Accounting and Auditing Update

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Editorial

Accounting for sales contracts in the consumer market and retail sectors is likely to change due to the application of the new revenue recognition standard. Ind AS 115, *Revenue from Contracts* with Customers introduces a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes the current revenue recognition guidance. In this edition of Accounting and Auditing Update (AAU), we focus on the consumer market and retail sectors' companies. Our article on this topic highlights the significant areas (e.g. determination of performance obligations, variable consideration, contract manufacturing arrangements, etc.) where current guidance in Ind AS is expected to change due to implementation of Ind AS 115. This standard is applicable to Indian companies covered in the Ind AS road map from 1 April 2018.

The International Auditing and Assurance Standards Board (IAASB) has recently released International Standard on Auditing (ISA) 540, its revised standard for the audit of accounting estimates and related disclosures. The new standard addresses changes in the financial reporting framework due to greater use of accounting estimates. The standard recognises that for certain accounting estimates, estimation uncertainty may be low based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. We have summarised key concepts introduced by ISA 540 in this edition of AAU.

The Institute of Chartered Accountants of India (ICAI) has issued educational material on Ind AS 27, *Separate Financial Statements*, which explains key requirements of the standard and Frequently Asked Questions (FAQs). The FAQs cover issues which are expected to be encountered frequently while implementing the standard. Our article on this topic highlights key issues discussed in the educational material along with the related guidance reiterated by ICAI.

As is the case each month, we also cover a regular round-up of some recent regulatory updates in India and internationally.

We would be delighted to receive feedback/suggestions from you on the topics we should cover in the forthcoming editions of AAU.

Sai Venkateshwaran
Partner and Head
CFO Advisory
KPMG in India

Ruchi Rastogi
Partner
Assurance
KPMG in India

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Ind-AS 115 – What does it mean for consumer market and retail sectors?

This article aims to:

Highlight key impact areas of adoption of Ind AS 115 by the consumer market and retail sectors.

From 1 April 2018, Ind AS 115, *Revenue from Contracts with Customers* is applicable for companies following the Ind AS road map framework. This standard replaces the existing revenue recognition under Ind AS i.e. Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue*. The standard also replaces the revised guidance note issued by the Institute of Chartered Accountants of India on Accounting for Real Estate Transactions for Ind AS entities that was issued in 2016. This standard comes with a concept of recognising revenue at a point in time or over time, provides more guidance on separating goods and services (in case of bundled contracts) and also provides guidance on measuring the transaction price.

Therefore, there is a need for a deeper understanding of the impact of the requirements of the new standards and determine the sector specific impact, both on business operations and financial reporting. For the consumer market sector, which is one of the largest and fastest growing sectors in the country, certain Ind AS 115 impacts affect the heart of business performance i.e. sales and the timing of recognising revenue, warranties and any other performance obligation which may be embedded in the sale of products made to customers.

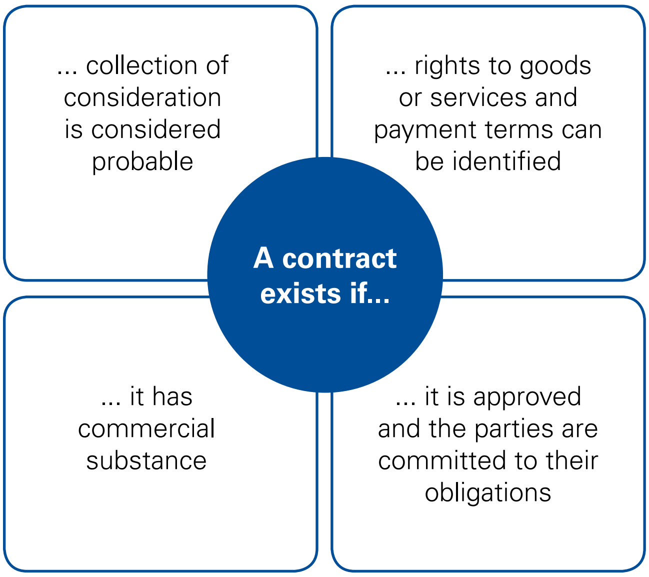
As we are all aware, Ind AS 115 follows a core principle that an entity recognises revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. As per the standard, a customer is 'a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration'.

Consequently, the standard lays down a five step model of determining the obligations of the company towards its customers and the point in time when the recognition of revenue should be made. These five steps are as under:

1. Identify the contract with the customer (one or multiple)
2. Identify the performance obligations in the contract (one obligation or multiple)
3. Determine the transaction price (total consideration for contract)
4. Allocate the transaction price to the performance obligation (allocate to various performance obligations identified)
5. Recognise revenue (at a point in-time or over-time).

Contract with customers

A contract should create enforceable rights and obligations and the standard specifies that enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Under Ind AS 115, a contract should meet all of the following criteria:



Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016

One can note here that in comparison to Ind AS 18, step number 1 and 3 are additions in this standard and to that extent provide explicit new requirements while an entity recognises revenue.

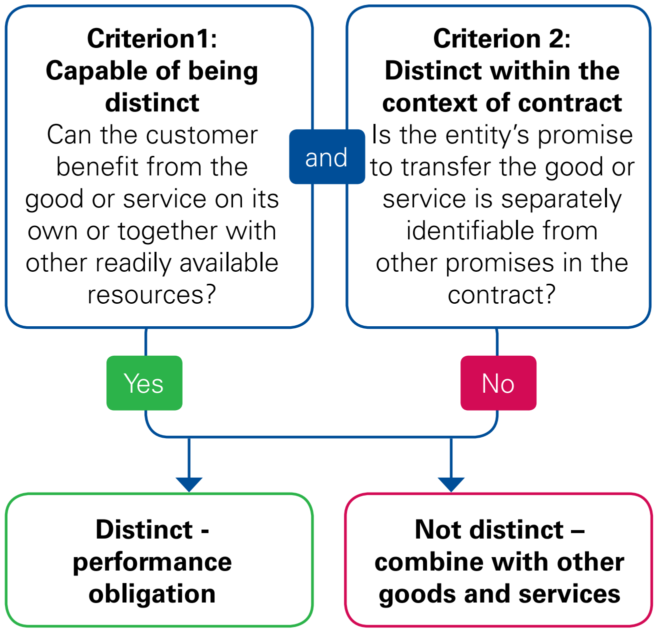
For companies in the consumer market and retail sectors, existing practices and the policies followed for establishing a contract with their customers, could require a reassessment in order to be compliant with the requirements of the standard.

