Accounting and Auditing Update

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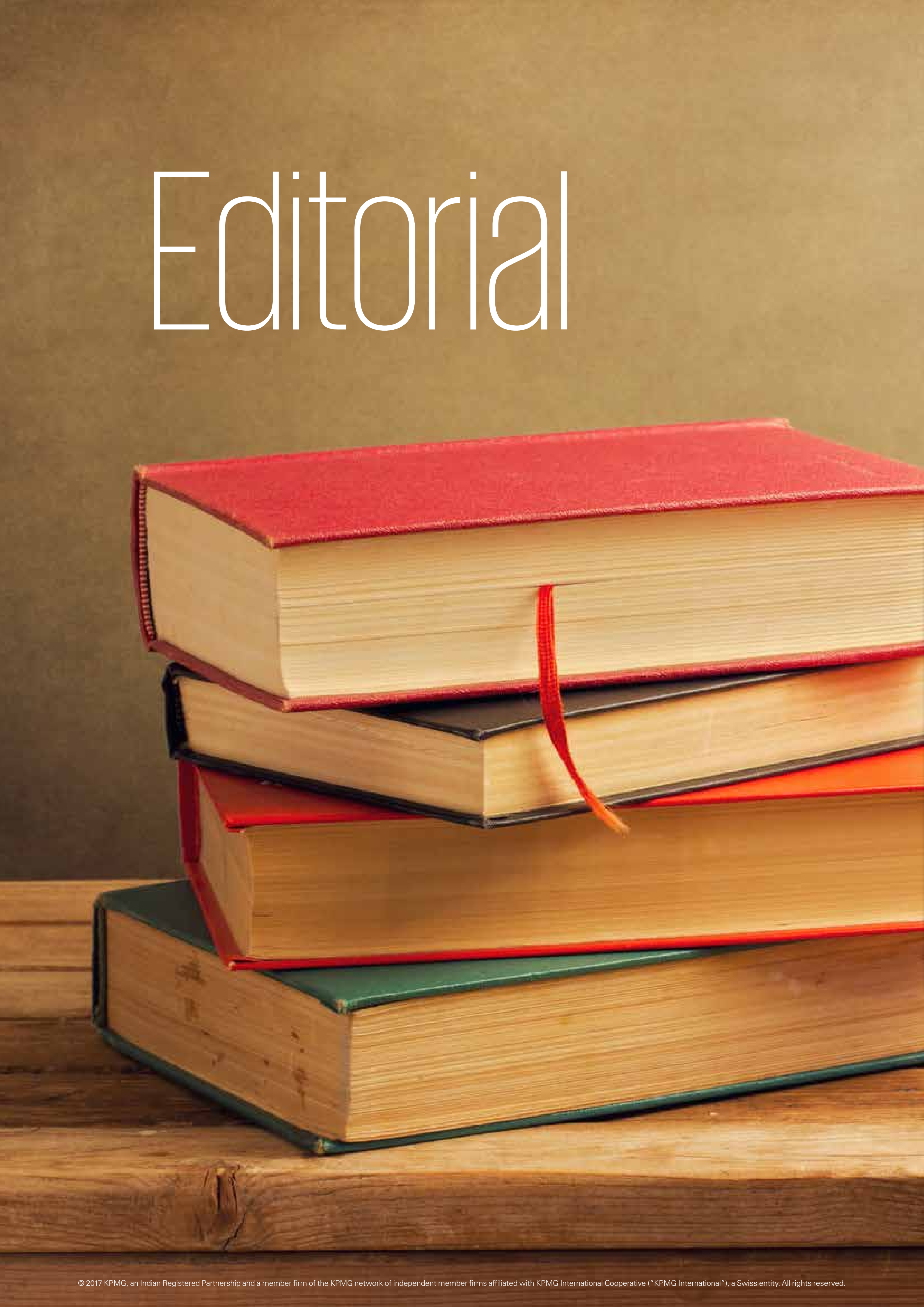
Editorial



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Goods and Services Tax (GST) is a destination based consumption tax which brings about a paradigm shift in the present indirect tax regime by subsuming most of the indirect taxes. GST integrates multiple indirect taxes (viz. central levies such as excise duty, service tax, and also state levies such as value added tax, octroi, entry tax, etc.).

It fundamentally impacts all aspects of business and extends beyond taxation. In this month's Accounting and Auditing Update (AAU), we analyse the impact of GST on Ind AS financial reporting.

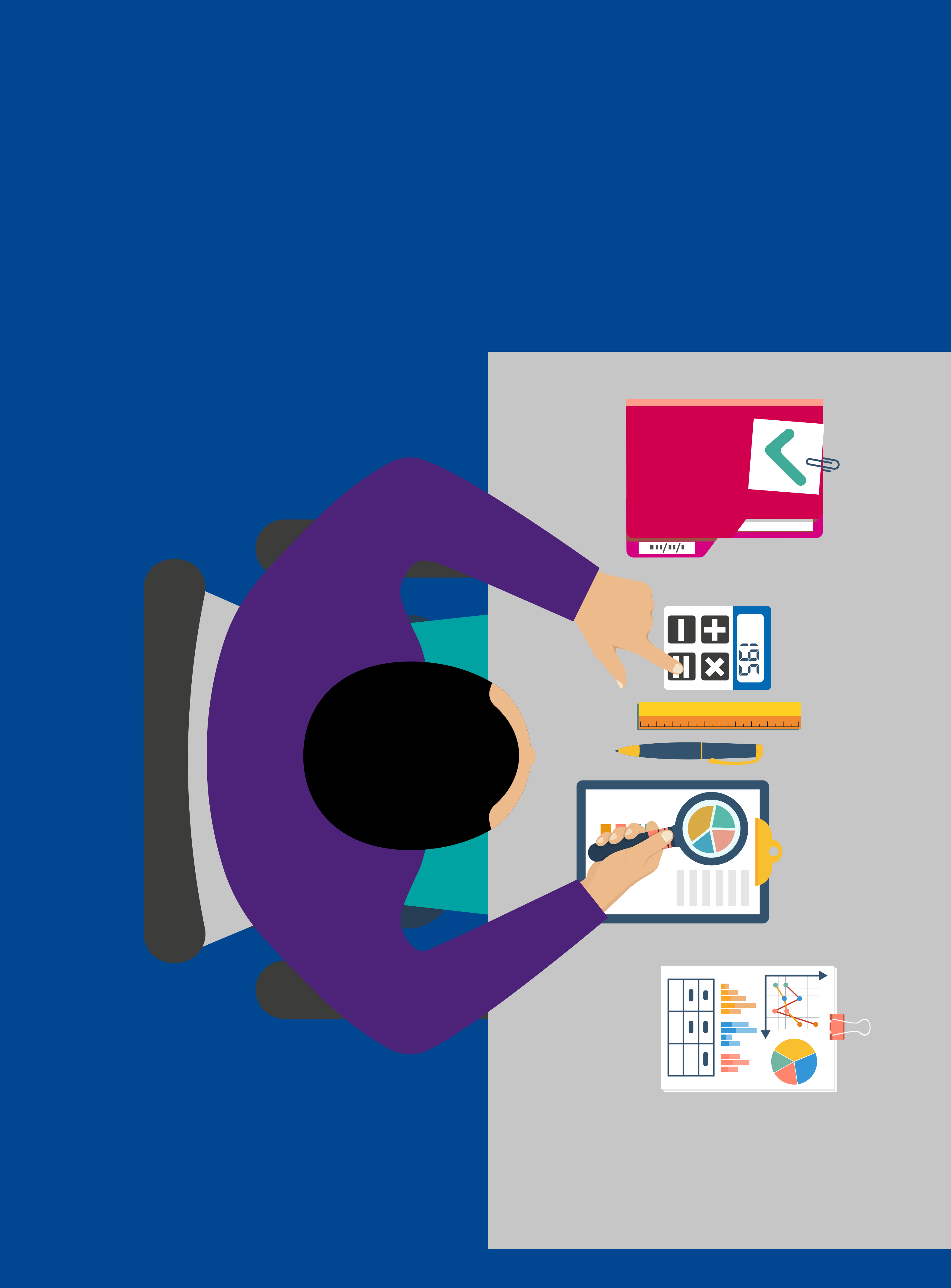
As banks transition to Ind AS, they would need to compute effective interest on floating rate financial instruments under Ind AS 109, *Financial Instruments.* This is a complex area of implementation and the standard does not prescribe an approach to compute Effective Interest Rate (EIR) in the case of floating rate financial instruments. In our article, we discuss alternative methods that banks may adopt for computing the EIR on floating-rate instruments held by them.

In our Companies Act, 2013 (2013 Act) section, we describe a provision relating to declaration and payment of dividend. The article also compares the requirements of the 2013 Act with the Securities and Exchange Board of India's (SEBI) regulations with regard to dividend.

The Ind AS framework on selection and application of accounting policies is an important area of judgement. While formulating accounting policies, an entity should consider materiality of transactions, events and conditions and apply accounting policies consistently to similar transactions. Our article emphasises the manner of selection and application of accounting policies along with disclosure requirements and how to present changes when there is a change in accounting policy.

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.



