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# Editorial

The new standard on leases, Indian Accounting Standard (Ind AS) 116, *Leases* is applicable to companies (following Ind AS road map) from 1 April 2019. The new standard introduces a significant change in accounting by lessees. The change in accounting involves significant judgement and requires assessment of accounting of lease at lease commencement and during the lease term. This standard would also require changes in processes and internal controls. Continuing with the series of implementation challenges, in this edition of Accounting and Auditing Update (AAU), we have covered few more key areas where companies are likely to face issues while implementing the new standard.

Ind AS 115, *Revenue from Contracts with Customers* brought in a new model for revenue recognition that is based on the transfer of control. It is a significant change from the earlier applicable revenue guidance and changed the way companies recognise, present and disclose their revenue. The annual reports presented by the companies for year ended 31 March 2019 are the first full set of financial statements presented by companies as per Ind AS 115 framework. In order to understand the insights that these financial statements provide on the impact of Ind AS 115 on revenue recognised, we have included an analysis of the disclosures given in the annual reports by the Nifty50 companies for the year ended 31 March 2019.

Recently, the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) considered an issue on accounting treatment of guarantee fee paid to a party other than the lender while computing effective interest rate on financial liability. Our article on the topic covers the guidance provided by the EAC.

As is the case each month, we have also included 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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# Ind AS 116, *Leases*: Emerging implementation challenges - Part 2[1]

This article aims to:

- Discuss few more implementation issues of the new standard on leases - Ind AS 116 with the help of practical examples.

1. Part 1 was included in September 2019 edition of AAU.

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The new standard on leases, Indian Accounting Standard (Ind AS) 116, *Leases* is applicable to the companies (covered under Ind AS road map) for accounting periods beginning on or after 1 April 2019. The new standard brings a paradigm shift in lessee accounting by eliminating distinction between operating leases and finance leases as required under Ind AS 17, *Leases* (erstwhile standard on leases). The definition of lease under Ind AS 116 is the new on/off balance sheet test for lessees. Accordingly, lessees are required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payment, if the lease arrangement/contract conveys the right to control the use of an asset for a period of time in exchange for a consideration.

Lessor accounting remains similar to the current practice i.e. lessors would continue to classify leases as finance lease or operating lease.

Continuing with the series of implementation challenges under Ind AS 116, in this article we will discuss some more areas where companies are likely to face issues under the new standard.

## Lease term

A lessee measures the lease liability at the inception of the lease at the present value of the future lease payments. Accordingly, there are two key inputs to the measurement of lease liability i.e.:

a. Lease term

b. Lease payments.

*Lease term* is the non-cancellable period of the lease, together with:

a. Optional renewable periods if the lessee is reasonably certain to extend and

b. Periods after an optional termination date if the lessee is reasonably certain not to terminate early.

The lease term begins at the commencement date and includes any rent-free period provided to the lessee by the lessor.

While determining the lease term and assessing the length of the non-cancellable period of a lease, Ind AS 116 requires an entity to apply the definition of a contract[2] and determine the period for which the contract is enforceable. As per Ind AS 116, a lease is not enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

2. A contract is an agreement between two or more parties that create enforceable rights and obligations.

**Issue:** Whether the termination rights held by the lessor should be considered while determining the lease term? Also, how lessee's termination rights should be evaluated while determining the lease term?

### Analysis

As per the requirements of Ind AS 116, if only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term.

Termination options held by the lessor only are not considered when determining the lease term because, in this situation, the lessee has an unconditional obligation to pay for the right-to-use the asset for the period of the lease, unless the lessor decides to terminate the lease.

A lessee is required to consider all relevant facts and circumstances that create an economic incentive to exercise or forfeit options to renew and terminate the lease. Some of the examples of relevant facts and circumstances are as follows:

a. Significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract

b. Costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations or termination penalties

c. The importance of the underlying asset to the lessee's operations.

A lease is no longer enforceable when both the lessee and lessor have the right to terminate it without an agreement from other party with no more than an insignificant penalty.

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## Lease payments

Lease payments are payments made by a lessee to the lessor relating to the right to use an underlying asset during the lease term. Both the lessee and the lessor are required to include the following payments in lease payments:

a. Fixed payments, including in-substance fixed payments less any lease incentive receivable

b. Variable lease payments that depend on an index or a rate

c. Amounts expected to be payable by a lessee under residual value guarantees

d. The exercise price of a purchase option if the lessee is reasonably certain to exercise that option and

e. Payments of penalties for terminating the lease, if the lease term reflects the assessment that the lessee will exercise an option to terminate the lease.

**Example:** Company A has entered into a lease arrangement for its office premises. Key particulars of the lease agreement are as follows:

- *Lease commencement date:* 1 December 2018
- *Lease term:* Five years
- *Fixed lease payments during the initial lease term:* INR1 million per month. In addition to this, company A is also required to pay property taxes, insurance and indirect taxes such as Value Added Tax (VAT) or Goods and Services Tax (GST)
- *Maintenance fees:* INR0.1 million per month
- *Annual escalation:* Fixed at five per cent per annum (general inflation adjusted in the market in which the lessor and lessee operate)
- *Renewal:* Company A has the right to renew the lease for an additional term of one year each
- *Lease payments during the renewal term:* Not defined in the lease agreement, subject to mutual agreement with lessor
- *Lease term for Ind AS 116 purposes:* Company A concludes the lease term to be eight years, as it is reasonably certain to renew the lease for an additional term of three years.

### Issue:

a. Are maintenance charges required to be considered as lease payments?

b. Are property taxes, insurance and other indirect taxes part of lease payments for the purposes of Ind AS 116?

### Analysis

The standard requires a lessee to account for each lease component within the contract as a lease separately from non-lease components of the contract. Fees for activities or costs that do not transfer goods or services to the lessee, for example, maintenance, utilities costs, etc. are considered non-lease components and need to be identified and excluded from the lease.

However, the standard provides a practical expedient which permits a lessee to elect, by class of the underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.

Accordingly, in the above example, the amount of maintenance fees (INR0.1 million) would be considered as a non-lease component as it does not separately transfer any goods or services to the lessee. Company A has an option to recognise the amount of maintenance fees as part of lease payments following the practical expedient. However, if the practical expedient is not chosen, then the maintenance fees would be recognised as an expense as and when they are incurred.

Real estate is often subject to property taxes, calculated as an assessed value of the property multiplied by a tax rate. Depending on the jurisdiction, the legal obligation to pay the property tax is either levied on the property owner or on the occupier. This distinction is important for tenants to determine how to account for taxes levied on their leased properties.

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It appears that the accounting for property tax is driven by the identity of the statutory obligor. The identity of the party that makes the cash payment to the tax authority is less relevant.

If the lessor has the statutory obligation to pay the property taxes, but the lease agreement requires it to be reimbursed, or paid, by the lessee, then we believe that the lessee should account for the property taxes as part of the total consideration that is allocated to the separately identified components of the contract. If the property taxes are determined as a percentage of an assessed value of the property, then reimbursements thereof are typically variable payments that do not depend on an index or rate.