Performance obligation and the customer taking control

A 'performance obligation' is the unit of account for revenue recognition. An entity assesses the goods or services promised in a contract with a customer and identifies a performance obligation either as:

- a good or service (or a bundle of goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer – i.e. each distinct good or service in the series is satisfied over time and the same method is used to measure progress.

In order for a promised good or service to be distinct and therefore, constitute as a performance obligation, at contract inception, it should meet the following two conditions as described in the diagram below:



Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016

Many contracts entered into by companies in the consumer market and retail sectors may include only a single promise, being the promise to transfer the specified goods to the customer. However, in some cases, contracts may explicitly or implicitly include additional promises e.g. customer options, customer loyalty programmes, shipping and handling services, warranties and training.

Apart from determining the obligations towards customers, the standard also requires that the satisfaction of a performance obligation is determined on transfer of a promised good or service (i.e. an asset) to a customer and that such a transfer occurs when (or as) the customer obtains control of that asset.

Principal vs agent

As mentioned above, a promise to transfer a good or a service can be stated explicitly in a contract or implicitly, based on established business practices that create a valid expectation that the entity will transfer the good or service. These could have a significant impact, especially in sales through distributor network model, where the contracts with customers may or may not specify the point of transfer of control.

Arrangements like freight and insurance are usually managed by the seller. Therefore, in such situations, the role of the seller would have to be distinguished between being either as a principal or as an agent. In the case of the former, revenue can be recognised only once the goods have been received by the customer and there is sufficient evidence of control being transferred to the customer. In the case of the latter, the seller acts as an agent and thus, while the seller can recognise revenue on dispatch of goods, (in practice it coincides with the transfer of control) it should reduce recoveries made towards arranging for freight and insurance for its customers from the gross revenue charged to customers. These recoveries would have to be adjusted with the costs incurred for providing these facilities to the customers.

Visibility and promotion spends

Companies often make payments to their distributors and retailers, for example, towards placement of products in the stores (slotting fees), promotion events or co-branded advertising. The existing practice under Ind AS warrants to reduce such payouts from sales or book as an expense basis the nature of the expense.

Ind AS 115 provides greater clarity in this regard and warrants companies to evaluate whether they received a distinct good or service against such payouts. In case a separate good or service is being received and consumed, such payouts need to be treated as costs/expense by the company. In absence of a distinct product or service being received, these payouts are reduced from the revenues of the company.

Product warranties

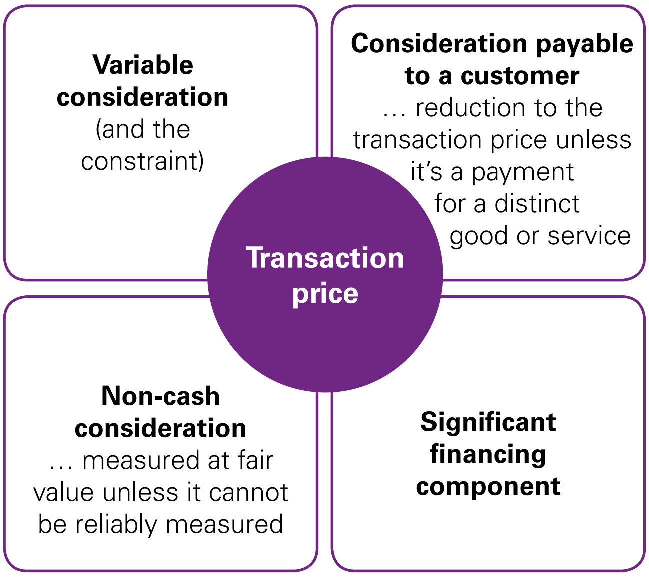
Product warranties are commonly supplied with the sale of a products (e.g. warranties given with white goods). The new standard, Ind AS 115, requires to distinguish such warranties in two types.

Type I: Where a customer can purchase the warranty separately to the purchase of the product. In such case, providing warranty forms a distinct service which the company is providing and thus, needs to account for a separate performance obligation. Thus, it would have to allocate the transaction price to the product and the warranty service given. Revenue in respect of the warranty is recognised over the period over which the warranty is valid.

Type II: Where buying a warranty separately is not given as an option to a customer. The customer only gets the standard warranty along with the product, which is typically called as an 'assurance warranty'. In such a situation, the accounting is as per Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, where a cost accrual is made for such a liability. To that extent the treatment is similar to the current requirements.

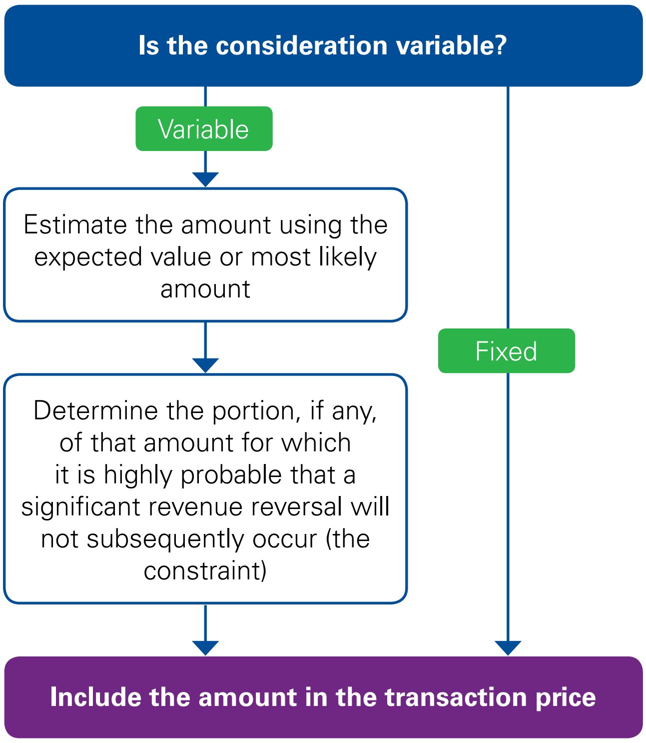
Determining the transaction price

An entity should consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.



Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016

Items such as price concessions, incentives, performance bonuses, completion bonuses, price adjustment clauses, penalties, discounts, and refunds, rights of return, credits, or similar items may result in variable consideration. The chart (on the next page) sets out how an entity accounts for variable consideration.



Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016

Volume discounts or rebates may be variable consideration or may convey a material right. Companies in this sector may have different structures of rebates and discounts, which could lead to different effects on the transaction price. For instance, certain agreements provide for a discount or rebate that applies to all purchases made, whereby discounts or rebates are applicable on a retrospective basis once a certain volume mark has been achieved. In other instances, discounts in the purchase price may apply only after a minimum volume has been achieved and to all future purchases thereafter.

If a discount is applied with a retrospective effect, the discount is representative of a variable consideration. In such instances, the entity estimates volumes that could be purchased and the consequent discount that is expected to be given, which in turn determines the transaction price. This estimate would be updated throughout the term of the contract.

However, in the second instance mentioned above, the entity would typically evaluate the agreement to decide whether the agreement provides a material right to the customer. If it is so determined, then such a commitment becomes a separate performance obligation and a portion on the transaction price needs to be allocated to this element. If a material right does not exist, then there are no accounting implications for the transactions completed before the volumes have been achieved and all purchases that happen after the volume mark has been achieved are accounted at the discounted price as committed.

Allocating the transaction price to performance obligations

The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

Ind AS 115 provides detailed guidance on allocation of transaction price. The entity is to allocate the transaction price to each performance obligation identified as part of the process, on the basis of relative stand-alone selling prices of such obligation. If observable price is not available, then price needs to be estimated by using:

- **Adjusted market assessment approach** – The entity needs to estimate the price that a customer would be willing to pay for the goods or service being offered, based on evaluation of the market in which goods or services are being sold
- **Expected cost plus a margin approach** – The expected costs of meeting a performance obligation are forecasted and an appropriate margin for such good or service are added.
- **Residual approach (only in limited circumstances)** – The stand-alone selling price is estimated by taking reference of the total transaction price less the sum of observable stand-alone selling prices of other goods or services promised in the contract. The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain, and observable stand-alone selling prices can be established for other goods or services promised in the contract.

  If the stated contract price for any of the performance obligations in the arrangement is not an appropriate estimate of stand-alone selling price, then it will be necessary for the entity to perform a relative selling price allocation of the transaction price.

Timing of revenue recognition

Under the standard Ind AS 18, revenue can be recognised on the sale of goods, amongst the other criteria, when the entity has transferred to the buyer significant risks and rewards of ownership.

However, under Ind AS 115, revenue is recognised at a point in time at which control of the good or service is transferred to the customer. The new standard includes certain indicators of transfer of control such as the customer has:

- A present obligation to pay
- Physical possession
- Legal title
- Risks and rewards of ownership
- Accepted the asset

As highlighted, the new standard Ind AS 115, uses the word 'control' and thereby the approach for recognising revenue is explicitly a control-based transfer of goods or services sold over-time or at a point in time. Thus, under Ind AS 115, revenue would be recognised as and when the 'control' over goods is transferred to the customers. Entities are, therefore, required to evaluate whether the control has passed on over a period of time or at a point in time for the purpose of recognising revenue.

Contract manufacturing arrangements

Currently contract manufacturing arrangements in companies in the consumer market and retail sectors, would typically treat such arrangements as product sales and entities would recognise revenue once the manufactured goods are delivered to the customer.

However, under Ind AS 115, if the manufactures so determines that it satisfies a performance obligation to manufacture goods over time, then it should recognise revenue over time, which could be as the manufacturing takes place over the contract period. Thus, it could be a trigger for significant changes to arrangements between a contract manufacturer and a brand owning company. Currently, these arrangements call for manufacturing of goods to the precise specifications of the customer and could qualify for recognition of revenue over the time of manufacturing of units.

Disclosures

An entity is required to disclose significant judgements made in accounting for customer contracts, including judgements related to the following:

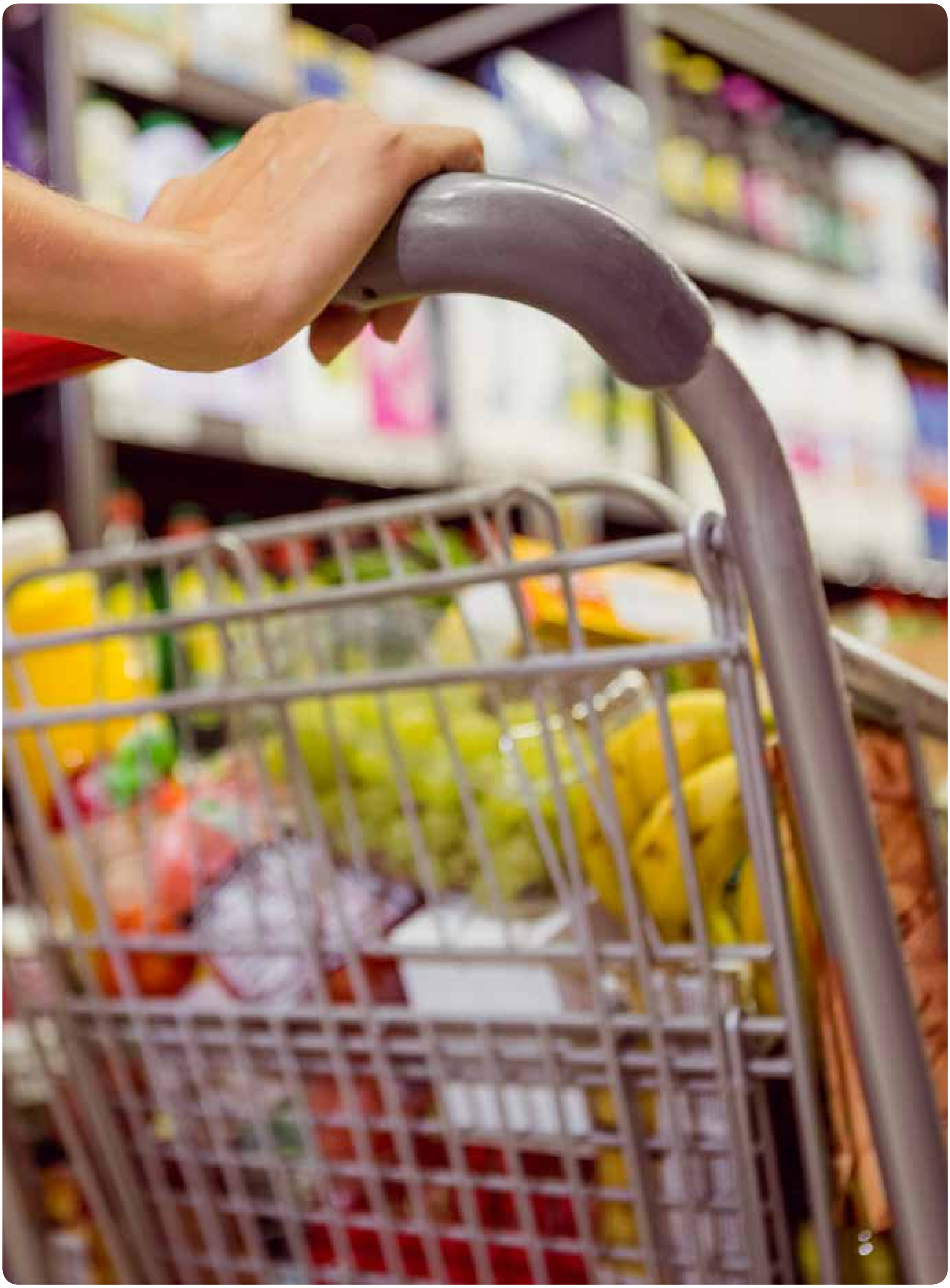
- Methods used to recognise revenue over time (output method or input method).
- Explanation of why the 'over time' method(s) faithfully depicts the transfer of goods or services.
- Transfer of control of goods or services for performance obligations that are satisfied at a point in time.
- Methods used to determine the transaction price and its allocation to performance obligations.
- Estimates of stand-alone selling prices.
- Measurement of obligations for returns.