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GST and Ind AS financial reporting

This article aims to:

– Highlight the implications due to application of GST on Ind AS financial reporting

Are we Goods and Services Tax (GST) ready? This was the question doing the rounds for quite some time as India Inc transitioned to GST regime on 1 July 2017. Considered to be one of the most significant tax reforms undertaken till date, impact of GST is not only restricted to taxation. It fundamentally impacts all aspects of business and extends beyond taxation. Accounting and financial reporting is one such aspect which needs to be carefully analysed. Further with certain set of companies moving on to the Ind AS financial reporting framework, it is pertinent to understand the interplay of GST with Ind AS accounting.

Transaction accounting

The accounting of indirect taxes now undergoes a significant shift. The reason is that GST subsumes several indirect taxes (e.g. excise duty, octroi, entry taxes, luxury taxes, etc.) each of which were accounted differently before 1 July 2017. GST would apply to majority of goods and services except certain specified items.

Under GST, a tax on goods and services would be comprehensive and provide a continuous chain of set-off benefits from the producer's point and service provider's point upto the retailer's level. The GST is expected to mitigate cascading or double taxation and is applicable on 'supply' of goods or services as against the present concept of tax on the manufacture of goods or on sale of goods or on provision of services. In order words, GST is based on the principle of destination based consumption taxation as against the earlier principle of origin based taxation. It is essentially a tax only on value addition at each stage, and a supplier at each stage is permitted to set-off, through a input tax credit mechanism, the GST paid on the purchase of goods and services is available for set-off on the GST to be paid on the supply of goods and services. The final consumer is expected to thus bear only the GST charged by the last dealer in the supply chain, with set-off benefits at all the previous stages, subject to rules as prescribed[1].

Revenue

A. Reconciliations

Companies may need to consider devising appropriate revenue reconciliations, to explain differences between amounts recorded as revenue in books and that considered for GST filings in various states. This is primarily due to that fact that accounting revenue may not always be equal to the revenue for GST purposes. This is further explained below:

a. Measurement of revenue - fair Value accounting

Under Ind AS revenue is measured at the fair value of the consideration received or receivable after taking into account any trade discounts and volume rebates. This may result in a difference as to what could be considered as revenue for GST and that recorded in the books of account.

For example, in multiple element contracts, where there are more than one performance obligations, the accounting guidance would require that each obligation be recorded on a fair value basis (if relative fair value method of purchase price allocation is used). Fair value allocated to each performance obligation may be different from the contracted rates which may not necessarily be at fair value. Accordingly, it is

1. Source: First Discussion Paper On Goods and Services Tax In India published by The Empowered Committee Of State Finance Ministers on 10 November 2009

expected that there could be a mismatch as to the amount of revenue recorded in the books for each obligation versus the contact revenue amount that would be considered for GST (as GST would be on the contracted invoice value (assuming the transaction between unrelated parties).

Further under Ind AS, revenue recognition may be deferred if the revenue recognition criteria are not met for example, in case of customer loyalty arrangements where every sale may entitle the buyer for certain loyalty points/credits, which in turn can then be redeemed by the buyer for free services/ products in future. Accordingly, in such situations some portion of the revenue from each sale would be deferred and would be recognised as revenue when the free services/products are delivered in future. However, for GST purposes transaction invoice value would be the basis of charge without any consideration to the accounting revenue.

Similarly where contractually extended credit terms are offered to the buyer at the time of sales, considering the fair value principle under Ind AS, the invoiced value would be split between revenue and interest income. This would in turn create a difference for revenue to be considered for GST and that recorded in books of account.

In case where a parent company provides financial guarantee for its subsidiary without any consideration or at a consideration below market, guidance under Ind AS requires the guarantee to be fair valued i.e. a notional guarantee commission income may have to be recorded by the parent company. Similarly interest free/below market loans provided to employees, others may result in notional interest income being recorded in the company's books on account of fair value adjustments under Ind AS. Whether such notional incomes would be considered for GST levy? Companies will need to consider these aspects carefully.

b. Risks and rewards

Another area that would lead to a difference, is the timing of transfer of risks and rewards and effective control over goods. Under Ind AS, revenue from sale of goods is recognised when the significant risks and rewards of ownership is transferred to the buyer and there is no effective control over goods. It is important to consider the contracted terms to evaluate the timing of transfer of risks and rewards for revenue recognition under Ind AS. While raising an invoice at the time of dispatch of goods would give rise to GST liability, it may not lead to revenue recognition in the books of account if the risks and rewards of the goods sold are not transferred to the buyer.

c. Barter transactions

Companies at times enter into barter exchanges of goods and services. Under the Ind AS guidance, when goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue and accordingly no revenue is recognised on such exchange. This is often the case with commodities like oil or milk where suppliers exchange or swap inventories in various locations to fulfil demand on a timely basis in a particular location. Only when goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue and recognised in books. However, under GST, companies may need to evaluate all barter exchanges as a supply of goods and services and consider any potential GST liability.

d. Percentage of completion to be estimated

For construction contracts, entities would use percentage of completion method to recognise revenue. Ind AS does not specify any specific method for assessing the percentage of completion. In practice, many entities use 'percentage of contract costs incurred in relation to total estimated contract costs (input measure)' for determining the percentage of completion. GST would impact the estimate of future costs that are expected to be incurred on a construction contract. Therefore, companies should take into account the impact of change in total estimated costs due to GST on 30 June 2017 for recognition of revenue from construction contracts while using percentage of completion method.

B. Presentation of revenue (gross vs net)

The Schedule III of the Companies Act, 2013 specifically requires sales to be disclosed inclusive of excise duty. Accordingly, companies presented sales inclusive of excise duty in the 31 March 2017 financial statements. Under the Ind AS framework, revenue is defined as gross inflow of economic benefits (when those inflows result in increase in equity) received or receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales tax, goods and services tax and value added tax are not economic benefits that flow to the entity.

GST is a tax on supply of goods and services collected on behalf of the government and hence, does not result in increase in equity. Accordingly, revenue in the GST regime will be presented exclusive of GST. A direct impact of this is on the ratios linked to sales and comparative previous period information. Accordingly, the management may have to include relevant notes in their financial statements or other investor presentations to explain this impact on the revenue amount disclosed.

Inventory

a. Cost of purchases

Under accounting principles, the cost of purchase of inventory comprises purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. It is likely that for several companies, cost of inventory may undergo a change. Prior to the GST regime, several taxes like octroi, entry taxes, CST, etc. formed part of the cost of the raw materials and direct expenses and were not refundable/creditable.

With taxes getting subsumed in GST, the cost of purchase is likely to reduce if GST is recoverable.

b. Valuation of inventory

Companies operating in excise exempt units were exempted from collecting excise on sales and consequently were not eligible for set off of input taxes paid on raw materials. As on the date of transition, an assessment is required for the set off of input taxes paid on such inventory. In case, these are eligible to be set off in the GST regime, then they would be excluded from inventory valuation.

Further, accounting principles require excise duty to be included in the cost of inventory lying in the factory. This is due to the fact that excise duty was considered as a tax on production, while the actual payment occurs when those goods move out of the factory. However, given that no excise duty would be payable from 1 July 2017, it would be appropriate not to include excise duty on stock of finished goods in factory as on 30 June 2017.

Provisions for estimated claims

Agreements with vendors and customers will need to be revisited to factor in the impacts on contracted price with the shift to GST. Companies should evaluate appropriate accounting basis of the impact of changes (claims, if any) based on their respective facts and circumstances.

Property, plant and equipment

Under the Ind AS accounting principles, cost of property, plant and equipment is defined as the purchase price including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates. Earlier certain taxes like octroi, purchase tax, etc. which were not creditable formed part of the cost of property, plant and equipment. Under the GST regime, given that these will be subsumed, the cost of fixed assets capitalised is likely to reduce if GST is recoverable.

Carry forward of tax credits

Available input tax credits as on 30 June 2017 need to be evaluated as to whether these would be available for set off in the GST regime or whether any provisions are required. The carry forward and set off is subject to compliance of conditions under the GST law. For example, all returns for last six months have been filed, inventory is not more than 12 months, etc.

Consider this

- These are initial days post transition to the GST regime. Hence, it is imperative that companies consider all aspects arising from the transition and avoid last minute surprises.
- As number of existing taxes have been subsumed in GST, accordingly, companies would need to revisit the accounting systems and chart of accounts. Further, GST returns are required to be filed state wise. Hence, the new design of chart of accounts will need to consider the ease of availability of data for analyses and to meet the various compliances required under GST. Also updates will be required to accounting manuals and other policy documents maintained by the company.
- Contracts may need to be reviewed to help ensure compatibility with the GST. Long-term contracts may need to include new clauses on, for example, tax, pricing and changes in law. Additionally, pricing of products and services may need to be reviewed.
- Companies may also need to re-design their internal management information system and provide adequate training to senior management, business teams, accounting and tax teams, vendors, customers and channel partners, to explain the changes in the prices, discount structures and promotional schemes.
- It is important that companies which have been impacted significantly by this change engage with the stakeholders (both internal and external) to explain them the impact of GST rollout.

Computation of EIR for floating-rate instruments

This article aims to:

- Discuss the approaches for computation of EIR for floating rate instruments by banks.

