ACCOUNTING AND AUDITING UPDATE

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Starting this month, KPMG in India is introducing a new series of the Accounting and Auditing Update which will bring to you recent affairs on accounting, financial reporting and regulatory challenges being faced by sectors in India; each month’s publication focussing on different sector. This month’s update discusses the automotive sector.

Ind AS is bringing about a paradigm shift in financial reporting which is going to potentially affect many key metrics of performance. We highlight four key areas of impact: revenue recognition, consolidation, moulds and toolings and embedded leases. Our article explains the new accounting requirements in these areas and the expected challenges that are likely to be faced by the sector.

We are also introducing an interview section in our publication where we speak with a CFO/finance director of a leading company from the industry where we explore some of the key accounting and reporting, and topical matters relevant to this industry. This month’s issue features an interview with industry leader Mr. V S Parthasarathy, Group CFO, Group CIO & President (Group Finance and M&A), Mahindra & Mahindra. He shares his perspective and experience on a wide range of issues.

Research and development is an important driver of growth, and the automotive sector does invest significantly in this area. In this issue, we explore the accounting requirements on research and development costs and discuss key accounting challenges relating to the capitalisation of development costs.

The automotive sector also has its share of legal disputes, contingencies and specific challenges such as product recalls. We discuss the accounting requirements, judgements and estimates required for such provisions and contingent liabilities.

This publication also highlights some salient taxation related challenges being faced by this sector. In particular, we elaborate on transfer pricing as an area and on the potential impact of the Goods and Services Tax (GST) on the automotive sector.

Finally, apart from our regular round up of regulatory updates, this edition of the Accounting and Auditing Update also provides an overview of the Guidance Note on Internal Financial Controls on Financial Reporting, issued by the Institute of Chartered Accountants of India recently.

As always, we would be delighted to receive any kind of feedback or inputs on the topics that we cover.
Overview
The performance of the Indian automotive sector is often considered as a litmus test to gauge the health of India’s economy. The industry is capital intensive, highly competitive, driven by constantly changing consumer preferences and subject to extreme price and market risks. With increasing globalisation, the supply and service chain in the automotive industry is becoming progressively technology driven, with an increased focus on specialisation. At one end of the supply and service chain are the principal manufacturer (also known as Original Equipment Manufacturer or OEMs) who actively engage with the market and the end consumers to understand the current trends and preferences for products, services and innovation. These OEMs coordinate with component suppliers and ancillary units (component manufacturers) at the other end of the chain, for production of components, parts and ancillary products used in vehicles. The dealer networks spread across geographies serve as distribution channels for the products and services. Coherent and coordinated functioning of these three vital exponents of the value chain, namely: OEMs, component manufacturers and dealers play a crucial role in bringing together a special value proposition to the end consumers.

There are many accounting and regulatory challenges faced by the industry. These challenges stem from various factors, including its capital structure, functioning, complex master supply agreements, sales agreements, etc. We will address some of these challenges in this publication.
Ind AS - Impact on the automotive sector

This article aims to:

- Provide key impact areas on adoption of Ind AS.
The Ministry of Corporate affairs has, in February 2015, laid out a road map for IFRS convergence in India by notifying the transition plan and issuing 39 converged standards known as Indian Accounting Standards or Ind AS.

Under the road map, from 1 April 2016, Ind AS would be mandatory for (a) companies having a net worth of INR500 crore or more and (b) associate companies, holding, subsidiaries, joint ventures or associate companies of such companies.

Further, from 1 April 2017, Ind AS would be mandatory for (a) companies whose equity and/or debt securities are listed or are in the process of being listed on any stock exchange in India or outside and having net worth of less than INR500 crore (b) unlisted companies having net worth of INR250 crore or more but less than INR500 crore; and (c) associate companies, holding, subsidiaries, and/or joint venture of such companies. The notification has a fairly wide coverage as it impacts not just the covered entity, but all entities within the consolidated group to which the entity belongs.

The adoption of Ind AS is expected to be a paradigm shift in financial reporting. As a consequence, the reported earnings (net income) and financial position (net worth) reported by companies adopting Ind AS is likely to undergo a change. Impact of this change would vary from company to company, with some sectors/companies being significantly impacted. We expect the adoption of Ind AS to lead to changes in the key metrics of the automotive sector.
A. Revenue recognition

Overview

Revenue is one of the most important metric of performance for any entity. The automotive sector is also expected to face various challenges when applying the revenue recognition requirements under Ind AS. Ind AS are principles-based rather than industry-specific. Accordingly, the standard does not provide specific industry based guidance.