The disaggregation of revenue disclosures are also required to be included in the entity's interim financial statements and the optional practical expedients that it has elected to use.

Summary

Companies in the consumer markets and retail sectors would have to assess whether their current systems and processes are capable of capturing, tracking, aggregating and reporting information to meet the new disclosure requirements. This may require significant changes to the existing data gathering processes, IT systems and internal controls as well.

To that extent, the objective of the revenue disclosures is to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.



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Revision in auditing of accounting estimates

This article aims to:

Provide an overview of the revised international standard on auditing for accounting estimates.

Introduction

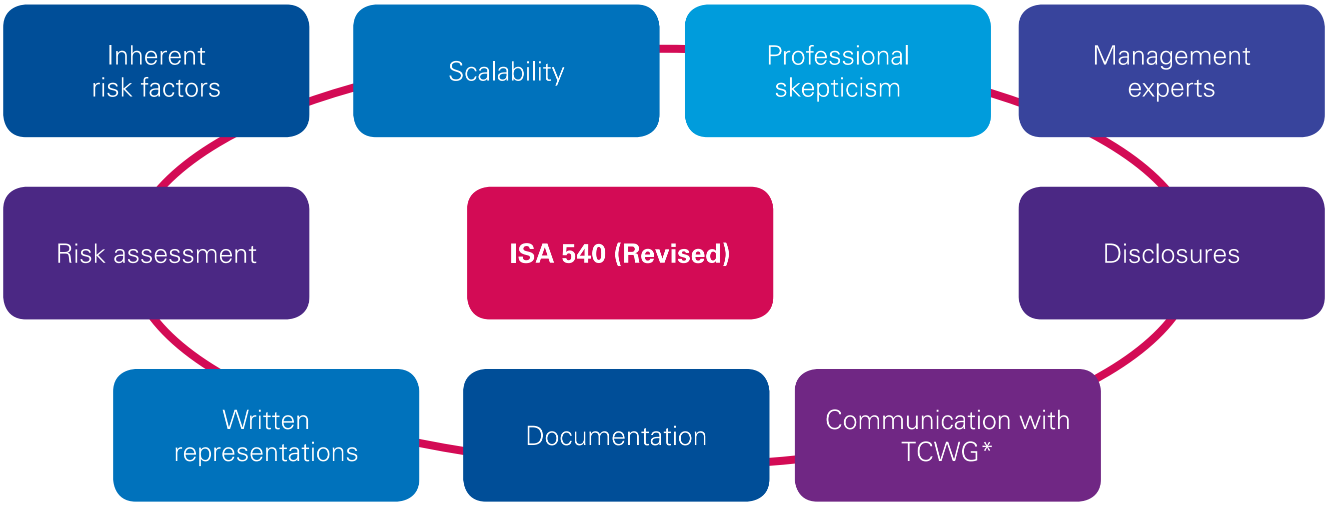
Developments in the business environment and introduction of new accounting standards have given rise to a greater use of accounting estimates. This is particularly in case of IFRS 9, *Financial Instruments*, which requires banks and other financial institutions to adopt the Expected Credit Loss (ECL) model for accounting for loan loss provisions, which fundamentally changes the way that banks and other entities account for their loan assets and other credit exposures. These management estimates could be complex and involve judgements, and accordingly, they need to be reported appropriately and be robustly challenged. The International Auditing and Assurance Standards Board (IAASB) had initiated outreach activities and it was highlighted to them that auditing accounting estimates is a key area where enhanced standards were needed to derive improved audit performance.

With this view, IAASB revised the International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates and Related Disclosures* (ISA 540 (Revised)) in October 2018[1]. The revised auditing standard would enable auditors appropriately deal with increasingly complex accounting estimates and related disclosures. It establishes robust requirements for auditing accounting estimates and provides detailed guidance which is expected to foster audit quality. The guidance requires auditors to perform appropriate procedures in relation to accounting estimates and related disclosures.

ISA 540 (Revised) is applicable to audits of financial reporting periods beginning on or after 15 December 2019, although early adoption is permitted and encouraged. Some of the key features of the revised auditing standard are given in figure 1 on the next page.

1. ISA 540 (Revised) overrides the extant ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Figure 1: Overview of ISA 540 (Revised)



Source: KPMG in India's analysis, 2018 read with ISA 540 (Revised)
*TCWG - Those Charged with Governance

Examples of accounting estimates related to classes of transactions, account balances and disclosures include:

- Inventory obsolescence
- Depreciation of property and equipment
- Valuation of infrastructure assets
- Valuation of financial instruments
- Outcome of pending litigation
- Provision for ECL
- Valuation of insurance contract liabilities
- Warranty obligations
- Employee retirement benefits liabilities
- Share-based payments
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets
- Impairment of long-lived assets or property or equipment held for disposal
- Non-monetary exchanges of assets or liabilities between independent parties
- Revenue recognised for long-term contracts.

