on Companies (Indian Accounting Standards) Rules, 2018, can be accessed here:
https://www.pwc.in/publications/2018/pwc-reportinginbrief-companies-indian-accounting-standards-amendment-rules-2018.html

Non-applicability of AS 22, 'Accounting of taxes on income' or Ind AS 12, 'Income taxes to a government company'[4]

The MCA, vide notifications dated 5 February 2018 and 2 April 2018, has directed that the provisions of AS 22/Ind AS 12 relating to deferred tax asset or deferred tax liability shall not apply, with effect from 1 April 2017, to a government company which:

a. is a public financial institution under sub-clause (iv) of clause (72) of section 2 of the Companies Act, 2013;

b. is an NBFC registered with the RBI under section 45-IA of the Reserve Bank of India Act, 1934; and

c. is engaged in the business of infrastructure finance leasing with not less than 75% of its total revenue being generated from such business with government companies or other entities owned or controlled by the government.

As per section 2(45) of the Companies Act, 2013, 'Government company' means any company in which not less than 51% of the paid-up share capital is held by the Central Government, or by any state government or governments, or partly by the Central Government and partly by one or more state governments, and includes a company which is a subsidiary company of such a government company.

Constitution of National Financial Reporting Authority (NFRA)

In its meeting on 1 March 2018, the Union Cabinet approved the proposal for the establishment of the NFRA and creation of one post of Chairperson, three posts of full-time members and one post of Secretary to the NFRA. The decision aims to establish the NFRA as an independent regulator for the auditing profession, which is one of the key changes brought in by the Companies Act, 2013. The jurisdiction of the NFRA for the investigation of chartered accountants and their firms under section 132 of the Companies Act, 2013, would extend to listed companies and large unlisted public companies, the thresholds for which shall be prescribed in the rules. The Central Government can also refer to such other entities for investigation where public interest would be involved.

In connection with the above, the MCA set 21 March 2018 as the date on which the provisions of the Companies Act, 2013, related to the constitution of NFRA shall come into force. The MCA has also notified the National Financial Reporting Authority (Manner of Appointment and Other Terms and Conditions of Service of Chairperson and Members) Rules, 2018.

Companies (Accounts) Amendment Rules, 2018[5]

The MCA has issued the Companies (Accounts) Amendment Rules, 2018. The amendment rules have notified Form AOC-3A, the format for abridged financial statements for companies which are required to comply with Ind AS.

4. http://www.mca.gov.in/Ministry/pdf/NotificationSO529_06022018.pdf
5. http://www.mca.gov.in/Ministry/pdf/CompaniesAccountsAmmendmentRule_01032018.pdf

Companies engaged in defence production exempted from segment reporting disclosure[6]

The MCA, vide notification dated 23 February 2018, has exempted companies engaged in defence production from the application of the accounting standard notified under Section 129 of the Companies Act, 2013, related to segment reporting.

Companies (Removal of Difficulties) Order, 2018[7]

The MCA has issued the Companies (Removal of Difficulties) Order, 2018. The order clarifies that an independent director re-appointed for a second term under section 149 (10) of the Companies Act, 2013, will be removed by the company only by passing a special resolution and after giving him or her a reasonable opportunity of being heard. Before the order, such removal required the passing of an ordinary resolution.

RBI

Deferral of Ind AS for Scheduled Commercial Banks (SCBs)[8]

The RBI has deferred Ind AS implementation for SCBs by one year. The statement on the deferment of Ind AS has been included in the RBI's Statement on Developmental and Regulatory Policies dated 5 April 2018 and reads as follows:

'SCBs excluding Regional Rural Banks (RRBs), were required to implement Ind AS from April 1, 2018 vide our Circular dated February 11, 2016. However, necessary legislative amendments – to make the format of financial statements, prescribed in the Third Schedule to Banking Regulation Act 1949, compatible with accounts under Ind AS – are under consideration of the Government. In view of this, as also the level of preparedness of many banks, it has been decided to defer implementation of Ind AS by one year by when the necessary legislative changes are expected.'

Accordingly, SCBs shall now apply Ind AS from accounting periods beginning on or after 1 April 2019.

6. https://www.mca.gov.in/Ministry/pdf/notificationSegment2302_26022018.pdf
7. https://www.mca.gov.in/Ministry/pdf/CompaniesRODorder2018_22022018.pdf
8. https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR264270719E5CB28249D7BCE07C5B3196C904.PDF

Spreading of mark-to-market (MTM) losses[9]

Banks are required to MTM the individual scrips in available for sale (AFS) at quarterly/more frequent intervals and held for trading (HFT) at monthly/more frequent intervals and provide for net depreciation, if any.