Revenue recognition is a complicated area, particularly due to complex sales promotion strategies such as additional services when selling vehicles, warranties, dealer incentives and unconditional and conditional repurchase agreements.

The current Indian GAAP also does not provide industry specific guidance. The standards under Indian GAAP are also principles-based. Paragraph 10 of Accounting Standard 9, Revenue Recognition (AS 9), states that “revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.”

Paragraph 11 of the AS 9 further states that in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

i. The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

ii. No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

In general, property refers to a person’s legal right of whatever description. It is the right to possess, use and enjoy a determinate thing. Accordingly, it is important to analyse whether either of the two conditions above have been satisfied by the company at the time of sale of an automobile to its customers.

In practice, automobile manufacturers recognise the full amount of consideration at the time of transfer of risk and rewards of ownership of the vehicles in accordance with the terms of sale agreement and make a provision towards other performance obligation.

In India, Ind AS 115, Revenue from Contracts with Customers is the standard on revenue recognition that is converged with IFRS 15, Revenue from Contracts with Customers.

The new standard contains a single model that can be applied while accounting for contracts with customers across various industries including automotive and is expected to replace the current guidance under Indian GAAP.
Five-step model

As per the new standard, entities will apply a five-step model to determine when to recognise revenue, and at what amount. The model specifies that revenue should be recognised when (or as) an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled. To achieve the core principle, the new standard establishes a five step model:

1. **Identify the contract(s) with the customer** (One or multiple)
2. **Identify the performance obligation in the contract** (One obligation or multiple)
3. **Determine the transaction price** (Total consideration for contract)
4. **Allocate the transaction price** (Allocate to various performance obligations identified)
5. **Recognise revenue** (At a point in time or over time)

One of the challenges for India is whether we are adopting Ind AS 115 or the earlier version of IFRS standards i.e. IAS 11, Construction Contracts, IAS 18, Revenue, IFRIC 13, Customer Loyalty Programmes, IFRIC 15, Agreements for the Construction of Real Estate, IFRIC 18, Transfer of Assets from Customers and SIC-31, Revenue-Barter Transactions Involving Advertising Services.

Ind AS 115 implementation is expected to be deferred to 1 April 2018; it is not expected to apply from 1 April 2016. In the following paragraphs we will describe some key impact areas that adopting Ind AS is likely to have from a revenue recognition perspective, particularly with respect to steps 2, 3 and 5 of the new standard.

Currently, under Indian GAAP revenue on sale of vehicles is generally recognised when the risks and rewards of ownership of vehicles is transferred by the automobile company to its dealers.

Under Ind AS 115, revenue would be recognised as and when the ‘control’ over vehicles is transferred to the customer. The standard requires entities to determine whether the control is passed on over a period of time or at a point in time for the purposes of recognising revenue which is in contrast to the existing practice of recognising revenue as and when the risk and rewards are transferred.
**Key impact areas**

**Dealer incentives (cash rebates, bonuses, free goods) including reimbursement of free maintenance services given to customers**

Sale contracts between automobile manufacturers and dealers often include incentives such as cash rebates, bonuses, free goods (such as accessories relating to the vehicles) which are contingent upon specific milestones such as the number of vehicles sold in a period. These also include clauses regarding reimbursement of free maintenance services (to dealers) given to customers. This gives rise to the question of whether to treat such costs as selling and distribution/marketing spends or as a separate component in the sale transaction.

**Separate performance obligations**

Ind AS 115 clarifies that at contract inception, an entity should assess the goods or services promised (step 2) in a contract with a customer and should identify as a performance obligation each promise to transfer to the customer either:

- A good or service (or a bundle of goods or services) that is distinct; or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A good or service is distinct from other goods or services, and so is a performance obligation if it satisfies both of the following conditions:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer, and
- The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

For example, if a manufacturer sells a motor vehicle to its customer (a dealer), the manufacturer may also promise to provide additional goods or services (such as maintenance) to the dealer’s customer. Ind AS 115 requires an entity to identify all of the promises, both explicit and implicit, that are made to the customer as part of the contract with that customer. Consequently, a promise of a good or service (such as maintenance) that the dealer can pass on to its customer would be a performance obligation if the promise could be identified (explicitly or implicitly) in the contract with the dealer. An implicit promise may exist when a car manufacturer has a history of offering free maintenance services e.g. oil changes and tire rotation for two years to customers who have purchased its vehicles from dealers. These services may not be explicitly stated in the contract between the manufacturer and dealers. As the car manufacturer has a customary business practice of offering two-year maintenance incentive, the maintenance would therefore be treated as a separate performance obligation in the sale of the vehicle to the dealer. Revenue from the sale of the vehicle would be recognised when control of the vehicle is transferred to the dealer. Revenue from maintenance services is recognised when the services are provided to the retail customer.