Although ISA 540 applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by ISA 540 will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be low based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive.

Overview of ISA 540 (Revised)

Key concepts introduced by ISA 540 are as follows:

Risk assessment

ISA 540 (Revised) focusses on determining what drives the risks of material misstatement of an accounting estimate at the assertion level by obtaining an understanding of the entity and its environment, including the entity's internal control revolving around the estimate. An auditor would need to perform procedures to obtain an understanding to the extent necessary to provide an appropriate basis for identification and assessment of risks of material misstatement.

Subsequently, the auditor's further audit procedures should be responsive to the assessed risks of material misstatement at the assertion level and may include any of the three testing approaches (individually or in combination) as given below:

- Audit evidence from events occurring up to the date of the auditors' report
- Testing how management made the accounting estimate or
- Developing the auditors' point estimate or range.

While performing risk assessment procedures, auditors are required to separately assess inherent risk and control risk of an accounting estimate at assertion level. For significant risks[2] identified, the auditor would obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Testing operating effectiveness of controls

While designing and performing tests to obtain sufficient appropriate audit evidence, auditors may consider testing the design and implementation and the operating effectiveness of relevant controls if as per the auditor's expectation, the controls are operating effectively or substantive procedures alone cannot provide sufficient appropriate audit evidence.

Inherent risk factors[3]

Inherent risk related to an accounting estimate is the susceptibility of an assertion about the accounting estimate to material misstatement, before consideration of controls. Inherent risk results from inherent risk factors, which include:

- **Complexity:** Complexity may be inherent in the process of making an accounting estimate. There may be complexity in the methods, models or data (for example, when data is difficult to obtain). Greater complexity in the models and methods may require specialised skills or knowledge.
- **Subjectivity:** Subjectivity reflects inherent limitations in the knowledge or data reasonably available about valuation attributes. Management judgement is required in determining certain matters that involve subjectivity.
- **Estimation uncertainty:** Estimation uncertainty is the susceptibility to a lack of precision in measurement of an estimate. It often arises due to constraints on the availability of knowledge or data.
- **Other inherent risk factors:** Other inherent risk factors include the extent to which the estimates are susceptible to misstatements due to management bias or fraud, changes in financial reporting requirements, and other factors.

The assessment of inherent risk depends on the degree to which inherent risk factors affect the likelihood or magnitude of misstatement, this varies on a scale that is referred to as the spectrum of inherent risk. The relevance and significance of inherent risk factors may vary from one estimate to another, for example:

- Accounting estimates of ECLs are likely to be complex because the ECLs cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for ECLs are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgements about future events or conditions. Similar considerations apply to insurance contract liabilities.
- An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.

2. Significant risks are identified and assessed as risks of material misstatement that, in the auditors judgement requires special audit consideration

3. Qualitative inherent risk factors and their inter-relationship are explained in an appendix to ISA 540 (Revised).

- Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgement, for example, an accounting estimate that requires a single critical judgement about a liability, the amount of which is contingent on the outcome of the litigation.

Scalability

ISA 540 (Revised) is intended to apply to all estimates from complex calculations, which require the use of forward looking information for computation of ECLs, to a more straightforward estimation of the expected useful life of an asset. ISA 540 (Revised) acknowledges that the degree to which an accounting estimate is subject to estimation uncertainty varies substantially. Accordingly, the nature, timing and extent of the risk assessment and further audit procedures would vary in relation to the estimation uncertainty and the assessment of the related risks of misstatement. Thus, the assessed risks of material misstatement would affect the persuasiveness of the audit evidence needed (i.e. higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be) and influence the approach the auditor selects to audit an accounting estimate.

Professional skepticism

The IAASB recognises the central role that professional skepticism plays in auditing accounting estimates, therefore, several key principles have been inculcated in ISA 540 (Revised) to enhance the application of professional skepticism. Some of the key provisions are:

- Enhanced risk assessment requirement: The importance of professional skepticism increases when the accounting estimates are affected by a greater degree of the inherent risk factors or when there is greater susceptibility to misstatement due to management bias or fraud; and
- 'Stand back' provision: All audit evidence should be obtained in an unbiased manner, and the evidence, whether corroborative or contradictory should be evaluated to determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

Concept of reasonable

ISA 540 requires the auditor to evaluate, based on the audit procedures and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. According to the standard, reasonable in the context of the applicable financial reporting framework means that the relevant requirements of the applicable financial reporting framework have been applied appropriately including those that address:

- The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity.
- The selection of management's point of estimate, and
- The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

Management experts

For estimates where application of specialised skill or knowledge is required, the management may engage an expert (for example, where a specialised matter requires estimation or where the estimate involves a complex model). ISA 540 (Revised) states that assumptions that may be made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate. Accordingly, the auditor will be required to apply relevant risk assessment procedures when evaluating the work of the expert[4].

Disclosures

Some of the accounting estimates may have a substantial impact on the financial statements of entities and involve significant management judgement. For example, while computing the ECLs, banks or other financial institutions need to incorporate forward looking information such as economic or earnings forecast and determine future credit repayments and other cash flows.

4. In evaluating the work of a management's expert, the auditor should also consider the expert's competence, capabilities and objectivity, the auditor's understanding of the nature of the work performed by the expert, and the auditor's familiarity with the expert's field of expertise.

The IAASB noted the increasingly important role of disclosures in financial reporting, particularly with respect to accounting estimates. It noted that, in many cases, disclosures relating to accounting estimates are critical to users' understanding of the accounting policies applied, the nature and extent of estimation uncertainty, and key judgements and other matters relating to accounting estimates, in particular when estimation uncertainty is high. Thus, it requires auditors to evaluate whether the disclosures made in the financial statements are in accordance with the requirements of the applicable financial reporting framework (for example, disclosures pertaining to ECL should be in accordance with IFRS 9), and include details of how the accounting estimate was developed, including the nature, extent and sources of estimation uncertainty.

Communication with those charged with governance[5]

The IAASB recognised the importance of a two-way dialogue between the auditor and those charged with governance. Therefore, it emphasised on communications with those charged with governance or management regarding significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control. In addition, it has noted that the auditor may be required by law or regulation to communicate about certain matters with other relevant parties, such as regulators or prudential supervisors.