With a view to addressing the systemic impact of a sharp increase in the yields on government securities, the RBI, vide notification dated 2 April 2018, has decided to grant banks the option to spread provisioning for MTM losses on investments held in AFS and HFT for the quarters ended 31 December 2017 and 31 March 2018. The provisioning for each of these quarters may be spread equally over up to four quarters, commencing with the quarter in which the loss is incurred.

SEBI

SEBI board meeting

In its board meeting held on 28 March 2018, SEBI, among other matters, considered the recommendations of the Kotak Committee on Corporate Governance (Kotak Committee).

The board accepted the following recommendations of the Kotak Committee without any modifications:

1. Reduction in the maximum number of listed entity directorships from 10 to 8 by 1 April 2019 and to 7 by 1 April 2020
2. Expanding the eligibility criteria for independent directors
3. Enhanced role of the Audit Committee, Nomination and Remuneration Committee, and Risk Management Committee
4. Disclosure of utilisation of funds from QIP/preferential issue
5. Disclosures of auditor credentials, audit fee, reasons for resignation of auditors, etc.
6. Disclosure of expertise/skills of directors
7. Enhanced disclosure of related party transactions (RPTs) and related parties to be permitted to vote against RPTs
8. Mandatory disclosure of consolidated quarterly results with effect from FY 2019–20
9. Enhanced obligations on the listed entities with respect to subsidiaries
10. Secretarial audit to be mandatory for listed entities and their material unlisted subsidiaries under the SEBI Listing Obligations and Disclosure Requirements (LODR) Regulations

9. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11236&Mode=0

The Board decided to accept the following recommendations with modifications:

1. Minimum 6 directors in the top 1000 listed entities by market capitalisation by 1 April 2019 and in the top 2000 listed entities, by 1 April 2020
2. At least one woman independent director in the top 500 listed entities by market capitalisation by 1 April 2019 and in the top 1000 listed entities, by 1 April 2020
3. Separation of CEO/MD and Chairperson (to be initially made applicable to the top 500 listed entities by market capitalisation effective 1 April 2020)
4. Quorum for board meetings (1/3rd of the size of the board or 3 members, whichever is higher) in the top 1,000 listed entities by market capitalisation by 1 April 2019 and in the top 2,000 listed entities, by 1 April 2020
5. Top 100 entities to hold AGMs within 5 months after the end of FY 2018–19, i.e. by 31 August 2019
6. Webcast of AGMs will be compulsory for the top 100 entities by market capitalisation effective FY 2018–19
7. Shareholder approval (majority of minority) for royalty/brand payments to related party exceeding 2% of consolidated turnover (instead of the proposed 5%)

For an overview of the key recommendations of the Kotak Committee, refer to the previous edition of PwC ReportingPerspectives:

https://www.pwc.in/assets/pdfs/publications/2018/pwc-reportingperspectives-january-2018.pdf

Enhancing fund governance for mutual funds[10]

The SEBI had issued a circular dated 30 November 2017 on enhancing fund governance for mutual funds. Based on representations received from the mutual fund industry and in order to ensure a smooth transition, SEBI has made the following key changes in the circular dated 30 November 2017:

1. Para A (1) (iii) (b) of the aforesaid circular permits existing independent trustees and independent directors, who have held office for 9 years or more (as on 30 November 2017), to continue in their respective position for a maximum of 1 additional year. The aforesaid provision may now be complied with, in a phased manner, within a period of 2 years.
2. Further, auditors who have conducted an audit of the mutual fund for 9 years or more, in terms of clause B (2) (iii) (b) of the aforesaid circular, may continue till the end of FY 2018–19.

10. https://www.sebi.gov.in/legal/circulars/nov-2017/enhancing-fund-governance-for-mutual-funds_36778.html

International Accounting Standards Board (IASB): IFRS

IASB issues amendment to IAS 19 regarding pension expenses

On 7 February 2018, the IASB issued amendments to the guidance in IAS 19, 'Employee benefits', in connection with accounting for plan amendments, curtailments and settlements.

The amendments require an entity:

- to use updated assumptions to determine current service cost and net interest for the remainder of the period after a plan amendment, curtailment or settlement; and
- to recognise in profit or loss as part of past service cost, or a gain or loss on settlement, any reduction in a surplus, even if that surplus was not previously recognised because of the impact of the asset ceiling.

The amendments are applied prospectively to plan amendments, settlements or curtailments that occur after the beginning of the first annual reporting period beginning on or after 1 January 2019.