Interest on financial instruments at amortised cost, or debt instruments at Fair Value Through Other Comprehensive Income (FVOCI), is recognised using the Effective Interest Rate (EIR) method under Indian Accounting Standard (Ind AS) 109, *Financial Instruments.*

The EIR method results in the recognition of a constant periodic return on the carrying amount of the asset or liability. Besides the interest coupon, the EIR includes transaction costs, fees paid/received between the parties to the contract and all other premiums or discounts. Generally, the EIR is determined on initial recognition of a financial asset or liability, as the rate that exactly discounts estimated future cash flows through the expected life of the instrument to the gross carrying amount of the financial asset, or the amortised cost of the financial liability. The EIR remains constant over the life of the financial instrument and revisions to estimated cash flows may result in an adjustment in the gross carrying amount/amortised cost of the financial asset or financial liability.

However, for floating-rate financial assets and financial liabilities, Ind AS 109 states that 'periodic re-estimation of cash flows to reflect the movements in the market rate of interest alters the effective interest rate.' Since Ind AS 109 does not further specify how the EIR for floating rate instruments should be computed, different approaches are often adopted by entities.

In India, the interest charged on floating rate loans may most commonly be reset as a result of a change in a Bank's Base Rate (BBR) or the Marginal Cost of Funds based Lending Rate (MCLR) for INR loans or a change in an international benchmark (such as LIBOR) for foreign currency loans. In the case study below, we demonstrate the alternative methods that banks may adopt for computing the EIR on floating-rate instruments held by them.

Key characteristics of loans advanced

Bank C (the bank) provides INR and foreign currency term loans to corporates. The interest rates for the terms loans are based on MCLR for INR loans and LIBOR for foreign currency loans.

As per the bank's policy, floating-interest rate loans are advanced to corporates with a credit rating of AAA, AA+, AA, AA- and A+. On 1 April 2017, the bank extended a floating rate, foreign currency term loan to a AAA rated entity. Details of the loan are:

Particulars	Details
Amount of loan extended	USD15 million
Average coupon rate	6-month LIBOR + 3%, payable on a half-yearly basis
Period of the loan	Principal is repayable at the end of four years
Reset date of the LIBOR	1 April and 1 October, each year
Documentation charges and other expenses incurred by bank	2% of the loan amount
Processing fees collected by bank	1% of the loan amount
Classification of loan in financial statements of the bank	As per the bank's policy, all term loans advanced to AAA rated companies are held by it throughout the term of the loan. Accordingly, the loan is classified and subsequently measured at amortised cost.

The 6-month LIBOR on 1 April 2017: 1.43 per cent per annum.

As on 1 April 2017, the bank expected the 6-month LIBOR to be as follows:

Period	1 Oct 2017	1 Apr 2018	1 Oct 2018	1 Apr 2019	1 Oct 2019	1 Apr 2020	1 Oct 2020
LIBOR	1.45%	1.60%	1.70%	1.78%	1.85%	1.90%	1.90%

On 1 October 2017, the actual LIBOR is 1.45 per cent per annum. The LIBOR curve was revised, and the expected LIBOR for the next three years are as follows:

Period	1 Apr 2018	1 Oct 2018	1 Apr 2019	1 Oct 2019	1 Apr 2020	1 Oct 2020
LIBOR	1.70%	1.75%	1.80%	1.88%	1.95%	1.95%

The bank is transitioning to Ind AS and is required to prepare Ind AS financial statements, including an opening balance sheet on 1 April 2017, financial statements for the half-year ended 30 September 2017 and the year ended 31 March 2018. The bank is therefore required to compute the applicable EIR and amortised cost for the outstanding loans as on those dates.

Note: Since this illustration aims to demonstrate the computation of EIR and amortised cost of a financial asset, to simplify computation, ECL has been excluded from the illustration. We also assume that these loans are not credit impaired. Hence, the EIR is computed on the gross carrying amount of the loan.

Accounting issue

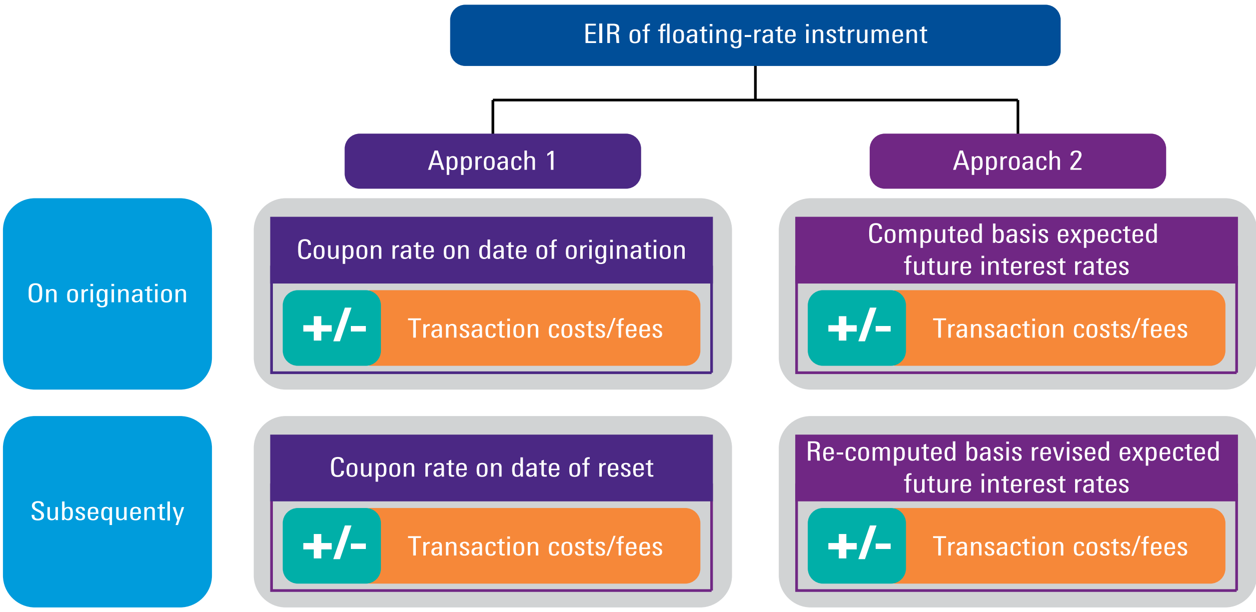
While computing the gross carrying amount of financial assets or amortised cost of financial liabilities, Ind AS 109 requires banks to consider the estimated cash receipts or payments, as the case may be, and other contractual terms of the instrument. Fees and transaction costs that are an integral part of the EIR of the financial instrument are amortised over its expected life.

In accordance with this, Bank C needs to compute the EIR and the amortised cost of the loan on initial recognition and at each period end, considering that the periodic re-estimation of cash flows to reflect movements in market rates of interest will change the effective interest rate of the floating rate loan.

Accounting guidance

Ind AS 109 does not provide any specific guidance on the approach to be applied for computing the EIR of a floating rate instrument. Accordingly, the bank could adopt one of the following two approaches (as shown in Figure 1) to compute the EIR of the floating rate loan.

Figure 1: Two possible approaches for computing the EIR of a floating rate loan



(Source: KPMG in India's analysis, 2017 read with Insights into IFRS, KPMG IFRG Ltd.'s publication, 13th edition September 2016)

Analysis

Approach 1 (EIR based on prevailing coupon rate)

Under this approach, the EIR is computed on the basis of the coupon rate prevailing on the date of origination, estimating future cash flows on the basis of this interest rate. At each reset date, the estimate of future cash flows is revised on the basis of the new coupon rate, with a resultant change in the EIR.

In the absence of material transaction costs and/or processing fees, the floating rate loan (whose coupon is based on market interest rates) would be initially recognised at an amount equal to the principal receivable on maturity, hence there would be no significant difference between the coupon rate and the EIR. Accordingly, the periodic re-estimation of future interest cash flows would not have a significant effect on the carrying amount of the loan. However, in the current case, the amount initially recognised is required to be adjusted for origination fees collected and transaction costs incurred by the bank. These amounts are included for determining the EIR on initial recognition and would generally be amortised over the expected life of the loan in accordance with Ind AS 109.

Ind AS 109 does not prescribe a methodology for amortisation of transaction costs or origination fees for floating rate loans, where the interest rates are reset on a periodic basis. Therefore, the bank is required to develop and apply a consistent method which would result in a reasonable basis of amortisation for transaction costs and origination fees.

- One possible method (method 1) could be to include the unamortised amounts in the computation of the altered EIR when cash flows are re-estimated to reflect changes in the market rates of interest.
- Another method (method 2) may involve determining an amortisation schedule of transaction costs and fees on the basis of the EIR at inception. Changes in the market rate of interest would not alter this amortisation schedule.

While amortisation of transaction costs and fees on a straight-line basis is not permitted under Ind AS 109, banks may consider applying a straight-line basis of amortisation if the result is not materially different to amortisation on the basis of the EIR (or re-computed EIR) as mentioned above. Under this method, the transaction costs and fees would be amortised on a straight-line basis over the expected life of the loan and interest accrued at the applicable coupon rate. Due to the significant costs and efforts involved in amortising transaction costs and fees on floating rate loans based on the EIR, banks in India may evaluate if this method is suitable, subject to materiality considerations, due to its ease of implementation.

The following analysis demonstrates the computation of EIR based on the methods above.