If the lessee has the statutory obligation to pay the property taxes, then we believe that the lessee should account for the property taxes as levies as explained in Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets.*

In some jurisdictions, the lessor and the lessee may be jointly liable for the property taxes - i.e. both parties are equally liable to pay the full amount. This may be the case if joint liability is specified by law, or liability is initially placed on the lessor but, in the event of non-payment, there are legal mechanisms in place that allow the tax authority to demand payment from the lessee. In this case, we believe that the lessee should account for the property taxes in the same way as it would if it were solely liable for them – as levies. This is because they are considered to be a tax that is levied on the lessee and are, therefore, not a lease payment.

## Discount rates

A lessee is required to discount the lease payment using the interest rate implicit in the lease if it can be readily determined. Otherwise, the lessee should use its incremental borrowing rate. Interest rate implicit in the lease is essentially a measure of the minimum return that the lessor expects to earn on a lease. On the other hand, lessee's incremental borrowing rate is the rate that the lessee expects to borrow at over a similar term and with a similar security. A lessee would often struggle to determine the interest rate implicit in the lease due to non-availability of all the information required to determine it.

**Example:** Company A enters into a lease arrangement. Key facts are as follows:

- *Lease commencement date:* 1 December 2018
- *Lease term:* Five years
- *Fixed lease payments during the initial lease term:* USD1 million per month
- *Underlying lease asset:* Contract manufacturing facility
- *Company A's functional currency:* INR.

Company A is a subsidiary of company P. The incremental borrowing rate for company P is readily available for an asset similar to the underlying asset in the above lease.

### Issue:

a. Can a subsidiary use the discount rate determined by its parent, in case both the companies have identical underlying assets? If not, what are the essential components of the discount rate that the subsidiary should consider?

b. Is the lease liability a monetary liability? If yes, how should company A account for the foreign exchange gains/(losses) on restatement?

### Analysis

The incremental borrowing rate as defined under Ind AS 116 is the rate that is determined at the contract or individual lease level. Factors that could impact incremental borrowing rate for a company could be company's credit rating, nature of the security, the amount of funds borrowed and the terms of the borrowings. A lessee could also operate in multiple jurisdictions and the economic environment in those jurisdictions would also influence its incremental borrowing rate. These factors could vary from lease to lease, resulting in different incremental borrowing rates for every lease. Accordingly, in the above example, company A cannot use the incremental borrowing rate determined by its parent, company P, even if it relates to an identical underlying asset.

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However, in some cases, it might be reasonable for a subsidiary to use its parent's or group's incremental borrowing rate as an input and would need to adjust it as needed when determining the appropriate discount rate for a lease. For instance, this might be appropriate when the subsidiary does not have its own treasury function, all funding for the group is managed centrally by the parent and this results in the parent providing a guarantee of the lease payments to the lessor.

On transition to Ind AS 116, under modified retrospective approach, a lessee may opt to determine a single discount rate for a portfolio of leases with similar characteristics if it reasonably expects that this approach would not differ materially from applying the standard to the individual leases within that portfolio.

With respect to right-of-use asset and related lease liability, it should be noted that the right-of-use asset is a non-monetary asset while the lease liability is a monetary liability. Therefore, for a lease denominated in a foreign currency, remeasurement into the lessee's functional currency is required using the following rate:

| Particulars | Current exchange rate | Commencement date exchange rate |
|---|---|---|
| Lease liability | Yes | No |
| Right-of-use asset | No | Yes |

Source: KPMG LLP's publication *'Leases - Issues In-Depth - US GAAP'*, April 2016

Any foreign currency exchange differences relating to lease liabilities denominated in a foreign currency should be recognised in the statement of profit and loss.

## Others

### Security deposit

Another important concern relates to the treatment of security deposits and advance rentals made by a lessee to the lessor. Security deposit is generally held by the lessor throughout the term of the lease and is refunded in full to the lessee at the end of the lease term (if the lessee has performed fully and observed all the conditions or provisions in the lease). However, the lessor may apply the security deposit to remedy the breach of any provisions in the lease contract and to indemnify any consequential costs and losses related to the leased property that are properly chargeable to the lessee under the contract.

Security deposit itself is not part of the lease payments. An entity needs to carefully consider the terms and conditions of the agreement to determine whether the security deposit, in whole or in part, is in the scope of Ind AS 109, *Financial Instruments* and, if so, the contractual terms of the financial instrument. The difference between the initial carrying amount of the deposit (which may be fair value if the deposit is in the scope of Ind AS 109) and the nominal value of the deposit is an additional lease payment made by the lessee and it should, therefore, be included in the measurement of the right-of-use asset.

### Inter-company lease arrangements

Inter-company lease arrangements that were previously classified as operating leases by both the lessee and the lessor may no longer attract equal and opposite accounting in each group company's accounts.

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**Example:** Company A enters into a lease arrangement with company P, its parent company. Key facts are as follows:

- *Lease commencement date:* 1 December 2018
- *Lease term:* Five years
- *Fixed lease payments during the initial lease term:* USD1 million per month
- *Underlying lease asset:* Contract manufacturing facility
- *Company A's functional currency:* INR.

**Issue:** How should the inter-company lease arrangement be accounted in the separate and consolidated financial statements of a parent company?

## Analysis

Under Ind AS 17, accounting for inter-company leases was straightforward. There was automatic elimination of rent income of a lessor with the rent expense of a lessee on consolidation as follows:

| Lessor | Lessee |
|---|---|
| **Underlying asset:**<br>Asset<br>Depreciation<br>**Lease:**<br>**Rent income** | **Lease:**<br>**Rent expense**<br><br>**Eliminates automatically** |

However, under Ind AS 116, inter-company leases will not eliminate automatically on consolidation. Rather it will be a complex elimination journal.

| Lessor | Lessee |
|---|---|
| **Underlying asset:**<br>Asset<br>Depreciation<br>**Lease:**<br>**Rent income** | **Lease:**<br>**Right-of-use asset**<br>**Lease liability**<br>**Depreciation**<br>**Interest expense**<br>**Complex elimination journal** |

Source: KPMG IFRG's presentation *'The new leases standard - intercompany leases'*

## Conclusion

Companies should carefully evaluate the requirements of the standard in light of its own facts, circumstances and individual transactions and should consider providing adequate disclosures of the effects of the new standard to the investors and other stakeholders.

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# Ind AS 115 disclosures - an analysis of Nifty50 annual reports

This article aims to:

- Highlight the disclosures provided by Nifty50 companies on adoption of Ind AS 115, *Revenue from Contract with Customers.*

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## Introduction

On 28 March 2018, the Ministry of Corporate Affairs (MCA) notified Ind AS 115, *Revenue from Contracts with Customers* which is based on IFRS 15, *Revenue from Contracts with Customers*. The standard is effective for accounting periods beginning on or after 1 April 2018 for all companies applying Ind AS. The revenue standard brings in new model for revenue recognition that is based on the transfer of control. It is a significant change from the earlier applicable revenue guidance and changed the way companies recognise, present and disclose their revenue. It applies to all revenue contracts with customers including construction contracts. The annual report of the financial year ended 31 March 2019 is the first annual report where companies presented the disclosure relating to revenue recognition as per Ind AS 115 framework.