However, if the car manufacturer does not have a customary business practice of offering free maintenance, and instead announces the maintenance programme as a limited-period sales incentive after control of the vehicle has been transferred to the dealer, then the free maintenance would not be a separate performance obligation in the sale of the vehicle to the dealer. In this case, the car manufacturer would recognise the full amount of revenue when control of the vehicle is transferred to the dealer. If the car manufacturer subsequently creates an obligation by announcing that it will provide incentives, the car manufacturer would accrue as an expense its expected cost of providing maintenance services on the vehicles in the distribution channel i.e. controlled by dealers when the programme is announced.

Determining whether a sales incentive to end customers was offered pre- or post-sale to the dealer would be challenging for some entities, especially for implied sales incentives where the entity has a customary business practice of offering incentives. The entity would need to assess whether the dealer and customer has an expectation that the entity would provide a free service.

**Discount arrangements and incentives**

Ind AS defines the transaction price as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer (excluding amounts collected on behalf of third parties) and consist of both fixed and variable elements. A key challenge is determining variable element of the transactions price considering that such estimate of variable consideration are included in the transaction price only to the extent that it is highly probable that the revenue recognised would not be subject to significant future reversal as and when the underlying estimate is revised. Thus, an entity will have to perform a careful assessment to examine the fixed and variable elements in a transaction price and allocate the same to separate performance obligation for the purposes of revenue recognition.

The standard further explains that the amount of consideration can vary (step 3) because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or other similar items including the fact that there is an element of contingency in the form of the occurrence or non-occurrence of a future event. For example, an automotive entity may provide incentives to a customer as part of an arrangement. Examples of sales incentives offered by a seller include cash incentives, discounts and volume rebates.
Thus, under the Ind AS, cash incentives would be considered as a reduction from revenue. The concept of variable consideration is expected to bring major changes to current practice as the concept is much wider than what is currently practiced in India.

Since automotive entities develop unique sale promotions in order to increase their sales, very careful consideration and judgement is required to ensure appropriate accounting.

**Warranties**

Generally, automobile manufacturers include warranty pursuant to a vehicle’s sale. Under Ind AS 115, a warranty is considered as a performance obligation if the customer has an option to purchase the good or service with or without the warranty. The standard explains that the nature of a warranty can arise from an assurance that the product complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. The standard has envisaged two alternatives in relation to accounting for warranty costs.

- **The customer has an option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately):** The warranty is a distinct service because the automobile manufacturer promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an automobile manufacturer would account for the promised warranty as a performance obligation and allocate a portion of the transaction price to that performance obligation.

- **Customer gets additional services as part of the warranty:** When a warranty is not sold separately, (e.g. extended warranty) the warranty or part of the warranty may still be a performance obligation, but only if the warranty or part of it provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. A warranty that only covers the compliance of a product with agreed-upon specifications (an ‘assurance warranty’) is accounted for under other relevant guidance e.g. Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

The assessment of whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications is a matter of judgement which requires a consideration of facts whether the warranty is required by law, the length of the warranty period and the nature of the tasks that the entity promises to perform.

If an automobile manufacturer provides a warranty (or part of it) and it is considered to be a performance obligation, then the automobile manufacturer would allocate a portion of the transaction price to the service performance obligation. If an automobile manufacturer provides a warranty that includes both an assurance element and a service element and the entity cannot reasonably account for them separately, then it accounts for both of the warranties together as a single performance obligation.

**Repurchase agreements**

Internationally unconditional and conditional repurchase agreements and residual value guarantees are a common way for automobile manufacturers to improve sales of new vehicles. Through such arrangements, OEMs sell new cars to fleet customers or rental companies with a commitment to buy them back after a period of time for a fixed or formula-driven price.