Method 1

Under this method, the EIR is computed on the basis of the interest rate prevailing on the date of initial recognition and includes the origination fees and transaction costs which are an integral part of the EIR of the loan. Accordingly, as on 1 April 2017, the EIR for the loan extended by the bank is computed as approximately 4.16 per cent per annum. On conversion to INR, the approximate interest income for the six months ended 30 September 2017 and gross carrying amount of the loan as on 1 April 2017 and 30 September 2017 are as follows:

Date	Interest (INR)* *(4.16%)*	Cash flows (INR) *(4.43%)*	Gross carrying amount (INR)
1 April 2017	-	-	981,871,500
30 September 2017	20,425,629	21,579,638	**982,860,529**

** Interest amount excludes the exchange differences on translation of the loan.*

(Source: KPMG in India's analysis, 2017)

On 1 October 2017, the coupon rate of the loan is reset on the basis of the 6-month LIBOR resulting in the re-estimation of future cash flows. This would result in a change in the EIR of the loan. Hence, on the date of reset (i.e. 1 October 2017), the EIR should be re-computed by discounting the revised estimated cash inflows (at 1.45% p.a.), to the gross carrying amount as on that date. On this basis, the revised EIR of the loan is 4.18 per cent per annum as on 1 October 2017. Interest will be accrued at the altered EIR on the gross carrying amount of the loan. On conversion to INR, the approximate interest income for the six months ended 31 March 2018, and the gross carrying amount as on that date are as follows:

Date	Interest (INR)* *(4.18%)*	Cash flows (INR) *(4.45%)*	Gross carrying amount (INR)
1 October 2017	-	-	982,860,529
31 March 2018	20,774,688	22,211,063	**1,005,889,041**

** Interest amount excludes exchange difference on translation of the loan.*

(Source: KPMG in India's analysis, 2017)

Method 2

This method involves the computation of an amortisation schedule for transaction costs and fees on the basis of the EIR at inception of the loan. Interest income would be recognised at the coupon rates of the loan.

In the illustration above (method 1), the EIR is computed as 4.16 per cent per annum as on 1 April 2017. Under this simplified method, the amortisation schedule for the transaction costs and fees is determined on the basis of this EIR. Changes in the coupon rate on subsequent reset dates would not alter the amortisation of the transaction costs and fees. Interest income would be recognised by the bank at the revised coupon rate and the amortisation amount for the transaction costs/fees would be presented as part of interest income on the loan.

Straight-line basis of amortisation

The bank may consider amortising the transaction costs and origination fees on a straight-line basis if the result is not materially different to the amortisation schedule determined by either of the two methods mentioned above.

The following table presents a comparison of the approximate amortisation of transaction costs and fees under each of these methods for the six months ended 30 September 2017 and 31 March 2018:

(Amounts in INR)

Period	Amortised under method 1	Amortised under method 2	Amortised on a straight-line basis
1 April 2017 to 30 September 2017	1,130,751	1,130,751	1,216,500
1 October 2017 to 31 March 2018	1,169,375	1,169,726	1,232,813

(Source: KPMG in India's analysis, 2017)

Amortisation of transaction costs and origination fees on a straight-line basis results in a difference of approximately 0.3 to 0.4 per cent in the net interest income recognised on the loans. The bank should evaluate whether this difference is material in the context of its financial statements. If not, the bank may consider adopting this simplified method for amortisation. Interest income would then be accrued at the coupon rate applicable to each reset period and the amortisation amount for transaction costs/fees would be presented as part of interest income.

Approach 2 (EIR based on expectation of future interest rates)

In accordance with this approach, the EIR of the loan is computed on the basis of expectations of future interest rates, adjusted for transactions costs and origination fees, which are an integral part of the EIR. For this computation, banks need to determine their expectation relating to future interest rates over the period of the loan (i.e. determine the forward yield curve).

Method 1

As on 1 April 2017, the bank has determined the 6-month LIBOR forward curve for the period of the loan. Considering these to be the coupon rates for the loan over its life, the EIR of the loan is computed as approximately 4.42 per cent per annum at the time of initial recognition. The approximate interest income and gross carrying amount of the loan as on 30 September 2017 are computed as follows.

Date	Interest (INR)* *(4.42%)*	Cash flows (INR) *(4.43%)*	Gross carrying amount (INR)
1 April 2017	-	-	981,871,500
30 September 2017	21,708,282	21,579,638	984,144,566

* *Interest amount excludes the exchange differences on translation of the loan.*

(Source: KPMG in India's analysis, 2017)

The difference between the interest income accrued in the financial statements and the cash flows represents the amortisation of the transaction costs and origination fees pertaining to the loan.

On 1 October 2017, the bank assesses if there has been any change in its expectations of future interest rates that will affect the EIR of the loan. It uses a LIBOR forward curve based on the revised expectations and would be required to re-compute the EIR of the loan as on 1 October 2017. The EIR is approximately 4.46 per cent per annum (inclusive of the unamortised transaction costs and origination fees). The approximate interest income for the six months ended 31 March 2018, and the gross carrying amounts of the loan as on that date are computed as follows.

Date	Interest (INR)* *(4.46%)*	Cash flows (INR) *(4.45%)*	Gross carrying amount (INR)
1 October 2017	-	-	984,144,566
31 March 2018	22,214,185	22,211,063	**1,008,661,721**

** Interest amount excludes the exchange differences on translation of the loan.*

(Source: KPMG in India's analysis, 2017)

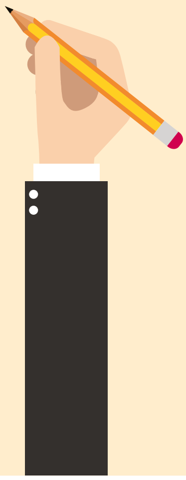
Method 2 and straight-line basis of amortisation

As explained above, the bank may determine an amortisation schedule for transaction costs and origination fees on the basis of the EIR computed at the time of initial recognition. While interest income is accrued on the basis of the EIR computed from the revised forward curve at each reset date, the amortisation schedule for transaction costs and fees is held constant.

Alternatively, the bank may consider amortising transaction costs and origination fees on a straight-line basis if the result is not materially different than that derived from applying either of the methods stated above.

Consider this

- When determining the Expected Credit Losses (ECL) of a financial asset, entities need to discount the expected losses up to the reporting date, using the effective interest rate determined on initial recognition of the asset, or an approximation thereof. However, where entities need to determine the ECL for financial assets with a variable coupon rate, the EIR pertaining to the period for which the ECL is being computed, should be considered for discounting losses until the end of that period.
- In this case study, we have illustrated the computation of EIR for a single financial asset. However, banks may determine a composite EIR for a portfolio of loans with similar terms, credit risk and homogenous characteristics.
- When computing the EIR of a financial asset, all contractual terms pertaining to the asset should be considered. Accordingly, where banks have provided borrowers with a prepayment option, without any significant penalty, and on the basis of the historical experience and current estimates, it believes this option will be exercised by the entity, it should consider a shorter term while computing the EIR of the loan.



Declaration and payment of dividend under the Companies Act, 2013

This article aims to:

– Provide an overview of the provisions of the Companies Act, 2013 relating to declaration and payment of dividend along with highlighting the related key requirements of the Listing Regulations.

Introduction

Dividend is a return given to the shareholders who have invested capital in a company.

Companies are required to comply with the provisions of the Companies Act, 2013 (2013 Act) for the declaration and payment of dividends. The 2013 Act extends the definition of dividend to include interim dividend in it as well.

A company can pay dividend out of the following sources:

a. From current year's profits

b. From profits of any previous Financial Year (FY) remaining undistributed, or

c. From (a) and (b) both, or

d. From its reserves (in case of inadequate or no profits).

This article provides an overview of the key requirements of the 2013 Act with respect to the declaration and payment of dividend. The article also highlights the related key requirements comprised in the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations).

Declaration/payment of dividend from the profits

A company could declare or pay dividend out of its profits for the current year or profits for any previous FYs. However, before declaring any dividends, the companies are required to make following adjustments to the profits which would be available for distribution as dividends:

a. Make a provision for depreciation (in accordance with Schedule II to the 2013 Act)

b. Set-off carried over previous losses and depreciation not provided in the previous year(s) against its profits for the current year.

The 2013 Act also mentions that a company may, before declaration of any dividend in any FY, transfer a certain percentage of its profits for that FY as it may consider appropriate to the reserves of the company. It is important to note that Section 205 of the Companies Act, 1956 (1956 Act) provided a mandatory requirement for transfer of profits to general reserve before declaration of dividend. Therefore, it might be a prudent practice to transfer an appropriate percentage of profits to reserves before declaration of any dividend.

Further, board of directors of a company have discretion to decide whether certain percentage of profits should be transferred to reserves before the declaration of dividend in a FY.

Additionally, the 2013 Act reiterates that dividend should be declared or paid by a company only from its free reserves.

Interim dividend

An interim dividend could be declared during any FY out of the following sources:

- Surplus in the statement of profit and loss
- Profits of the FY in which such interim dividend is sought to be declared.

However, in case a company has incurred loss up to the end of the quarter (current FY) immediately preceding the date of declaration of interim dividend, then the interim dividend should not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three FYs.

The 2013 Act mentions that a company can declare interim dividend any time during the FY. This could be interpreted to mean that the interim dividend for a particular FY could only be declared during that particular FY period; thus, restricting the ability of companies to declare interim dividend after the close of the FY but before the annual general meeting. This requirement seems to be a departure from the past practice under the Companies Act, 1956. Therefore, the Company Law Committee recommended and the Companies Amendment Bill, 2016 proposed that dividend could be declared any time till the date of the annual general meeting.