Ind AS 115 contains extensive disclosure requirements as compared to those under the erstwhile standards including more disaggregated information about revenue and more information about performance obligations remaining at the reporting date. The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

## About the analysis

The annual reports presented by the companies for year ended 31 March 2019 are the first full set of financial statements as per Ind AS 115 framework. Therefore, to understand the insights that these annual reports provide on the impact of Ind AS 115 on revenue recognised, we have analysed the disclosures given in the annual reports by the Nifty50 companies for the year ended 31 March 2019.

In our analysis of Nifty50 companies, we have excluded seven companies that are banks as Ind AS is not yet applicable to them. We have excluded four Non-Banking Financial Companies (NBFCs) as well from our analysis as impact of adoption of Ind AS 115 on NBFCs would be different from corporate entities. Accordingly, our analysis is based on balance 39 companies (covered companies).

Therefore, in the subsequent section of this article, we have analysed the disclosures relating to revenue recognition as per Ind AS 115 presented by the covered companies in their annual reports for year ended 31 March 2019.

## Our observations

### Ind AS 115 transition approach

Ind AS 115 provides two methods of accounting i.e. the retrospective method (with or without one or more of four practical expedients) and the cumulative effect method.

Under the retrospective method, an entity is required to restate each period before the date of initial application that is presented in the financial statements. The date of initial application is the start of the reporting period in which an entity first applies the new standard i.e. 1 April 2018.

The entity recognises the cumulative effect of applying the new standard in equity at the start of the earliest comparative period presented. An entity that elects to apply the new standard using the retrospective method can choose to do so on a full retrospective basis or with one or more practical expedients.

While under the cumulative effect method, an entity applies the new standard as of the date of initial application, without restatement of comparative period amounts. The entity records the cumulative effect of initially applying the new standard as an adjustment to the opening balance of equity at the date of initial application.

Entities are required to provide the qualitative and quantitative disclosures relating to the transition approach followed such as:

- Transition method selected
- Practical expedients followed
- Description of the nature and effect of the change due to adoption of Ind AS 115
- Quantitative impact of adoption of Ind AS 115 on financial statement line item, etc.

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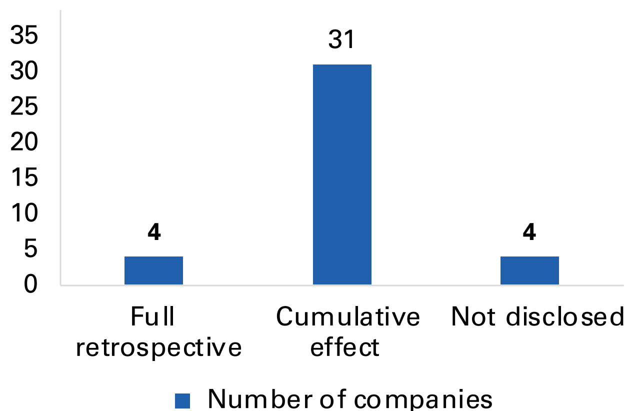
The following chart depicts the approach followed by covered companies for transition to Ind AS 115:

**Transition approach**

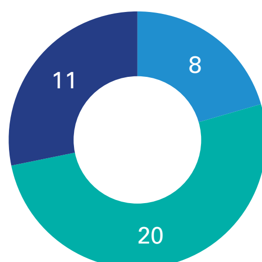



Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

Out of 39 companies analysed, 31 companies followed the cumulative effect method to transition to Ind AS 115 while four companies followed full retrospective method. We found that balance four companies did not make a disclosure of the method used for transition to Ind AS 115.

Application of Ind AS 115 was expected to result in changes in judgements that may affect determination of the amount and timing of revenue recognised. Out of 39 companies, 28 companies have presented a note relating to transition approach followed, by disclosing that there is a change in accounting policy due to adoption of Ind AS 115. These companies have also presented the impact of change in accounting policy on financial statements as part of Ind AS 115 disclosures. Balance 11 companies have not presented qualitative disclosure relating to impact of Ind AS 115.

The following chart represents the 'disclosure of the impact of transition' to Ind AS 115:




Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

We further analysed 28 companies (that provided the disclosure relating to transition approach) to understand the quality of disclosures provided. We found that only eight companies have disclosed detailed disclosure on nature of the adjustments and the reasons for the changes in the financial performance of the company. The disclosures also contain the quantitative impact of Ind AS 115 on net worth, revenue, or profits.

Balance 20 companies disclosed that the adoption of Ind AS 115 did not have any material impact on revenue and in certain cases only led to reclassification of certain financial line items without impacting financial performance of the company. The reason for limited impact of transition to Ind AS 115 could be that majority of the companies have adopted the cumulative effect method of transition to Ind AS 115.

### Accounting policy

Revenue is the most important measure of financial performance of the company. Therefore, the accounting policy on revenue recognition is considered to be one of the most important accounting policy. Ind AS 115 provides significant new requirements relating to revenue recognition, for example, it excludes transfer of risks and rewards approach for recognising revenue and has introduced a new, five step, revenue recognition model.

Thus, the adoption of Ind AS 115 requires entities to reassess their accounting policy disclosures. Ind AS 115 provides specific requirements relating to revenue recognition and associated costs which require entities to provide detailed disclosure of accounting policy relating to revenue recognition.

In our analysis, we observed that all the companies have provided an accounting policy on revenue recognition and have provided disclosure of the 'amounts' of revenue recognised into its various categories such as sale of goods and services. However, the quality and details given in the disclosure varies from company to company.

We found that only 13 companies have provided comprehensive revenue recognition policy in relation to sale of products and services and balance 26 companies have followed a checklist approach and not explained the accounting policy in detail.

### Disaggregation of revenue

Ind AS 115 requires the disclosure of revenue into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. An entity is also required to disclose information to enable users to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment.

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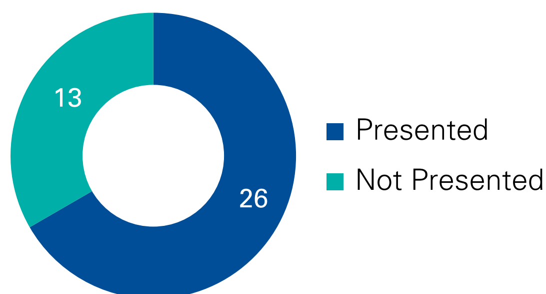
In determining these categories, an entity considers how revenue is disaggregated in:

- Disclosures presented outside the financial statements – e.g. earnings release, annual reports or investor presentations
- Information reviewed by the chief operating decision maker for evaluating the financial performance of operating segments
- Other information similar to above that is used by the entity or users of the entity's financial statements to evaluate performance or make resource allocation decisions.

*Observation*

Out of 39 companies, 26 companies presented disaggregation of revenue while 13 companies did not provide this disclosure. Examples of disaggregation which 26 companies generally presented include type of goods or services, geography, market, types of customers and types of contracts.