Documentation

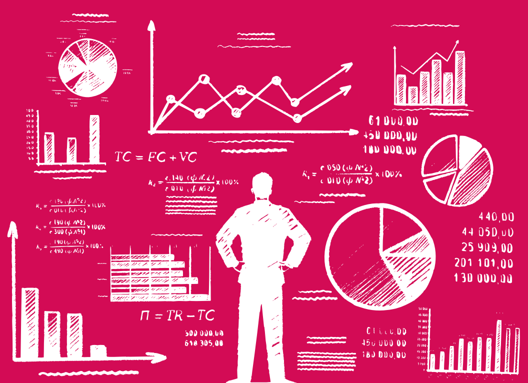
The documentation requirements have been extended to include the auditor's understanding of the entity and its environment, the assessment and the corresponding response to risks of material misstatements, indicators of possible management bias, and other judgements relating to auditors determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework.

Written representations

ISA 540 (Revised) permits auditors to request written representations from management and when appropriate, those charged with governance about whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosure are appropriate to achieve recognition and measurement or disclosure that is in accordance with the applicable financial reporting framework. The auditor may also consider the need to obtain representations about specific accounting estimates, including in relation to the method, assumptions, or data used.

Consider this

- The amendment of ISA 540 has brought about consequential amendments to other standards on auditing with regard to risk assessment, documentation, relevance of external information sources as audit evidence and communication with those charged with governance. These amendments will become effective at the same time as ISA 540 (Revised).
- If the auditor's consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter which needs be reported in the auditor's report.
- Where the auditor is not able to obtain sufficient and appropriate audit evidence regarding the accounting estimate, he/she should evaluate the implications for the audit or the auditor's opinion on the financial statements.
- Considering the complications surrounding the accounting estimates in the Indian scenario, we expect similar amendments to be made in the Standard on Auditing (SA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* in the near future.



5. An appendix to ISA 540 (Revised) includes matters that the auditor may consider communicating with those charged with governance with respect to the auditor's views bout significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures.

3 Measurement of investments under separate financial statements

This article aims to:

Outline the guidance given in the educational material on Ind AS 27.

Overview

Ind AS 27, *Separate Financial Statements*, defines separate financial statements as those financial statements which are presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with Ind AS 109, *Financial Instruments*.

The standard outlines the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements.

Recently, the Institute of Chartered Accountants of India (ICAI) has issued educational material on Ind AS 27, which explains the key requirements of the standard and Frequently Asked Questions (FAQs) covering the issues which are expected to be encountered frequently while implementing the standard.

Practical issues and clarifications issued by ICAI relating to accounting of investments

The following section aims to discuss the key issues discussed by ICAI relating to measurement of investments in separate financial statements

Measurement of investment in separate financial statements

Ind AS 27 provides that when an entity prepares separate financial statements, it should account for investments in subsidiaries, joint ventures and associates either at cost, or in accordance with Ind AS 109. Further, the entity is required to apply the same accounting for each category of investments consistently. However, when investments (that are accounted at cost) are classified as held for sale (or included in a disposal group that is classified as held for sale), then they should be accounted for in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*.[1]

1. Under Ind AS 105, assets that meet the criteria to be classified as held for sale, are measured at the lower of carrying amount and fair value less costs to sell, and are presented separately in the balance sheet.

The measurement of investments accounted for in accordance with Ind AS 109 is not changed when classified as held for sale.

Measurement of investments by an investment entity

Ind AS 110, *Consolidated Financial Statements* provides that a parent which is an investment entity is not required to consolidate its subsidiaries or apply Ind AS 103, *Business Combinations* when it obtains control of another entity. As an alternative, such an entity should measure an investment in a subsidiary at Fair Value Through Profit or Loss (FVTPL) in accordance with Ind AS 109 and would not present consolidated financial statements.

Further Ind AS 27 clarifies that if a parent is required to measure its investment, as per Ind AS 110, in a subsidiary at FVTPL in accordance with Ind AS 109, then while preparing separate financial statements such an entity should also account for its investment in a subsidiary at FVTPL.

The education material reiterated the above principle for measurement of investments by an investment entity in its separate financial statements.

Assessment of different category of investments

As mentioned above, Ind AS 27 requires, an entity to account for investments in subsidiaries, joint ventures and associates either at cost, or in accordance with Ind AS 109 in its separate financial statements. Further, the entity should apply the same accounting for each category of investments.

However, Ind AS 27 does not define the term 'category'. It seems that subsidiaries, associates and joint ventures would qualify as separate categories.

In this regard the educational material has clarified that Ind AS 27 should not be read to mean that, in all circumstances all investments in associates are considered as one category of investment and similarly all investments in joint ventures or an associate, are one category of investment. These categories can be further divided into sub-categories provided the sub-category can be defined clearly and objectively and results in information that is relevant and reliable.

Therefore, an investment in subsidiaries and associates can be considered to fall in different categories of investments by an entity and can use different measurement basis. Therefore, based on the above guidance, an entity can carry its investments in subsidiaries at cost and its investments in associates as financial assets in accordance with Ind AS 109 in its separate financial statements.

Measurement of subsidiary in case of impairment loss

If an entity measures its subsidiary at cost, then it should account for impairment loss in its investment, if any. For example,

AB Limited has an existing investment in its subsidiary, PQR Limited – INR700 crore

Net assets of PQR limited as at 31 March 2018 - INR400 crore

Value in use as well as fair value less costs to sell of PQR Limited - INR600 crore

As per Ind AS 36, *Impairment of Assets*, if, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss. Further the standard requires that impairment loss on a non-revalued asset should be recognised in statement of profit and loss.

Based on the guidance given in Ind AS 36, the education material highlights that in the above example, an impairment loss of INR100 crore should be recognised in the statement of profit and loss. Additionally, an entity should also consider the underlying cash flows that support the investment while considering the investment for impairment.