Declaration/payment of dividend from the reserves

When a company has inadequate profits or loss in any year, then the company could declare dividend out of the accumulated profits earned by it in the previous years and transferred to the reserves, subject to the following conditions:

a. **Reserves mean free reserves:** Dividend should be declared or paid out of *free reserves*[1] only.

b. **Maximum rate of dividend:** The rate of dividend should not exceed average of the rates at which dividend was declared by the company in the immediately preceding three years. This condition would not be applicable to a company which has not declared any dividend in each of the three preceding FYs.

c. **Maximum amount to be withdrawn:** The total amount to be withdrawn from the accumulated profits should not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statements.

d. **Utilisation of amount withdrawn:** The amount withdrawn should be first utilised to set-off the losses incurred in the FY in which dividend is declared before any dividend in respect of equity shares is declared.

e. **Maintain adequate balance in reserves:** The balance of reserves should not fall below 15 per cent of its paid-up share capital as appearing in the latest audited financial statements, after such withdrawal.

Free reserves and Ind AS transition adjustments

Section 123 of the 2013 Act and the related Rules seem to ease the process of declaration and payment of dividend along with safeguarding the interest of the shareholders. However, additional input is required from MCA to deal with the meaning of free reserves and Ind AS transition adjustments to retained earnings in the year of transition.

As per the provisions of the 2013 Act, in case of inadequate or no profits, dividend could be paid out of free reserves only.

Free reserves means reserves which are available for distribution as dividend as per the latest audited balance sheet of a company. However, the definition excludes any unrealised gains, notional gains or revaluation of assets (whether shown as reserves or otherwise) or change in carrying amount of asset/ liability recognised in equity reserves from its definition.

With Indian Accounting Standards (Ind AS) being applicable to the companies, there seems to be an ambiguity with the treatment of certain adjustments. (For instance, uncertainty over the treatment of adjustments to retained earnings on first-time adoption of Ind AS as to whether such adjustments would be considered while computing free reserves). Similarly, if accumulated losses convert into profits due to first-time adoption adjustments then would such adjustments be considered as part of free reserves and would be available for distribution of dividend or whether any adjustments would be required to be made to the profits computed under Ind AS.

General conditions for declaration and payment of dividend

A company declaring or paying dividend (whether from profits or reserves) is required to comply with these additional conditions:

a. **Ensure compliance with Section 73 and 74 of the 2013 Act:** A company would not be able to declare any dividend on the equity shares, if it fails to comply with the provisions of Section 73 (acceptance of deposits from members and public) and Section 74 (repayment of deposits) of the 2013 Act till the time such failure continues.

b. **Proportional dividend:** A company could pay dividends in proportion to the amount paid-up on each share subject to authorisation by its articles.

c. **Deposit dividend in a separate bank account:** The amount of dividend (including the interim dividend) should be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

d. **Pay only to a registered shareholder:** Dividend should be paid only to a registered shareholder or on the order of such a shareholder, to the banker in cash. However, the 2013 Act does not prohibit the capitalisation of profits or reserves of the company for issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company.

e. **Mode of payment of dividend:** Dividend payable in cash could be paid by cheque, warrant or in any electronic mode to the shareholder entitled to the payment of dividend.

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1. Free reserves means reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend except the following:

   i. Any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

   ii. Any change in carrying amount of an asset or of a liability recognised in equity, including surplus in the statement of profit and loss on measurement of the asset or the liability at fair value.

f. **Unpaid dividend account:** Dividend declared but not paid or claimed within 30 days from the date of declaration to any shareholder, should be transferred to a special account in any scheduled bank called as 'unpaid dividend account' within seven days from the date of expiry of 30 days.

   Additionally, the company is required to prepare a statement containing the details of the amount remaining unpaid within 90 days from the date of making transfer to the unpaid dividend account and should place it on the website of the company.

   In case of default in transferring the amount or any part of the dividend to the unpaid dividend account, an interest at the rate of 12 per cent per annum would be required to be paid by the company on the amount not transferred.

g. **Investor Education and Protection Fund (IEPF):** The amount transferred to the unpaid dividend account but remaining unpaid or unclaimed for a continuous period of seven years should be transferred to the IEPF. Additionally, all the shares in respect of which dividend has not been paid or claimed for the seven years should be transferred to the IEPF.

   However, in case any dividend has been paid or claimed for any year during the period of seven consecutive years, then the shares should not be transferred to the IEPF.

   The company is required to send a statement comprising the details of the amount and share transferred in the IEPF in the prescribed form to the authority that administers the IEPF.

h. **Disclosure in Board's report:** Board of directors are required to disclose the amount which the company proposes to carry to its reserves and the amount of dividend which it recommends should be paid in its report.

Requirements prescribed under the Listing Regulations

- **Declaration on per share basis:** Dividends should be disclosed on per share basis in its financial results.
- **Record date:** Listed entities are required to intimate the record date to all the stock exchange(s) where it is listed for various purposes including for declaration of dividend.
- **Declaration of dividend:** Listed entities should recommend or declare all dividend at least five working days (excluding the date of intimation and the record date) before the record date fixed for the purpose.
- **Formulation of dividend distribution policy:** The top 500 listed entities (based on the market capitalisation) are required to formulate a dividend distribution policy which should be disclosed in their annual report and on their websites. The policy should disclose the following parameters:

  a. Circumstances under which the shareholders of the listed entities may or may not expect dividend

  b. Financial parameters that should be considered while declaring dividend

  c. Internal and external factors that should be considered for declaration of dividend

  d. Policy as to how the retained earnings should be utilised and

  e. Parameters that should be adopted with regard to various classes of shares.

  If the listed entity proposes to declare dividend on the basis of the parameters other than specified above or proposes to change such additional parameters, it should disclose such changes along with the rationale in its annual report and on its website.

  Listed entities (other than top 500 listed entities) could disclose their dividend distribution policies on a voluntary basis in their annual reports and on their websites.
- **Forfeiture of dividend not allowed:** A listed entity is not allowed to forfeit unclaimed dividends before the claim becomes barred by law and such forfeiture, if effected would be annulled in appropriate cases.
- **Transfer to IEPF:** The unclaimed dividend should be transferred to the IEPF as per the provisions of the 2013 Act.
- **Disclosure of information having a bearing on performance:** A listed entity should promptly inform the stock exchange(s) of all the information having bearing on the performance/obligation of the listed entity, price sensitive information or any action that should affect payment of interest or dividend of non-convertible preference shares or redemption of non-convertible debt securities or redeemable preference shares.

- **Financial results:**

  Equity listed entity

  Equity listed entities are required to disclose the following in respect of dividends paid or recommended for the year including interim dividends:

  a. Amount of dividend distributed or proposed for distribution per share; distinguish the amounts in respect of different classes of shares and indicate the nominal values of shares

  b. Where dividend is paid or proposed to be paid pro-rata for shares allotted during the year, the date of allotment and number of shares allotted, pro-rata amount of dividend per share and the aggregate amount of dividend paid or proposed to be paid on pro-rata basis.

  Debt listed entity

  The Board of Directors of a debt listed entity are required to address the modified opinion in auditors' reports that have a bearing on the interest payment/dividend payment pertaining to non-convertible redeemable debentures/redemption or principal repayment capacity of the listed entity.

  Further they are required to disclose the following line items relating to dividend in their financial results:

  a. Previous due date for the payment of interest/dividend for non-convertible redeemable preference shares/repayment of principal of non-convertible preference shares/non-convertible debt securities and whether the same has been paid or not and

  b. Next due date for the payment of interest/dividend of non-convertible preference shares/principal along with the amount of interest/dividend of non-convertible preference shares payable and the redemption amount.

     Additionally, disclose the track record of dividend payment on non-convertible redeemable preference shares in the notes to the financials results[2].

- **No dividend in case of default:** The listed entity should not declare or distribute any dividend wherein it has defaulted in payment of interest on debt securities or redemption or in creation of security as per the terms of the issue of debt securities.

  This is not applicable in case of unsecured debt securities issued by regulated financial sector entities eligible for meeting capital requirements as specified by the respective regulators.

Right to dividend when transfer of shares is pending

In case, any instrument of transfer of shares has been delivered to any company for registration but the company fails to register the transfer of such shares, then the company is required to comply with the following:

a. Transfer the dividend in relation to such shares to the unpaid dividend account until the registered shareholder authorises the company to pay such dividend to the transferee specified in the instrument of transfer

b. Keep in abeyance any offer of rights shares and any issue of fully paid-up bonus shares in respect to such shares.

Penal provisions for default in payment of dividend

In case a company fails to pay the dividend or does not post the warrant to any shareholder entitled to the payment of the dividend within 30 days from its declaration, then every director of the company would be punishable with:

- *Imprisonment:* Up to two years and
- *Fine:* Not less than INR1,000 for every day during which such default continues.

Additionally, company would be liable to pay simple interest at the rate of 18 per cent per annum during the period for which such default continues.

However, following situations would not be considered as default in payment of dividend:

- Dividend could not be paid by reason of the operation of any law
- Shareholder gave directions to the company for payment of dividend which could not be complied
- Dispute regarding right to receive the dividend

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2. In case the dividend has been deferred at any time, then the actual date of payment should be disclosed.

- Adjustment of dividend by the company against any sum due from the shareholder
- Any other reason (the failure to pay dividend or to post the warrant within the period was not due to any default on the part of the company).