The following chart shows the comparison of covered companies regarding presentation of the disaggregation of revenue information:

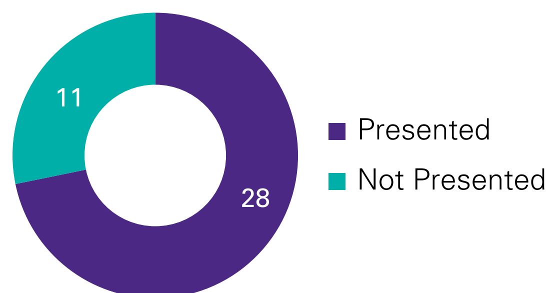



Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

## Other disclosure requirements under Ind AS 115

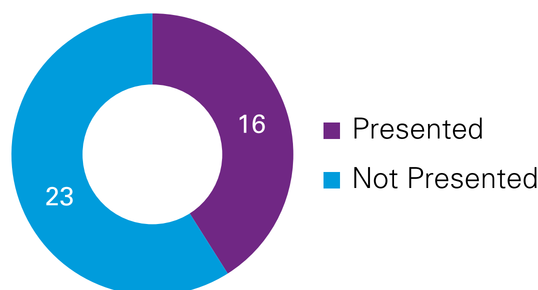
Following section depicts some of the disclosure requirements which are new, and companies were expected to provide detailed disclosure of such requirements. We analysed these disclosures and have showcased the results with the help of pie charts.

I. Narrative disclosure to describe changes in contract balances such as opening and closing balances related to contracts with customers.



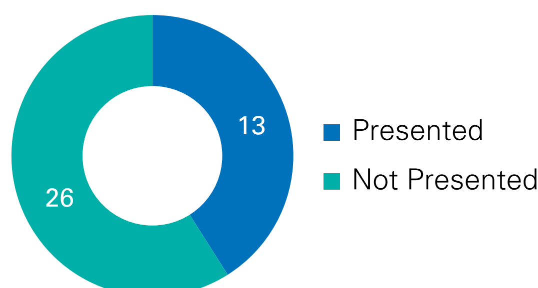

Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

II. Significant changes in the balances of contract assets and contract liabilities, including both qualitative and quantitative information.




Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

III. Revenue recognised in the current period from performance obligations satisfied (or partially satisfied) in previous periods.




Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

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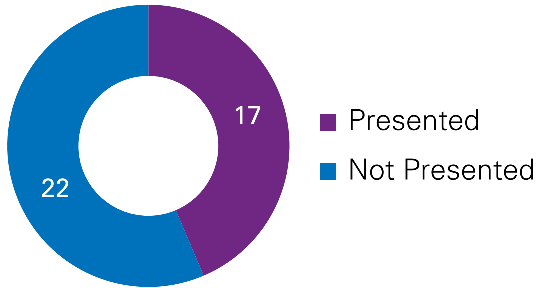
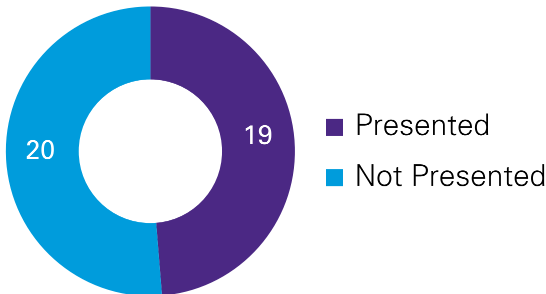
IV. The aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the reporting date. A quantitative (using time bands) or a qualitative explanation of when an entity expects that amount to be recognised as revenue is also required.



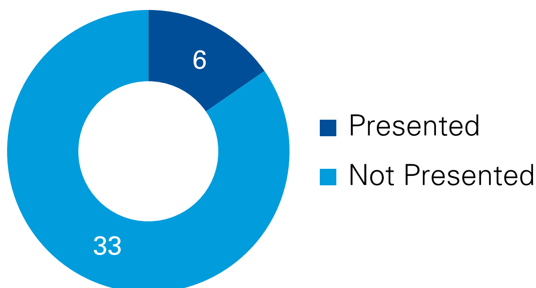

Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

V. Significant judgements when applying the standard[1]



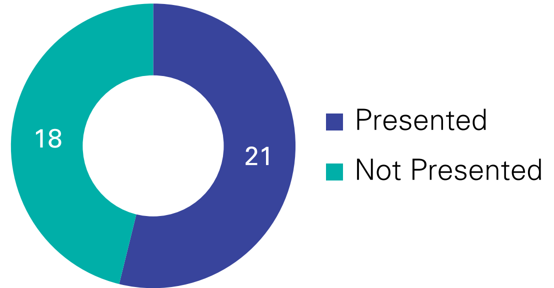

Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty 50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

VI. Disclose information about the assets recognised from the costs incurred to obtain or fulfil a contract.




Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

VII. Reconciliation of the amount of revenue recognised in the statement of profit and loss with the contracted price showing separately each of the adjustments made to the contract price specifying the nature and amount of each such adjustment separately.




Source: KPMG in India's analysis based on the primary data gathered from annual reports of Nifty50 companies (excluding banks and NBFCs) for the year ended 31 March 2019

## Conclusion

Ind AS 115 is a complex standard that contains both qualitative and quantitative disclosure requirements for annual and interim periods. The above charts describe some of the disclosure requirements of Ind AS 115. The standard contains many more line items for which disclosures have to be provided. We expect that as companies gain experience in applying the standard, they would continue to assess the impact of Ind AS 115 and provide detailed disclosures.

1. As per Ind AS 115, companies need to disclose judgements made in applying the new standard that affect the determination of the amount and timing of revenue recognition. While performing our analysis on the covered companies we found certain examples of significant judgements that companies have presented. These examples of areas of significant judgements are the timing of the satisfaction of performance obligations, determination of the transaction price including estimation of variable consideration and amounts allocated to performance obligations.

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# Accounting for guarantee fee paid to a party other than a lender

This article aims to:

- Discuss the accounting treatment of guarantee fee paid (subsequent to initial payment) to a party other than the lender while computing effective interest rate on financial liability.

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## Introduction

Ind AS 109, *Financial Instruments* requires financial instruments to be initially recognised at their fair value (i.e. generally the transaction price) plus or minus directly attributable transaction costs. Ind AS 109 also introduces the concept of Effective Interest Rate (EIR) for financial instruments measured at amortised cost and defines it as 'the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability'. The EIR thus computes the effective interest earned on loans granted/effective cost incurred on loans received.

In addition, financial assets (excluding equity instruments) that are classified into the Fair Value through Other Comprehensive Income (FVOCI) category also require the application of the EIR method for recognition of interest income.

The EIR is calculated on initial recognition of a financial instrument and considers all contractual terms of the instrument and other fees and transaction costs that are an integral part of the EIR of a financial instrument.

In this article we aim to discuss the accounting for guarantee fee paid subsequent to initial payment to a party other than the lender while computing EIR.

## Background

The Expert Advisory Committee (EAC)[1] of the Institute of Chartered Accountants of India (ICAI) has considered an issue on accounting treatment of guarantee fee paid to the Government of India (GOI) in relation to the loan taken by an entity from a foreign lender. On the basis of this issue, it issued an opinion on 'Computation of Effective Interest Rate on Borrowings'.