Measurement of subsidiary at fair value

In relation to measurement of investments at fair value, Ind AS 109 requires that all investments in equity instruments and contracts on those instruments would be measured at fair value. However, in certain limited circumstances, cost may be an appropriate estimate of fair value. This would be in a situation where recent information available is insufficient to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

However, in the above mentioned situations an entity is required to use all information about the performance and operations of the investee that becomes available after the date of initial recognition. In case of existence of any factors which indicates that cost might not be representative of fair value, then an entity would measure its investments at fair value. Further, Ind AS 109 explains that cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Basis the above requirements, the education material clarified following:

- When an entity has elected to account for its investments in its subsidiary at FVTPL in accordance with Ind AS 109, then all such investments should be measured at fair value in accordance with Ind AS 109. However, in certain limited circumstances, as mentioned above, cost may be an appropriate estimate of fair value.
- The exception to use cost as an appropriate estimate of fair value is not allowed in case of equity investments held by certain entities such as financial institutions and investment funds.
- In case of unlisted companies, current observable prices may not be available. Therefore, in such cases, instead of considering cost as a default measurement basis, fair value should be determined using unobservable inputs.

The educational material reiterates that the use of 'cost' in this case does not refer to use of cost method; instead it only recognises that cost is an approximate of fair value in limited circumstances. For assessing whether cost is representative of fair value, an entity should carefully assess all facts and circumstances. For example, an entity should evaluate the existence of other factors such as whether the environment in which the investee operates is dynamic, whether there have been changes in market conditions and the passage of time. The existence of these factors might undermine the appropriateness of using cost as a means of measuring the fair value of unquoted equity instruments at the measurement date.

Where observable prices are not available, the measurement of fair value is based on valuation techniques that use unobservable inputs. Ind AS 109 does not provide any exemption from use of fair value in case fair value cannot be measured reliably. An entity should use the guidance provided under Ind AS 113, *Fair Value Measurement*, which would enable determination of fair value reliably for unlisted entities.

Therefore, an entity should determine the fair value as per guidance provided in Ind AS 109. In the cases where even after following the guidance of Ind AS 109, it is concluded that cost is an approximate of fair value of its investment in a subsidiary, then the entity can use the cost as its deemed fair value.

4 Regulatory updates

Amendments to Schedule III to the Companies Act, 2013

Schedule III to the Companies Act, 2013 (2013 Act) provides general instructions for the presentation of financial statements of a company under both Accounting Standards (AS)/Indian Accounting Standards (Ind AS). Schedule III has two parts and they are as follows:

- Division I is applicable to a company whose financial statements are required to comply with the Accounting Standards (ASs)
- Division II is applicable to a company whose financial statements are drawn up in compliance with Ind AS (other than Non-Banking Financial Companies (NBFCs)).

As per the Ind AS implementation road map issued by the Ministry of Corporate Affairs (MCA) on 30 March 2016, NBFCs are required to adopt Ind AS in a phased manner from accounting periods beginning on or after 1 April 2018 (with comparatives for the periods ending on or after 31 March 2018).

On 11 October 2018, MCA through its notification has amended Schedule III to the 2013 Act. The amendments, inter alia, have incorporated a new division to Schedule III i.e. Division III which provides general instructions for presentation of financial statements of an NBFC.

The amendments are applicable from 11 October 2018.

The table below provides an overview of the changes made to the respective divisions of Schedule III to the 2013 Act:

Division	Summary of changes
Division I (Applicable to companies required to follow AS)	Minor changes in reference of 'fixed assets' and 'securities premium reserve' in the balance sheet.
Division II (Applicable to companies required to follow Ind AS (other than NBFCs))	• New disclosures introduced in relation to 'trade payables' to include disclosures relating to Micro, Small and Medium Enterprises (MSME) in the balance sheet and the related notes. • New categories introduced for classification of 'trade receivables' and 'loans receivables' in the notes to the balance sheet. • Description of purpose of each reserve included within 'other equity' to be provided in the notes to the statement of changes in equity.
Division III (Newly inserted - Applicable to NBFCs required to follow Ind AS)	It provides the general instructions for preparation of financial statements of an NBFC that is required to comply with Ind AS.

Source: KPMG in India's analysis, 2018 based on the amendments to Schedule III to the 2013 Act

Please refer to KPMG in India's First Notes dated 26 October 2018 for detailed overview of the key changes made to Division I and II and it also highlights the key requirements of Division III (applicable to NBFCs) to Schedule III of the 2013 Act.

(Source: MCA notification dated 11 October 2018)

Co-origination of loans by banks and NBFCs for lending to priority sector

The Reserve Bank of India (RBI) in its statement on developmental and regulatory policies dated 1 August 2018, introduced a co-origination model between 'banks' and 'Non-Banking Financial Companies - Non-Deposit taking - Systemically Important' (NBFC-ND-SIs) to provide competitive credit to priority sector.

On 21 September 2018, RBI issued detailed guidelines relating to the model. As per the guidelines, all scheduled commercial banks (excluding regional rural banks and small finance banks) could engage with NBFC-ND-SIs to co-originate loans for the creation of priority sector assets. The arrangement should entail joint contribution of credit at the facility level, by both lenders. The bank could claim priority sector status in respect of its share of credit while engaging in the co-origination arrangement. However, the priority sector assets on the bank's books should at all times be without recourse to the NBFC.

The other key features of the arrangement are as follows:

- **Sharing of risks and rewards:** Minimum 20 per cent of the credit risk by way of direct exposure should be on NBFCs' books till maturity and the balance would be on banks' books.
- **Interest rate:** The NBFC would have the flexibility to price their part of the exposure, while the bank should price its part of the exposure in a manner found fit as per their respective risk appetite/assessment of the borrower and the RBI regulations issued from time to time.
- **Loan sanction:** The NBFC should recommend to the bank proposals as found relevant for joint lending. The lenders should be entitled to independently assess the risks and requirements of the applicant borrowers. The loan agreement would be tripartite in nature, wherein, both the bank and the NBFC should be parties as lenders to the loan agreement with the customer.
- **Common account:** The bank and the NBFC would be required to open an escrow type common account for pooling respective loan contributions for disbursal as well as to appropriate loan repayments from borrowers, without holding the funds for usage of float.
- **Provisioning/reporting requirement:** Each of the lenders are required to follow its independent provisioning requirements including declaration of an account as non-performing asset, as per the regulatory guidelines respectively applicable to each of them.

(Source: RBI statement on developmental and regulatory policies dated 1 August 2018 and notification no. RBI/2018-19/49 dated 21 September 2018)

Exposure drafts issued by ICAI

The Companies (Indian Accounting Standards) Rules, 2015 lays down the road map for entities for implementation of Ind AS converged with IFRS in a phased manner. For other class of companies not covered under the Ind AS road map (i.e. primarily unlisted entities with net worth less than INR250 crore, including non-corporate entities) AS as notified under Companies (Accounting Standards) Rules, 2006 continue to remain applicable.