Recommendations of the Company Law Committee (CLC) and the Companies (Amendment) Bill, 2016 (Amendment Bill)

The CLC and the Amendment Bill proposed the following in relation to declaration and payment of dividend:

- **Alignment of Rules with the provisions of the 2013 Act:** There is an inconsistency in Section 123 and corresponding dividend rule with respect to 'free reserves'.

  The CLC recommended that to avoid any legal challenges the requirements of the Rule and the Section should be harmonised appropriately. Therefore, the Rules should be amended to align Rule 3 with the provisions of the 2013 Act, to make it clear that in case a company declares dividend out of surplus i.e. accumulated credit balance of the statement of profit and loss which has not been transferred to reserves, the provisions of the 2013 Act and Rule 3 would not be applicable.

- **Declaration of interim dividend:** The Amendment Bill considered the recommendation of the CLC and proposed that the interim dividend could be declared out of the profits of the current FY till the quarter preceding the date of declaration and the same could be declared at any time till the date of the annual general meeting.

  Additionally, the Amendment Bill proposed that if the company has incurred losses during the current FY, then it should not declare dividend at the rate higher than the average dividends declared by the company during the immediately preceding three FYs.

Consider this

- Interim dividend should not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three FYs, in case the company has incurred loss up to the end of the quarter (current year) immediately preceding the date of declaration of interim dividend.
- No mandatory rule for transfer of profits to reserves before declaration of dividend.
- Definition of free reserves whether it will include Ind AS adjustments remains uncertain.
- Interim dividend to be declared within the FY and cannot be declared until the annual general meeting.

Accounting policies and changes under Ind AS

This article aims to:

– Discuss the criteria for selection of an accounting policy under Ind AS and its impact on financial reporting.

The selection and application of accounting policies is an important area of judgement for an entity. Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* prescribes the criteria for selecting and changing accounting policies, accounting treatment and disclosure of changes in accounting policies.

It defines accounting policies as the specific principles, bases, conventions, rules and practices that are applied by an entity in preparing and presenting financial statements.

This article highlights the requirements relating to accounting policies, their disclosures and changes in accounting policies under Ind AS.

Manner of selection and application of accounting policies

When an Ind AS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item should be determined by applying the Ind AS. For example, for sale of goods, an entity would formulate its accounting policy based on the principles of revenue recognition and measurement contained in Ind AS 18, *Revenue.* Similarly, accounting policy of property, plant and equipment would be governed by the principles laid out in Ind AS 16, *Property, Plant and Equipment.*

There could be situations where there is no guidance given in Ind AS for a particular transaction or an event, then in those situations Ind AS 8 requires the management to use judgement in developing and applying an accounting policy that would result in information that is reliable and relevant to the economic decisions of users.

There is a hierarchy of accounting literature to be used in arriving at the policy selected, which provides entities with a basic structure for resolving issues in the absence of specific guidance.

In case Ind AS does not cover a particular issue, then the entity should consider:

- in the first instance, the guidance and requirements in standards and interpretations dealing with similar and related issues, and then
- the Framework.

The entity should also consider the most recent pronouncements of International Accounting Standards Board (IASB) and in absence thereof, other standard-setting bodies and accepted industry practice, to the extent that they do not conflict with standards, interpretations and the Framework.

Selection of accounting policies – considerations

Ind AS specifies certain considerations that should be followed while an entity formulates it accounting policies:

Materiality

Materiality[1] of transactions, events and conditions should be considered when making a judgement about accounting policies. Ind AS does not apply to items that are immaterial. Therefore, those policies need not be applied when the effect of applying them is immaterial. However, in certain cases, disclosure of an accounting policy may be significant because of the nature of the entity's operations regardless of whether the amounts for the current and prior period are material.

1. The Framework refers to materiality as an entity-specific aspect of relevance. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. Either the size or the nature of the item, or a combination of both, could be the determining factor.

Consistency of accounting policies

An entity should select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate.

Certain standards permit the application of different methods of accounting to different categories of items. In those cases an appropriate accounting policy should be selected and applied consistently to each category of items. For example, Ind AS 2, *Inventories* requires the same cost formula to be used for all inventories having a similar nature and use to the entity, but also recognises that different cost formulas may be justified for inventories with a different nature or use. However, Ind AS 2 recognises that a difference in the geographical location of inventories, by itself, is not sufficient to justify the use of different cost formulas. For example, an oil refiner could not use a weighted-average costing formula for crude oil supplies in the U.S. and use a FIFO (First in First Out) costing formula at non-U.S. locations.

For preparing consolidated financial statements, if a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

Disclosures of accounting policies

In applying the entity's accounting policies, the management makes a number of judgements that can significantly affect the amounts recognised in the financial statements. Ind AS 1, *Presentation of Financial Statements* requires an entity to disclose judgements (other than estimates) that have the most significant effect on the amounts that it recognises in the financial statements - e.g. whether risks and rewards have been transferred in a revenue-generating transaction.

Further, Ind AS 1 requires entities to provide a summary of significant accounting policies as part of financial statements to assist users to understand the financial statements and to compare them with financial statements of other entities. Additionally, the summary of significant accounting policies should disclose:

- the measurement basis (or bases) used in preparing the financial statements, and
- the other accounting policies used that are relevant to an understanding of the financial statements.

In deciding whether a particular accounting policy should be disclosed, an entity would consider:

- Whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position
- Whether disclosure of the particular accounting policy is selected from alternatives allowed in Ind AS
- The nature of the entity's operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity
- Inappropriate accounting policies cannot be rectified either by disclosure of the accounting policies used or by notes or explanatory material.

Some Ind AS specifically require disclosure of particular accounting policies. Few examples are set out below:

- Ind AS 2, requires disclosure of accounting policies adopted in measuring inventories, including the cost formula used
- Ind AS 7, *Statement of Cash Flows,* requires disclosure of accounting policy adopted for determining the composition of cash and cash equivalents
- Ind AS 11, *Construction Contracts,* requires disclosures with respect to contract revenue
  - The methods used to determine the contract revenue recognised in the period
  - The methods used to determine the stage of completion of contracts in progress
- Ind AS 16, requires disclosure for each class of property, plant and equipment
  - The measurement bases used for determining the gross carrying amount
  - The depreciation method used
  - The useful lives or the depreciation rates used.
- Ind AS 18, requires the disclosure of accounting policies adopted for the recognition of revenue, including the method adopted to determine the stage of completion of transactions involving the rendering of services.
- Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* requires disclosure of accounting policy for government grants
- Ind AS 107, *Financial Instruments: Disclosures,* requires disclosures for the measurement basis used in preparing the financial statements and other accounting policies used that are relevant to an understanding of the financial statements.

Changes in accounting policies

A change in accounting policy is made in two scenarios:

- it is required by a new or revised Ind AS, or
- a voluntary change may be made if it will result in a reliable and more relevant presentation.

Generally a new, revised or amended Ind AS would provide specific transitional provisions on the manner in which the change in accounting policy should be adopted. However, in the absence of specific transitional provisions or voluntary change in accounting policy, an entity should apply change in the accounting policy retrospectively.

Any accompanying financial information presented in respect of prior periods e.g. historical summaries – is also restated as far back as is practicable to reflect the change in accounting policy. An early application of an Ind AS would not be considered as a voluntary change in accounting policy.

As mentioned earlier, in the absence of an Ind AS that specifically applies to a transaction, other event or condition, the management may, apply an accounting policy from the most recent pronouncements of IASB and in absence thereof those of the other standard-setting bodies that use a similar framework to develop accounting standards. If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy.

In cases where an entity changes its accounting policy retrospectively, then the new accounting policy should be applied as if it has always been applied including any income tax effect. As per Ind AS 8, the entity should do the retrospective application by adjusting the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented. In case it is impracticable to determine the period-specific effects for one or more prior periods presented then the entity should restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective application is practicable.

Further, the following changes in accounting policy are subject to special requirements.

- *First-time adoption of Ind AS:* Changes in accounting policy that arise on the first-time adoption of Ind AS are the subject of a separate standard, Ind AS 101, *First-time adoption of Indian Accounting Standards.* This includes changes in policies between interim and annual financial statements in the year of first-time adoption of Ind AS.
- *Property, plant and equipment and intangible assets:* A change in accounting policy to revalue items of property, plant and equipment or intangible assets is accounted for as a revaluation in accordance with the relevant standard.
- *Exploration and evaluation activities:* An entity is permitted to change its existing Ind AS accounting policy for exploration and evaluation activities only if the change makes the financial statements more relevant and no less reliable, or more reliable and no less relevant, to the needs of users.

Disclosure relating to changes in accounting policies

Ind AS 8 requires an entity in respect of changes in accounting policy to disclose the reasons for the change and the amount of the adjustment for the current period and for each prior period presented. Therefore, such disclosures should be made separately for each accounting policy change. The entity should consider that the financial statements of subsequent periods need not repeat these disclosures.

Additionally, a third balance sheet would be required to be presented as at the beginning of the preceding period following a retrospective change in accounting policy that has a material effect on the information in the balance sheet.