In the given case, a power sector entity entered into a loan agreement for Euro500 million with a foreign lender for financing its projects. The loan agreement with the lenders sets out the rate of interest and fees payable by the company to the lenders. This loan is guaranteed by GOI for due and punctual payment of the principal, interest and other charges through separate guarantee agreement. The company is required to pay an initial guarantee fee to the GOI on the sanctioned amount and thereafter, subsequent guarantee fee is payable on first April of every year on the amount outstanding at the beginning of the year as per the office memorandum of Ministry of Finance, GOI.

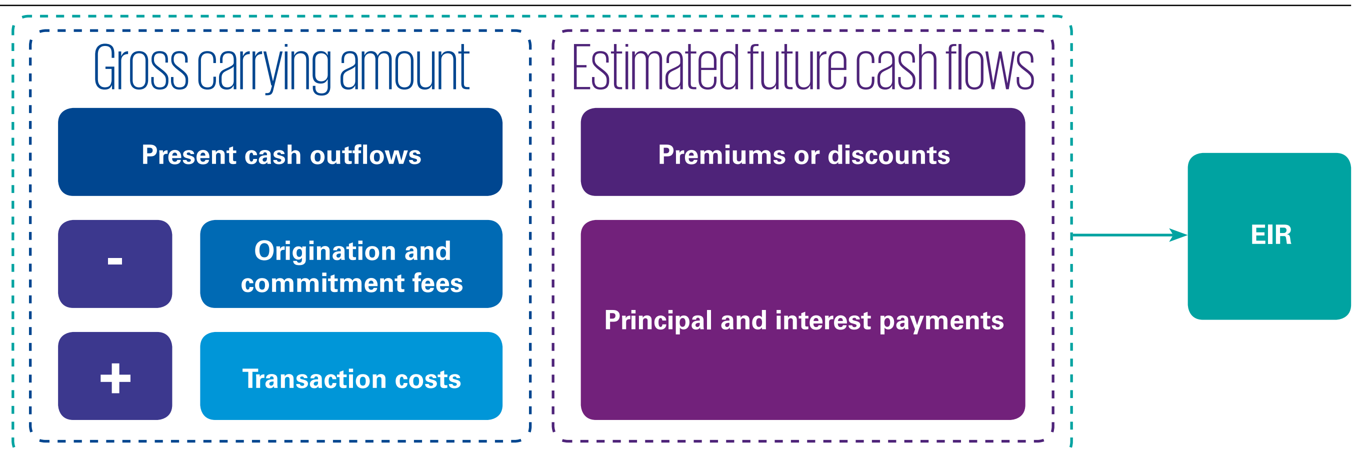
As per the loan agreement, guarantee provided by the GOI in this case is a precondition for obtaining and continuing with the loan facility. As per the terms of the agreement, in case the loan continues, guarantee will also continue and therefore, during the term of loan, the guarantee is not cancellable.

## Accounting issue

The company initially recognised the foreign loan at fair value minus transaction costs and subsequently measured at amortised cost using the EIR method as per Ind AS 109. However, while calculating the EIR on above mentioned borrowing, the company only considered the cash flows arising under the loan agreement towards interest and fees payable to the lenders. The guarantee fee is not payable to the lenders, but it is payable to the GOI. An issue arose whether the guarantee fee should be considered for the purpose of computing the EIR.

## Accounting guidance

Figure 1 below demonstrates the factors to be considered while computing EIR of a financial instrument.




Source: KPMG in India's analysis, 2019, read with Ind AS 109

1. ICAI Journal, The Chartered Accountant, August 2019 edition.

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As per Appendix A to Ind AS 109, when calculating the EIR, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest, transaction costs, and all other premiums or discounts.

## Analysis

Ind AS 109 provides that in applying the EIR method, an entity identifies transaction costs and fees that are an integral part of the EIR of a financial instrument. Fees that are an integral part of the EIR of a financial instrument are treated as an adjustment to the EIR, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss.

In addition, Ind AS 109 provides examples of fees that are an integral part of the EIR of a financial instrument. Origination fees paid on issuing financial liabilities measured at amortised cost is an example of fees that is an integral part of EIR method. While transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties, transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Additionally, transaction costs are incremental costs that are directly attributable to the acquisition or issue of a financial liability. Ind AS 109 further clarifies that an incremental cost is one that would not have been incurred if the entity had not acquired or issued the financial instrument.

In the context of given case, EAC concluded on the basis of the guidance in Ind AS 109, the guarantee fee paid to GOI (initially as well as subsequently) is an incremental cost which is directly attributable to the acquisition of the loan facility as this cost would not have been incurred if the company had not incurred the loan liability. Additionally, the terms of loan agreement specify that the guarantee provided by the GOI in this case is a precondition for obtaining and continuing with the loan facility. Therefore, the financial guarantee fee paid (initially as well as subsequently) by the company should be considered for computation of EIR while measuring the loan liability at amortised cost to comply with Ind AS 109.

## Conclusion

The companies should evaluate the costs incurred in relation to borrowings for determining whether the costs incurred are incremental costs and are directly attributable to the acquisition or issue of a financial liability. Consider all the relevant facts and circumstances and available guidance while arriving at an appropriate conclusion.

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# Regulatory updates

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## MCA notifications relating to maintenance of data bank of independent directors

### Background

Section 150 of the Companies Act, 2013 (2013 Act) provides that an independent director may be selected from a data bank maintained by any body, institute or association, as may by notified by the Central Government (CG). A company needs to ensure exercise of due diligence before selecting an independent director from the data bank.

### New development

On 22 October 2019, the Ministry of Corporate Affairs (MCA) has issued following notifications relating to the creation and maintenance of the data bank of independent directors:

a. **Constitution of institute for data bank:** The MCA has notified Indian Institute of Corporate Affairs (institute) at Manesar (Haryana) as an institute which would create and maintain an online data bank of persons who are eligible and willing to act as independent directors[1]. The notification is effective from 1 December 2019.

b. **Notification of Companies (Creation and Maintenance of data bank of Independent Directors) Rules, 2019:** The Rules provide the manner of creation and maintenance of data bank by the institute along with its duties. The Rules are effective from 1 December 2019 (except those relating to definitions and panel to be created for approving the courses and study material of the institute).

c. **Compliances required by the independent directors:** The MCA has amended Rule 6 of the Companies (Appointment and Qualifications of Directors) Rules. As per the amendment, following individuals should apply online to the institute for inclusion of their names in the data bank for a period of one year or five years or for their life-time:

   i. *Every individual who has been appointed as an independent director in a company as on 1 December 2019:* Within a period of three months from 1 December 2019 i.e. up to 29 February 2020 and

   ii. *Every individual who intends to get appointed as an independent director in a company after 1 December 2019:* Before such appointment.

   Every individual whose name is included in the data bank is required to pass an online proficiency self-assessment test (with 60 per cent score in aggregate) conducted by the institute within a period of one year from the date of inclusion of his/her name in the data bank, failing which, his/her name shall stand removed from the data bank of the institute[2].

   However, an individual will not be required to pass the online proficiency test in case, he/she has served for a period of 10 years[3] or more as on the date of inclusion of his/her name in the data bank as a director or a key managerial personnel in a listed public company or in an unlisted public company with a paid-up share capital of INR10 crore or more.