The MCA had requested the Accounting Standards Board (ASB) of ICAI to upgrade AS with a view to bring them nearer to the requirements of Ind AS. In this context, ICAI has recently issued exposure drafts for two standards i.e. AS 40, *Investment Property* and AS 38, *Intangible Assets.*

The exposure draft of AS 40 is based on the principles of Ind AS 40, *Investment Property* notified by MCA. There is no corresponding standard on investment property in the existing AS. However, AS 13, *Accounting for Investments*, provides limited guidance on accounting for investment properties. The requirement of proposed AS 40 are largely similar to Ind AS 40, however, proposed AS 40 does not require disclosure of fair values of investment property when cost model is used. Also, since the principles with regard to revenue recognition under AS are different from Ind AS, certain principles of AS 40 have been amended to align with the requirements of revenue recognition as per AS.

The period to provide comments on exposure draft ends on 10 November 2018.

Further, the exposure draft of AS 38 is based on principles of Ind AS 38, *Intangible Assets* notified by MCA and it will replace existing AS 26, *Intangible Assets*. The requirements of proposed AS 38 and Ind AS 38 are largely similar, except that under AS 38 provides certain relief to small and medium-sized entities from certain recognition, measurement and disclosure requirements as per Ind AS 38.

The period to provide comments on exposure draft ends on 2 November 2018.

(Source: Exposure draft of AS 40 and AS 38 issued by ICAI)

IASB amends definition of business in IFRS 3

Introduction

In June 2015, the International Accounting Standards Board (IASB) completed the post-implementation review of IFRS 3, *Business Combinations* and observed that entities have difficulties when determining whether they have acquired a business or a group of assets. Basis the review, IASB decided to issue narrow scope amendments aimed at resolving the difficulties that arise when an entity is determining whether it has acquired a business or a group of assets.

In June 2016, the IASB published Exposure Draft (ED) Definition of a Business and Accounting for Previously Held Interests to propose amendments to IFRS 3 and IFRS 11, *Joint Arrangements*. The ED included proposed amendments relating to definition of business.

New development

Recently, on 22 October 2018, IASB issued amendments to IFRS 3 to provide assistance to companies in determining whether an acquisition made is of a business or a group of assets. The amendments to the definition of business highlight that the output of a business is to provide goods and services to customers, whereas the previous definition focussed on returns in the form of dividends, lower costs or other economic benefits to investors and others. The new definition is narrow and is likely to facilitate more robust decision-making when assessing whether a set of acquired assets and activities constitutes a business.

The IASB has also provided additional guidance and illustrative examples to help entities in determining whether a substantive process has been acquired.

Effective date

Companies are required to apply the amended definition of a business to acquisitions that occur on or after 1 January 2020. Earlier application is permitted.

(Source: IASB's press release: IASB amends definition of business in IFRS Standard on business combinations dated 22 October 2018)

MCA notified constitution of NFRA

The National Financial Reporting Authority (NFRA) is a body recommended by Standing Committee on Finance in its 21 report. Basis the recommendation, the 2013 Act provides regulatory framework for its composition and constitution. Section 132 of the 2013 Act provides that NFRA would be responsible for recommending accounting and auditing policies and standards and oversight of the work of auditors and audit firms. The NFRA also has the power to levy monetary penalties or order debarment from practice.

The MCA notified sub-section (3) and (11) of Section 132 on 21 March 2018 and sub-sections (1) and (12) of Section 132 on 1 October 2018 relating to constitution of NFRA.

Recently, MCA on 24 October 2018 notified rest of the sub-sections of Section 132 of the 2013 Act. The notification of these sections paves a way towards the establishment of NFRA.

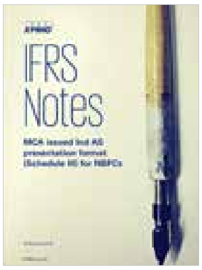
(Source: MCA notification S.O. 5385(E). dated 24 October 2018)

KPMG in India's IFRS institute

Visit KPMG in India's IFRS institute a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

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

IFRS Notes



MCA issued Ind AS presentation format (Schedule III) for NBFCs

26 October 2018

On 11 October 2018, the Ministry of Corporate Affairs (MCA) through its notification has amended Schedule III to the Companies Act, 2013 (2013 Act). The amendments, inter alia, have incorporated a new division to Schedule III i.e. Division III which provides general instructions for presentation of financial statements of an Non-Banking Financial Company (NBFC).

The amendments to Schedule III are applicable from 11 October 2018.

This issue of IFRS Notes provides an overview of the key changes made to Division I and II and also highlights the key requirements of Division III (applicable to NBFCs) to Schedule III of the 2013 Act website.

First Notes

ICAI clarifies applicability of disclosure norms relating to Specified Bank Notes (SBNs)

4 September 2018

The Ministry of Corporate Affairs (MCA) introduced a disclosure for Specified Bank Notes (SBNs) in the notes to account to balance sheet on 30 March 2017 following demonetisation. Therefore, Schedule III of the Companies Act, 2013 (2013 Act) was amended.

On 1 September 2018, the Institute of Chartered Accountants of India (ICAI) through an announcement clarified that the disclosure requirements relating to SBNs (in the notes to account as well as in the auditor's report) are not applicable for the Financial Year (FY) 2017-18 and subsequent years. Accordingly, consequent disclosures may be given in the financial statements/ auditor's reports.

The announcement is on the basis of the decision taken by the Corporate Laws and Corporate Governance Committee of ICAI (the committee) at its forty-first meeting held on 6 June 2018. The committee considered that the disclosure requirement was event specific. Additionally, the required disclosures were for the period falling under FY2016-17 (i.e. 8 November 2016 to 30 December 2016), therefore, these were relevant for FY2016-17 only.

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Voices on Reporting - Quarterly update publication

Special session: Webinar on Ind AS 115 – Consumer and retail sector

KPMG in India's Voices on Reporting – quarterly update publication (for the quarter ended 30 September 2018) provides summary of key updates from the Ministry of Corporate Affairs, the Securities and Exchange Board of India, the Institute of Chartered Accountants of India and the Central Board of Direct Taxes.

We will continue to provide a summary of relevant updates in future also. We hope you find this summary to be of use and relevance.

We would be delighted to receive feedback/ suggestions from you on the topics we should cover in the forthcoming editions of Voices on Reporting webinars and publications.

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