Ind AS 101 requirements

Ind AS 101 governs the selection of accounting policies in the first annual Ind AS financial statements and therefore, the general requirements of Ind AS 8 do not apply to changes in accounting policies that occur during the period covered by the first Ind AS financial statements. As such, it is acceptable for a first-time adopter to adopt an accounting policy or elect to use an optional exemption in its first annual Ind AS financial statements that differs from that applied in any interim Ind AS financial statements previously published during the year of adoption. It is also acceptable for a first-time adopter to adopt different accounting policies or use different optional exemptions between sets of interim Ind AS financial statements before the issue of the first annual Ind AS financial statements.

If a first-time adopter changes its accounting policies or use of optional exemptions, then as per requirements of Ind AS 101 such entity should:

- explain any such changes between the first interim and first annual Ind AS financial statements; and
- update the reconciliation from previous GAAP to Ind AS included in the previous interim financial information for those changes in the interim period in which the change is made.

Notwithstanding those changes in accounting policies between a first-time adopter's interim Ind AS and first annual Ind AS financial statements are not in the scope of Ind AS 8.

Consider this

- The entities transitioning to Ind AS should consider the facts and circumstances affecting the entity's nature of operations to determine appropriate accounting policies.
- Under current Accounting Standards (AS), a change in accounting policy does not require retrospective application of accounting policy and restatement of the comparative amounts for previous periods. In certain cases, an adjustment is made to the opening reserves of the current period to reflect the cumulative effect of applying the new policies. Whereas under Ind AS, an entity is generally required to retrospectively apply changes to accounting policies, by adjusting the opening balance of equity/retained earnings for the earliest period presented, and restating comparative amounts (including the comparative statement of profit and loss) for each period presented.
- Ind AS set out accounting policies that result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave uncorrected, immaterial departures from Ind ASs to achieve a particular presentation of an entity's financial position, financial performance or cash flows.
- As per Ind AS 8 following are not to be considered as changes in accounting policy:
  - Neither the adoption of an accounting policy for new transactions or events, nor the application of an accounting policy to previously immaterial items, is a change in accounting policy.
  - The changes in accounting policies of an entity on first-time adoption of Ind AS or to changes in those policies until or after the entity presents its first Ind AS financial statements.

Regulatory updates

MCA has amended the requirement for exemption from audit reporting on IFC

The Ministry of Corporate Affairs (MCA) issued a notification dated 5 June 2015 to provide modifications/exceptions/adaptations to some of the provisions of the 2013 Act as applicable to a private company. The MCA through its notifications dated 13 June 2017 provided further exceptions/modifications/adaptations to the provisions of the 2013 Act for private companies.

These exceptions/modifications/adaptations would be available to the companies which have not defaulted in filing of its financial statements under Section 137 or annual returns under Section 92 of the 2013 Act with the Registrar of Companies (ROC). The notification included exemption provided to private companies relating to requirement of reporting under Section 143(3) of the 2013 Act.

Section 143(3) requires an auditor of a company to state in his/her audit report whether the company has an adequate Internal Financial Controls (IFC) system in place and the operating effectiveness of such controls. The recent notification exempts specified private companies from the requirement of its auditor reporting on whether the company has adequate IFC system in place and the operating effectiveness of such controls.

Further, on 13 July 2017 MCA issued, corrigendum to its notification dated 13 June 2017 relating to auditor reporting on IFC of the company.

Section 143(3) post the amendment provides that an auditor of a private company is not required to report on the adequacy and operating effectiveness of IFC in the auditor's report provided such a private company meets either of the given conditions:

a. It is a one person company or a small company, or

b. It has a turnover of less than INR50 crore as per the latest audited financial statements and the borrowings of such a company from banks or financial institutions or anybody corporate at any point of time during the FY is less than INR25 crore.

Applicability: The MCA has clarified through its notification dated 25 July 2017 that the exemption relating to IFC reporting will be applicable for audit reports in respect of financial statements pertaining to financial years commencing **on or after 1 April 2016, which are made on or after the date of the notification i.e. 13 June 2017.**

(Source: MCA notifications dated 13 June 2017, MCA corrigendum dated 13 July 2017, MCA circular no. 8/2017 dated 25 July 2017)

MCA amended provisions relating to independent directors under the Companies Act, 2013

Background

The Companies Act, 2013 (2013 Act) became largely effective from 1 April 2014. The MCA has been issuing various amendments and clarifications to the 2013 Act and to the corresponding Rules to remove practical challenges faced by companies while implementing certain provisions of the 2013 Act.

New development

Recently, on 5 July 2017, the MCA amended certain provisions relating to independent directors and issued the following notifications:

- Companies (Appointment and Qualification of Directors) Amendment Rules, 2017

  Existing requirements - As per Rule 4 of the Companies (Appointment and Qualification of Directors) Rules, 2014, *unlisted public companies* are required to appoint at least two independent directors, if they meet any of the specified criteria.

Amendment: The amendment rules added a new sub-rule to the Rule 4, which provides that the provisions of Rule 4 would not be applicable to the following classes of unlisted public company:

a. A joint venture

b. A wholly owned subsidiary, and

c. A dormant company as defined under Section 455 of the 2013 Act.

- Amendment to Schedule IV (Code for independent directors) of the 2013 Act.

Schedule IV to the 2013 Act includes a code for professional conduct of independent directors. It lays down the guidelines relating to the professional conduct, role and functions, duties of an independent director, their manner of appointment, reappointment, resignation or removal and an evaluation mechanism.

The table below provides an overview of the amendments made to certain paragraphs of Schedule IV to the 2013 Act:

Paragraph	Overview
Paragraph III (sub-paragraph 12)	**Duties of independent directors:** As per the amendment, independent directors should, *inter alia*, act **within their authority** and assist in protecting the legitimate interests of the company, shareholders and its employees.
Paragraph VI (sub-paragraph 2)	**Resignation or removal:** As per the amendment, the new independent director should be appointed **within three months** from the date of such resignation or removal.
Paragraph VII (sub-paragraph 1)	**Separate meetings:** As per the amendment, at least one meeting of independent directors should be held in a **financial year**, without the attendance of non-independent directors and members of management.
New note	**Certain exemptions given to government companies from the requirements of Schedule IV** After paragraph VIII (evaluation mechanism) of the Schedule IV, a new note has been inserted which provides certain exemptions to a government company as defined under Section 2(45) of the 2013 Act. These exemptions are available to a government company if they are specified by the concerned ministries or departments of the Central Government (CG) or the state governments. The requirements of Schedule IV that would not be applicable to government companies are as following: 1. **Paragraph II (sub-paragraph (2) and (7)):** Functions of an independent director: • Bring an objective view in the evaluation of the performance of board and management and • Determine appropriate levels of remuneration of executive directors, Key Managerial Personnel (KMP) and senior management and has a prime role in appointing and where necessary recommend removal of executive directors, KMP and senior management. 2. **Paragraph IV:** The manner of appointment of an independent director. 3. **Paragraph V:** Reappointment of an independent director should be on the basis of report of performance evaluation. 4. **Paragraph VII (clauses (a) and (b) of sub-paragraph (3)):** The independent directors should review the following in its meeting: • Performance of non-independent directors and the board as a whole and • Performance of the Chairperson of the company, taking into account the views of executive directors and non-executive directors. 5. **Paragraph VIII:** The performance evaluation of independent directors should be done by the entire board of directors, excluding the director being evaluated. Further, whether to extend or continue the term of appointment of an independent director, should be determined on the basis of the report of performance evaluation.

(Emphasis added to highlight the changes)

(Source: KPMG in India's analysis, 2017 based on the provisions of Schedule IV to the 2013 Act and MCA notification dated 5 July 2017)

Others

The MCA has also issued revised Form DIR-5 '*Application for surrender of Director Identification Number (DIN)*'.

Applicability

The amendments became applicable from the date of publication of the notifications in the official gazette i.e. 5 July 2017.

Please refer to KPMG in India's First Notes dated 14 July 2017 for detailed analysis of recently released MCA notification relating to independent directors.

(Source: MCA notification G.S.R. 839(E). and S.O. 2113(E) dated 5 July 2017)

MCA proposes to notify the provisions relating to restriction on layers of subsidiaries under the 2013 Act

Background

The provisions (proviso to Section 2(87) and 186(1)) are aimed at monitoring misuse of multiple layers of subsidiaries for diversion of funds/ siphoning off funds and ensuring minority investor protection. Currently, proviso to Section 2(87) is not notified but Section 186(1) is currently applicable to companies.

New development

The MCA has pointed out that it has been receiving reports that certain companies could create shell companies for diversion of funds or money laundering. Therefore, MCA decided to operationalise the provisions relating to the restriction on number of layers for holding companies (Section 2(87)) and retain the requirements of Section 186(1) regarding the number of layers of investment companies although the Companies (Amendment) Bill, 2016 proposes to remove the restrictions in these two sections.

Accordingly, MCA through a notice (no.3/3/2017-CL-I) dated 28 June 2017 proposed the following:

- Notification of the proviso to Section 2(87) of the 2013 Act
- Insertion of new sub-rule 5 'Restriction on number of layers for certain holding companies' to the Companies (Specification of Definitions Details) Rules, 2014 (Definition Rules).