   The amendments are effective from 1 December 2019.

d. **Additional disclosure in board's report:** The MCA has amended Rule 8 of the Companies (Accounts) Rules. As per the amendment, the board's report should also contain 'a statement regarding opinion of the board of directors with regard to integrity, expertise and experience (including the proficiency[4]) of the independent directors during the year'. The amendment is effective from 1 December 2019.

(Source: MCA notifications dated 22 October 2019)

## Amendment to Schedule VII of the Companies Act, 2013

Schedule VII of the 2013 Act lays down a list of activities which are eligible for the Corporate Social Responsibility (CSR) expenditure and can be included by companies in their CSR policies. These, *inter alia,* includes, contributions or funds provided to technology incubators located within academic institutions which are approved by the CG.

On 11 October 2019, MCA through its notification amended Schedule VII of the 2013 Act. As per the amendment, CSR policy of a company may include 'contributions to:

a. Incubators funded by CG, State Government (SG), any agency or Public Sector Undertaking (PSU) of CG or SG or

1. This would include individuals already serving as independent directors on the board of companies.
2. No limit on number of attempts for the test.
3. For the purpose of computation of 10 years, any period during which an individual was acting as a director or as a key managerial personnel in two or more companies at the same time shall be counted only once.
4. Proficiency would mean the proficiency of the independent director as ascertained from the online proficiency self-assessment test conducted by the institute notified by the MCA.

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b. Public funded universities, Indian Institute of Technology (IITs), national laboratories and autonomous bodies (established under the auspices of Indian Council of Agricultural Research (ICAR), Indian Council of Medical Research (ICMR), Council of Scientific and Industrial Research (CSIR), Department of Atomic Energy (DAE), Defence Research and Development Organisation (DRDO), Department of Science and Technology (DST), Ministry of Electronics and Information Technology) engaged in conducting research in science, technology, engineering and medicine aimed at promoting Sustainable Development Goals (SDGs)'.

The amendment is effective from 11 October 2019.

(Source: MCA notification no. G.S.R. 776(E) dated 11 October 2019)

## ITFG clarifications' bulletin 22 and 23

The Ind AS Technical Facilitation Group (ITFG) of the Institute of Chartered Accountants of India (ICAI) issued its clarifications' bulletin 22 and 23 on 14 October 2019 and 26 October 2019 respectively. The bulletins provide clarifications on issues relating to application of Indian Accounting Standards (Ind AS) as follows:

- Recognition exemption for short-term leases under Ind AS 116, *Leases*
- Accounting for lease rental income under Ind AS 116
- Accounting for mining lease rights under Ind AS
- Applicability of Ind AS 115, *Revenue from Contracts with Customers* to distribution of gifts
- Restatement of financial statements in case of common control business combinations
- Accounting treatment of interest on loan obtained from a director
- Impact of change in tax rates while computing current tax and deferred tax assets/liabilities for the quarter/half-year ended 30 September 2019
- Remeasurement of deferred tax assets/liabilities on account of change in tax rates.

(Source: ICAI-ITFG clarifications' bulletin 22 and 23 dated 14 October 2019 and 26 October 2019)

## SEBI issues norms for resignation of statutory auditors of listed entities and their material subsidiaries

On 18 October 2019, the Securities and Exchange Board of India (SEBI) has issued a circular and prescribed conditions to be compiled with in case of resignation of the statutory auditor of a listed entity or its material subsidiary with respect to the limited review or auditor's report.

As per the prescribed conditions:

c. **In case an auditor resigns within 45 days from the end of a quarter:** An auditor should, before resignation, issue the limited review/audit report for such quarter.

d. **In case an auditor resigns after 45 days from the end of a quarter:** An auditor should, before resignation, issue the limited review/audit report for such quarter and the next quarter.

e. **In case an auditor has signed the limited review/audit report for the first three quarters of a financial year:** An auditor should, before resignation, issue the limited review/audit report for the last quarter of such financial year and the audit report for the financial year.

The above conditions would be included in the terms of appointment of the statutory auditor at the time of appointment/re-appointment. In case the statutory auditor has already been appointed, the terms of appointment should be modified accordingly.

The circular also prescribes the manner in which the matters of concern, if any, with the management of the listed entity/material subsidiary, which are expected to hamper the audit process, are to be reported by an auditor.

Additionally, it provides the format in which a listed entity is required to obtain information from the statutory auditor of the listed entity/material subsidiary upon resignation which includes the detailed reasons for such resignation. The format should be disclosed (as part of material deemed events) by the listed entity to the stock exchange(s) within 24 hours from its receipt.

The provisions of the circular are effective from 18 October 2019.

(Source: SEBI circular no. CIR/CFD/CMD1/114/2019 dated 18 October 2019)

## SEBI issues revised buy-back norms for listed companies

On 19 September 2019, SEBI has issued the SEBI (Buy-Back of Securities) (Second Amendment) Regulations, 2019 and made certain amendments to the buy-back norms. The amendments relate to identification of thresholds for compliance with the prescribed conditions for buy-back of securities.

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The amendments are as follows:

- **Special resolution:** Currently, buy-back is required to be authorised by the articles of the company and a special resolution should be passed at its general meeting.

  However, authorisation by articles and a special resolution is not required to be passed if the buy-back is less than 10 per cent of the total paid-up equity capital and free reserves of the company and an ordinary resolution has been passed at its meeting.

  The amendments clarified that the above limit of 10 per cent of the total paid-up equity capital and free reserves should be based on both stand-alone financial statements and Consolidated Financial Statements (CFS) of the company.

- **Maximum limit of buy-back:** As per the amendment, the maximum limit of buy-back (i.e. 25 per cent or less of the aggregate of paid-up capital and free reserves of the company) should be considered on the basis of both stand-alone financial statements and CFS of the company.

- **Post buy-back debt-to-capital and free reserves ratio:** One of the important conditions for buy-back requires a listed company to ensure that the ratio of the aggregate of secured and unsecured debts owed by the company after buy-back should not be more than twice the paid-up capital and its free reserves. A higher ratio could be prescribed by the CG.

  The amendments clarified following with respect to:

  - *Listed companies with Non-Banking Financial Companies (NBFCs) and Housing Finance Companies (HFCs) as subsidiaries:* These companies should compute the post buy-back debt to capital and free reserves ratio of 2:1 on the basis of both their stand-alone financial statements and CFS. Also, while computing the ratio, financial statements of all subsidiaries that are NBFCs and HFCs regulated by the Reserve Bank of India (RBI) or National Housing Bank (NHB) should be excluded.

    The buy-back would be permitted if the subsidiaries (i.e. NBFC and HFC) also have debt (secured and unsecured) to paid-up capital and free reserves ratio of not more than 6:1 on a stand-alone basis.

  - *Other listed companies:* The post buy-back debt to capital and free reserves ratio of 2:1 (except for companies for which higher ratio of the debt to capital and free reserves has been notified under the 2013 Act) should be considered on the basis of both stand-alone financial statements and CFS of the company.

- **Method of buy-back:** Currently, a company can buy-back its shares or other specified securities following certain prescribed methods which, *inter alia,* includes buy-back from open market through book-building process or stock exchange. However, buy-back from open market should be less than 15 per cent of the paid-up capital and free reserves of the company.