IFRS Interpretations Committee agenda decision on the presentation of interest revenue for certain financial instruments

IFRS 9, 'Financial Instruments', introduced a consequential amendment to paragraph 82(a) of IAS 1, 'Presentation of financial statements', under which interest revenue calculated using the effective interest method is required to be presented separately on the face of the income statement.

The IFRS Interpretations Committee has issued an agenda decision which concludes that this separate line item can be used only for interest on those financial assets that are measured at amortised cost or fair value through other comprehensive income (subject to the effect of applying hedge accounting to derivatives in designated hedge relationships). This means that interest income on items that are not measured at amortised cost or fair value through other comprehensive income will no longer be able to be included in interest revenue.

Financial Accounting Standards Board (FASB): US GAAP

FASB clarifies certain provisions within recently issued hedging guidance

On 14 February 2018, the FASB held a public board meeting where they clarified certain provisions in the hedge accounting framework amendments issued in ASU 2017-12, 'Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities'. Among other matters, the FASB clarified the following:

1. Amortisation of excluded components in net investment hedges

Constituents have raised questions about the new amortisation model for recognising excluded components in earnings. The FASB discussed a currency swap with a fair value of zero designated as the hedging instrument in a hedge of a net investment when hedge effectiveness is being assessed using the spot method. In this fact pattern, the FASB considers it reasonable for the entire change in 'clean' fair value of the currency swap (i.e. the change in fair value excluding interest accruals) to be deferred in the cumulative translation adjustment (CTA) section of other comprehensive income, and concluded that the recognition of interest accruals in earnings would be a systematic and rational method for recognising the excluded component.

Using this approach, the amount reported in the CTA at the end of the hedging relationship will equal the cumulative impact of changes in foreign exchange spot rates on the notional amount of the currency swap over the life of the hedging relationship. If the currency swap has a fair value other than zero at the time of designation, reporting entities will likely need to amortise an amount other than the interest accruals to ensure that only the cumulative impact of changes in foreign exchange spot rates remains in the CTA at the end of the hedging relationship.

The FASB also acknowledged that currency swaps could be structured with non-standard payment terms designed to allow for more favourable interest accrual amounts to be recognised in earnings relative to currency swaps with standard payment terms, but cautioned that reporting entities should consider whether their amortisation methodology results in a 'systematic and rational' method for recognising the excluded component in earnings.

2. Prepayable instruments designated in fair value hedges of interest rate risk

For prepayable instruments designated in fair value hedges of benchmark interest rate risk, the new standard permits companies to consider only the impact of the benchmark interest rate on the prepayment feature. The FASB concluded that contingently exercisable prepayment features that are not contingent on interest rates (a) do not need to be incorporated into the measurement of the change in value of the hedged item (e.g. debt) due to changes in the benchmark interest rate until the contingent event occurs, and (b) are eligible for designation under the last of layer approach. An exception is when a contingency is credit related (e.g. a feature that allows the investor to put debt back to the issuer upon an event of default by the issuer). In these situations, (a) the contingent feature must be measured in a manner consistent with GAAP prior to the amendments to the hedge accounting framework, and (b) the instrument would not be eligible for the last of layer approach if this were the only prepayment feature.

3. Transition elections

For fair value hedges of interest rate risk that exist upon adoption of ASU 2017-12, when an entity has elected to modify how it measures the hedged item (e.g. to be based on the benchmark rate component of the contractual coupon cash flows), any adjustments to the proportion of the designated hedged item or derivative would not result in a de-designation of the hedging relationship. However, reporting entities may not add new hedged items or hedging instruments to the hedging relationship without de-designation.

Accounting Standards Update (ASU) 2018-01: 'Land Easement Practical Expedient for Transition to Topic 842, Leases'

The amendments to this update permit an entity to elect an optional transition practical expedient to not evaluate under Topic 842 land easements that exist or expired before the entity's adoption of Topic 842 and that were not previously accounted for as leases under Topic 840. An entity that elects this practical expedient should apply the practical expedient consistently to all of its existing or expired land easements that were not previously accounted for as leases under Topic 840. Once an entity adopts Topic 842, it should apply that topic prospectively to all new (or modified) land easements to determine whether the arrangement should be accounted for as a lease. An entity that does not elect this practical expedient should evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease. An entity should continue to apply its current accounting policy for accounting for land easements that existed before its adoption of Topic 842. For example, if an entity currently accounts for certain land easements as leases under Topic 840, it should continue to account for those land easements as leases before its adoption of Topic 842. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in ASU 2016-02, 'Leases (Topic 842)'.

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