Overview of the proposals

Following is an overview of the proposals relating to restrictions on layers of subsidiaries:

- **Restriction on layers of subsidiaries by holding companies (Proviso to Section 2(87))**: The proposals seek following:
  - To allow a holding company to create up to two layers of subsidiaries only. However, one layer represented by a wholly owned subsidiary would not be taken into account for computing the number of layers.
  - The restriction regarding layers of the companies would not affect a holding company from acquiring a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country.
- **Restriction on layers of investment companies (Section 186(1)):** The requirement for making investment through not more than two layers of investment companies would continue to apply. The Section currently allows a holding company to acquire a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country. However, an investment company being a subsidiary of a holding company (covered under the proviso to Section 2(87)), would also be counted for the purpose of layer requirements.
- **Exemption from restrictions:** These above mentioned restrictions under both 'proviso to Section 2(87) and Section 186(1)' would not be applicable to the following class of companies:
  a. A banking company
  b. A systemically important Non-Banking Financial Company (NBFC) registered with the Reserve Bank of India (RBI)
  c. An insurance company
  d. A government company.
- **Disclosures in case of excess layers:** All holding companies, other than exempted companies, having layers of subsidiaries in excess of two on or before the commencement of the draft Rule 5 of the Definition Rules would be required to comply with the following requirements:
  a. Filing of return with the ROC: A return in Form SDD-14 comprising details of the layers of subsidiaries is required to be filed with the Registrar of Companies (ROC) within a period of three months from the date of its deployment (as an electronic form on the Ministry's MCA-21).
  b. No subsequent addition to the layer: Such a holding company should not add any additional layer of subsidiaries subsequent to the date of notification of the draft restrictions.

The last date to provide comments to the proposals ended on 20 July 2017.

Please refer to KPMG in India's First Notes dated 14 July 2017 for detailed analysis of recently released MCA notification relating to restriction on layers of subsidiaries under the 2013 Act.

(Source: MCA notice no.3/3/2017-CL-I dated 28 June 2017)

Ind AS Transition Facilitation Group (ITFG) issued Clarifications Bulletin 10

With Ind AS being applicable to corporates in a phased manner from 1 April 2016, the Institute of Chartered Accountants of India (ICAI), on 11 January 2016 announced the formation of the Ind AS Transition Facilitation Group (ITFG) in order to provide clarifications on issues arising due to applicability and/or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015 (Rules 2015).

Over the past year, ITFG issued nine bulletins to provide guidance on issues relating to the application of Ind AS.

The ITFG's Bulletin 10 issued on 6 July 2017 provides clarifications on six issues in relation to the application of Indian Accounting Standards (Ind AS).

The ITFG provided clarification on following issues relating to the application of Ind AS:

1. Accounting for interest-free loans provided by holding company in its stand-alone financial statements
2. Accounting for processing fees paid relating to undisbursed term loans
3. Recognition of deferred tax asset on tax deductible goodwill of subsidiary, not recognised in the consolidated financial statements
4. Applicability of deemed cost exemption on assets classified as held for sale
5. Consideration of amounts debited to Foreign Currency Monetary Item Translation Difference Account (FCMITDA) for computation of basic earnings per share
6. Classification of expenses for providing free third party goods.

Please refer KPMG in India's IFRS Notes dated 12 July 2017 which provides an overview of the issues discussed in ITFG's Bulletin 10.

(Source: ITFG of ICAI issued bulletin 10 dated 6 July 2017)

MCA issued Companies (Meetings of Board and its Powers) Second Amendment Rules, 2017

The MCA through its notification dated 13 July 2017 issued Companies (Meetings of Board and its Powers) Second Amendment Rules, 2017 to amend the Companies (Meetings of Board and its Powers) Rules, 2014. The MCA amended following rules to *inter-alia* amend the requirements relating to participation by a director in board meetings through electronic mode and the preservation of draft minutes till the confirmation thereof.

- Rule 3: Meetings of Board through video conferencing or other audio-visual means
  - Rule 3(3)(e) states that the notice of meetings of the Board (to be held through video conferencing or other audio visual means) will be sent to all directors in accordance with Section 173(3) of the 2013 Act. The directors who desire to participate through electronic mode, need to intimate their intention at the beginning of the calendar year, and such declaration will be valid for one calendar year.

    The amendment has added a proviso to this rule, which states that such intimation will not debar the director from attending the meeting in person, provided he/her has given a notice to that effect sufficiently in advance.
  - Rule 3(11)(a) states that at the end of discussion on each agenda item, the Chairperson of the meeting will announce the summary of decisions taken, along with names of directors who dissented to a decision.

    The amendment now requires 'draft minutes' with respect to the meeting to be preserved by the company till it receives a confirmation of the same from the directors, to whom the same has been circulated.
- Rule 6: Committees of the Board

  Rule 6 required the Board of Directors of all listed companies and public companies (satisfying specified financial thresholds) to constitute an audit committee and a nomination and remuneration committee of the Board.

  The amended rules require all listed companies and those companies covered under Rule 4 of the Companies (Appointment and Qualification of Directors) Rules, 2014 to constitute the above mentioned committees.

These amended rules will come into force from the date of publication in the Official Gazette[1].

(Source: MCA notification dated 13 July 2017)

1. Please note that this notification has not been published in the Official Gazette till 28 July 2017.

IASB issues exposure draft of amendment to IAS 16

Introduction

International Accounting Standard (IAS) 16, *Property, Plant and Equipment* prescribes that an item of Property Plant and Equipment (PPE) should be measured at its cost. Paragraph 16(b) of IAS 16 explains that the cost of PPE includes costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the management (available for use). Paragraph 17 of IAS 16 cites examples of directly attributable costs. One such example cited is the cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition.

New development

The IFRS Interpretations Committee (the Committee), in July 2014 considered a request for clarification on accounting for net proceeds received during the course of testing PPE, in case the net proceeds exceed the costs of testing.

However, after extensive discussion on this topic, the Committee recommended to the International Accounting Standards Board (IASB) to propose an amendment to IAS 16 to prohibit deducting sales proceeds from the cost of PPE.

Accordingly, on 20 June 2017, the IASB issued an Exposure Draft on Property, Plant and Equipment – Proceeds before Intended Use (the Exposure Draft) proposing a narrow-scope amendment to IAS 16.

The last date for comments on the exposure draft is 19 October 2017.

Overview of Exposure Draft

The IASB, in its Exposure Draft proposes to:

- Amend the example of directly attributable costs in paragraph 17(e) of IAS 16 related to the costs of testing whether the asset is functioning properly. The Exposure Draft clarifies that such testing involves assessing whether the technical and physical performance of the asset is such that the asset is capable of being used for its intended purpose. The proposed amendment also removes the requirement to deduct net proceeds from sale of items produced before the asset is available for use, from the cost of PPE.
- Clarify that the proceeds from the sale of items produced while making an asset available for use (such as inventories produced when testing an asset), and the costs of producing such items should be recognised in profit or loss, in accordance with applicable standards.

Effective date and transition

The Exposure Draft does not specify an effective date, which will be determined at a later stage by the IASB. It proposes to apply the amendment retrospectively only to those PPE which were available for use on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments. Early application would be permitted.

(Source: Exposure draft on amendment to IAS 16 issued by IASB dated 20 June 2017 and KPMG in India IFRS Notes dated 23 June 2017)

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

CBDT issues FAQs on computation of book profit for levy of MAT and proposes amendment to Section 115JB

27 July 2017

The Finance Act, 2017 provided a separate formulae for computation of book profit for the companies that prepare financial statements under Ind AS. Accordingly, Minimum Alternate Tax (MAT) would be calculated using the profits as per the statement of profit and loss before Other Comprehensive Income (OCI), as the starting point. The Finance Act, 2017 also provides certain adjustments to book profits for MAT computation.

The Central Board of Direct Taxes (CBDT) received a number of queries on various aspects of computation of MAT under Ind AS. These matters were referred to an expert committee. On 25 July 2017, CBDT issued clarifications in the form of Frequently Asked Questions (FAQs) on issues relating to the levy of MAT for Ind AS compliant companies along with the proposed amendment in the IT Act.

This issue of IFRS Notes provides an overview of the following:

1. Clarifications in the form of Frequently Asked Questions (FAQs) on issues relating to the levy of MAT for Ind AS compliant companies
2. Proposal for amendment to Section 115JB of the IT Act in relation to Ind AS compliant companies.

First Notes

MCA proposes to notify the provisions relating to restriction on layers of subsidiaries under the Companies Act, 2013

14 July 2017

The Ministry of Corporate Affairs (MCA) has pointed out that it has been receiving reports that certain companies could create shell companies for diversion of funds or money laundering. Therefore, MCA decided to operationalise the provisions relating to the restriction on number of layers for holding companies (Section 2(87)) and the requirements of Section 186(1) regarding the number of layers of investment companies although the Companies (Amendment) Bill, 2016 proposes to remove the restrictions in these two sections.

Accordingly, MCA through a notice (no.3/3/2017-CL-I) dated 28 June 2017 proposed the following:

- Notification of the proviso to Section 2(87) of the 2013 Act
- Insertion of new sub-rule 5 'Restriction on number of layers for certain holding companies' to the Companies (Specification of Definitions Details) Rules, 2014.

Comments to the proposals could be submitted up to 20 July 2017.

This issue of First Notes provide an overview of the MCA proposals.

Voices on Reporting - Quarterly update publication

Voices on Reporting – quarterly update publication (for the quarter ended 30 June 2017) provides summary of key updates from the Ministry of Corporate Affairs, the Securities and Exchange Board of India, the Reserve Bank 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.

The publication is available to download from KPMG in India website.

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