  The amendments clarified that the above threshold for open market (i.e. 15 per cent of the paid-up capital and free reserves) should be based on both stand-alone financial statements and CFS of the company.

The amendments are effective from 19 October 2019.

(Source: SEBI (Buy-Back of Securities) (Second Amendment) Regulations, 2019 dated 19 September 2019)

## SEBI issues revised norms for companies listed on Innovators Growth Platform (IGP)

On 23 September 2019, SEBI has issued certain amendments to the SEBI (Issue of Capital and Disclosure Requirements) Regulations (ICDR Regulations). The amendments, *inter alia,* grant an option to a company listed on IGP pursuant to Initial Public Offer (IPO) to trade under the regular category of the main board of the stock exchange subject to specified conditions.

The key conditions are as follows:

- The company has listed its specified securities for a minimum period of one year on the IGP of a recognised stock exchange.
- It has minimum 200 shareholders at the time of making an application for trading under the regular category.
- The company, any of its promoters, promoter group or directors are not debarred from accessing the capital market by SEBI.

The amendments also prescribe the eligibility requirements for a company to trade under the regular category of the main board of SEBI.

The amendments are effective from 23 September 2019.

(Source: SEBI (ICDR) (Fourth Amendment) Regulations, 2019 dated 23 September 2019)

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## Clarifications in relation to the Taxation Laws (Amendment) Ordinance, 2019

### Background

On 20 September 2019, the Ministry of Law and Justice issued the Taxation Laws (Amendment) Ordinance, 2019 (ordinance) and made certain amendments to the provisions of the Income-tax Act, 1961 (IT Act) and the Finance (No. 2) Act, 2019.

The key amendments made by the ordinance, *inter alia,* include:

- Tax concession for domestic companies
- Tax concession for new domestic manufacturing companies
- Reduction in Minimum Alternate Tax (MAT) rate including removal of MAT for companies availing the concessional tax rates.

### New development

On 2 October 2019, the Central Board of Direct Taxes (CBDT) issued a circular which clarifies that the provisions of Section 115JB of the IT Act relating to MAT itself shall not be applicable to a domestic company which exercises option under Section 115BAA of the IT Act (i.e. pays income-tax at a concessional rate of 22 per cent). Therefore, tax credit of MAT paid by a domestic company exercising option under Section 115BAA of the IT Act shall not be available consequent to exercising of such option.

Additionally, it provides that a domestic company which would exercise option for availing benefit of lower tax rate under Section 115BAA of the IT Act shall not be allowed to claim set-off of any brought forward loss on account of additional depreciation for an Assessment Year (AY) for which the option has been exercised and for any subsequent AY.

(Source: CBDT circular No. 29/2019 dated 2 October 2019)

## Amendments to IFRS pursuant to benchmark interest rate reform

On 26 September 2019, the International Accounting Standards Board (IASB) issued amendments to International Financial Reporting Standard (IFRS) 9, *Financial Instruments,* International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* and IFRS 7, *Financial Instruments: Disclosures.*

The amendments modify some specific hedge accounting requirements to provide relief from potential effects of the uncertainty caused by the Inter-Bank Offer Rates (IBOR) reform. Additionally, the amendments require companies to provide additional information to investors about their hedging relationships which are directly affected by these uncertainties.

The amendments will be effective for annual reporting periods beginning on or after 1 January 2020. Early application is permitted.

*For a detailed read, please refer KPMG in India's First Notes on 'Amendments to IFRS pursuant to benchmark interest rate reform' dated 22 October 2019.*

(Source: IASB notification dated 26 September 2019)

## Extension of last date of filing e-Form BEN-2 under the Companies Act, 2013

The Ministry of Corporate Affairs (MCA) through a circular dated 24 September 2019 has extended the last date of filing e-Form BEN-2 (Return of significant beneficial owners in shares by the reporting company) to 31 December 2019 without an additional fee.

(Source: MCA general circular No. 10/2019 dated 24 September 2019)

## Norms for lending by banks to Infrastructure Investment Trusts (InvITs)

The Reserve Bank of India (RBI) through a circular dated 14 October 2019 prescribe conditions subject to which banks are permitted to lend to InvITs. These, *inter alia,* includes the following:

- Banks are required to put in place a board approved policy on exposures to InvITs which should include, cover appraisal mechanism, sanctioning conditions, internal limits, monitoring mechanism, etc.
- Banks should undertake an assessment of all critical parameters including sufficiency of cash flows at InvIT level to ensure timely debt servicing.
- Banks should also monitor the performance of the underlying Special Purpose Vehicles (SPVs) on an ongoing basis.

The audit committee of the board of banks is required to review the compliance with the prescribed conditions on a half-yearly basis.

(Source: RBI notification no. RBI/2019-20/83 dated 14 October 2019)

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## Renewed focus on auditor independence matters under US GAAP

There has been a renewed focus on auditor independence matters from the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) in the last quarter. The SEC has amended the Loan Provision independence rules. The SEC's Office of the Chief Accountant (OCA) updated its Frequently Asked Questions (FAQs) on application of the SEC's rules on auditor independence. Additionally, the PCAOB issued a staff guidance for auditors and audit committees on the topic. These are explained as below:

### Loan Provision

Currently, the SEC's Loan Provision specifies that an accountant is not independent when the accounting firm, or any covered person, has a loan to or from:

- An audit client
- The client's officers and directors or
- Record or beneficial owners of more than 10 per cent of the audit client's equity securities.

The SEC observed that the existing rule resulted in an unexpected rate of non-compliance. However, certain violations may not impair the objectivity of an auditor. Therefore, a high rate of non-compliances may cause audit committees and other stakeholders to become desensitised to violations of the independence rules. Therefore, the SEC amended its auditor independence rules governing loans and debtor-creditor relationships (Loan Provision).

The key amendments to the Loan Provision are as follows:

- **Type of ownership:** Focus the analysis on beneficial ownership rather than on both record and beneficial ownership. The SEC believes that amending the Loan Provision to focus on the beneficial ownership of the audit client's equity securities will more effectively identify shareholders 'with a special and influential role with the issuer' and, therefore, better capture those debtor-creditor relationships that may impair the auditor's independence.
- **Ownership test:** Replace the existing 10 per cent bright-line shareholder ownership test with a significant influence test similar to other SEC rules and based on the concepts in equity method and joint venture guidance. The amended Loan Provision is more aligned with circumstances representing threats to an audit firm's independence. The SEC believes that in situations where the lender is unable to influence an audit client through its holdings, the lender's ownership of an audit client's equity securities alone would not threaten an audit firm's objectivity and impartiality.
- **Identifying beneficial ownership:** Add a 'known through reasonable inquiry' standard with respect to the identification of beneficial owners of the audit client's equity securities. An audit firm, in coordination with its audit client, would only be required to analyse whether beneficial owners of the audit client's equity securities that are known through reasonable inquiry have significant influence over the audit client.
- **Definition of an audit client:** For purposes of the Loan Provision, the amended rule excludes from the definition of audit client, for a fund under audit, any other fund (e.g. a 'sister fund') that otherwise would be considered an affiliate of the audit client.

The amendments are effective from 3 October 2019.

### FAQs on application of SEC's rules on auditor independence

Recently, the OCA has issued its updated FAQs on the SEC's rules on auditor independence. The FAQs provide guidance on some of the common situations encountered by companies and their auditors.

The key clarifications provided in the FAQs relates to the following:

- **Acceptance of gifts or entertainment from an audit client:** All relevant facts and circumstances associated with the giving or acceptance of gifts or entertainment from an audit client should be considered to evaluate whether the accountant will or will not be deemed independent under the general standard.
- **Applicability of 'not subject to audit' exception[5] to prohibited services (bookkeeping, internal audit outsourcing, valuation services, actuarial services, financial information system design and implementation) provided to separate entities under common control:** If the separate entities under common control have autonomous financial and business operations and the audit firm audits one of the entities, then the audit firm may be able to apply the 'not subject to audit' exception to entities that it does not audit.

  However, the 'not subject to audit exception' will not apply in other contexts such as a traditional corporate entity or an investment company complex, where the financial and business operations would not be autonomous.

5. Such services are allowed to an audit client *when it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.*

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### Staff guidance for auditors and audit committees

The PCAOB staff has issued a guidance on the independence-related communications with audit committees when an auditor identifies one or more violations of independence rules.

The staff guidance indicates that audit committees should separately evaluate the auditor's conclusions and decide whether to continue the audit engagement.

If the auditor and audit committee separately determine that the auditor's ability to remain objective and impartial in its judgements has not been impaired, either in fact or from the perspective of a reasonable investor:

- The auditor's annual independence affirmation (i.e. Rule 3526 communication) is modified to state that the auditor would be independent except for the violation(s) it has identified and discussed with the audit committee and
- The title of the auditor's report remains 'Report of Independent Registered Public Accounting Firm'.

The staff guidance also includes an example disclosure that the auditor might provide to the audit committee when the auditor has determined that, notwithstanding a violation, it has retained its ability to remain objective and impartial in its judgements.

(Source: KPMG LLP's publication - Defining Issues dated 2 July 2019 and 10 July 2019, KPMG LLP's Quarterly Outlook – September 2019 and FAQs issued by OCA dated 27 June 2019)

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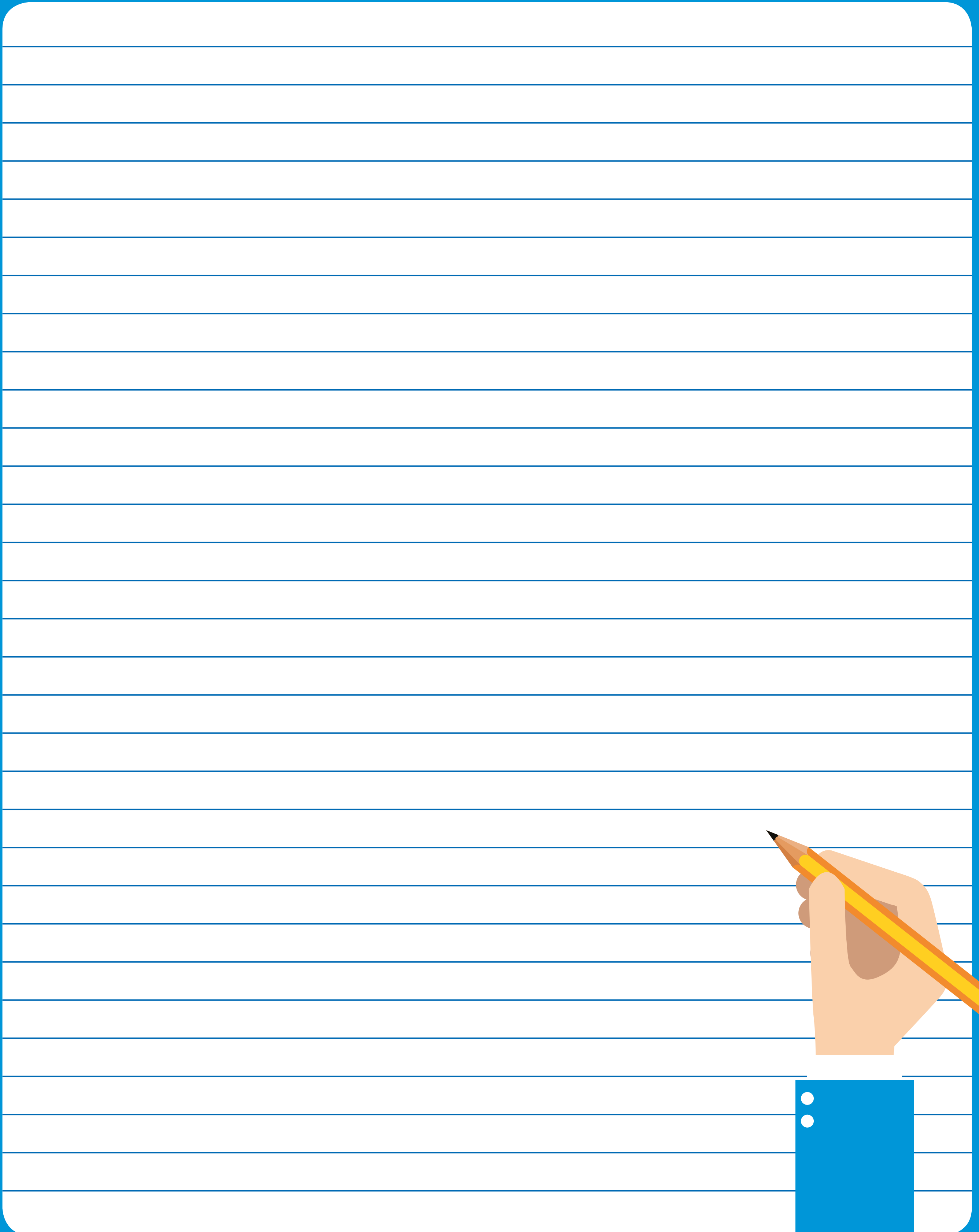
# Notes



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## 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.

## First Notes

**Amendments to IFRS pursuant to benchmark interest rate reform**

**22 October 2019**

On 26 September 2019, the International Accounting Standards Board (IASB) issued amendments to International Financial Reporting Standard (IFRS) 9, *Financial Instruments,* International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* and IFRS 7, *Financial Instruments: Disclosures.*

The amendments modify some specific hedge accounting requirements to provide relief from potential effects of the uncertainty caused by the Inter-Bank Offer Rates (IBOR) reform. Additionally, the amendments require companies to provide additional information to investors about their hedging relationships which are directly affected by these uncertainties.

The amendments will be effective for annual reporting periods beginning on or after 1 January 2020. Early application is permitted.

This issue of First Notes provides a summary of the amendments made by the IASB.

## Voices on Reporting

**KPMG in India is pleased to present Voices on Reporting (VOR) - a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.**

On 10 October 2019, KPMG in India organised a VOR webinar to discuss key financial reporting and regulatory matters that are expected to be relevant for stakeholders for the quarter ended 30 September 2019.

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