Ind AS 115 includes guidance on the nature of the repurchase right or obligation and the repurchase price relative to the original selling price where as, current accounting focusses primarily on whether the risks and rewards of ownership have been transferred. As a result determining the accounting treatment for repurchase agreements may, in some cases, be more straightforward under Ind AS 115, but different from the current practice. However, one would need to exercise judgement at contract inception to determine whether a customer with a put option has a significant economic incentive to exercise its right.

**A forward or a call option**

An entity has executed a repurchase agreement if it sells an asset to a customer and promises, or has the option, to repurchase it. If the repurchase agreement meets the definition of a financial instrument, it is outside the scope of Ind AS 115. If not, the repurchase agreement is in the scope of the Ind AS 115 and the accounting for it depends on its type e.g. forward, call option, or put option and on the repurchase price.

The standard explains that under a forward (an obligation) or a call option (a right), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain benefits from the asset even though the customer may have physical possession of it. If an entity expects to repurchase the asset for less than its original sales price, the entity accounts for the entire agreement as a lease. Conversely, if the entity expects to repurchase the asset for an amount that is greater than or equal to the original sale price, it accounts for the transaction as a financing arrangement. When comparing the repurchase price with the selling price, the entity considers the time value of money.

In a financing arrangement, the entity continues to recognise the asset and recognise financial liability for any consideration received. The difference between the consideration received from the customer and the amount of consideration to be paid to the customer is recognised as interest, and processing or holding costs, if applicable. If the option expires unexercised, the entity derecognises the liability and the related asset, and recognises revenue.
Put option

The guidance in relation to a put option also warrants that at contract inception, an entity need to consider whether the customer has a significant economic incentive to exercise that right which would determine the application of the stated accounting principles.

This requires an entity to consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. Accordingly, a careful assessment needs to be made in order to determine the recognition of revenue in a repurchase contract.

If a customer has a significant economic incentive to exercise the put option, the entity accounts for the agreement as a lease. Conversely, if the customer does not have a significant economic incentive, the entity accounts for the agreement as the sale of a product with a right of return.

If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is accounted for as a financing arrangement. In this case, if the option expires unexercised, the entity derecognises the liability and the related asset and recognises revenue at the date on which the option expires.

When comparing the repurchase price with the selling price, the entity considers the time value of money.

Conclusion

Given the wide scope of the standard on the timing of revenue recognition, automobile companies should consider carrying out an assessment of the potential impacts on revenue recognition. Such an assessment involves exercising significant judgement and would depend on the facts and circumstances of each contract.
B. Moulds and tooling

OEMs often engage with component manufacturers to produce automobile parts. These component manufacturers and OEMs produce ‘tools and moulds’ or ‘toolings’ which are used in the manufacturing process for the purpose of producing automobile parts as per the specifications of a vehicle.

These toolings are usually designed for the production of specific products or models, and their utility generally ceases with the discontinuance or modification of the models developed. Toolings may be fabricated by component manufacturers themselves or procured from an OEM. When the product is phased out, the tooling specific to that product is also scrapped. The tools and moulds are subject to wear and tear due to repeated usage in the manufacturing process and on average have a utility ranging from three to four years.

There are two key accounting challenges associated with toolings. One challenge relates to whether toolings are an item in the nature of inventory or property, plant and equipment. This assessment is sometimes cumbersome due to complexities in the underlying contractual agreements. However, it is important because the accounting consequences differ depending on whether the tool will be used (own use) or sold (sale).

Under Indian GAAP, the Expert Advisory Committee (EAC or the Committee) of the Institute of Chartered Accountants of India (ICAI) discussed the principles of classification of an item of machinery in Query no. 10 published in the Compendium of Opinions – Volume XVIII - Accounting treatment of special tools, jigs and fixtures. Deliberating on the facts and views cited by the querist, the EAC opined that in their view, the items of machinery discussed in the query satisfied the requirements of fixed assets (property, plant and equipment) and not inventory. The Committee highlighted that their views were based on the fact that the items of machinery:

- were not available for sale in the normal course of business, and
- were expected to be used for more than one accounting period and had a limited estimated useful life.

Similarly, under Ind AS 16, Property, Plant and Equipment, similar assessment would be required and OEM/component manufacturer would have to assess the contractual arrangement.

Under Ind AS 16 property, plant and equipment comprises tangible assets held by an entity for use in the production or supply of goods or services, for rental to others or for administrative purposes, that are expected to be used for more than one period. The definition of property, plant and equipment is not restricted to assets that have an explicit link to an entity’s revenue generating operations, such as a plant used in the manufacturing of goods for sale, or that which forms a part of an entity’s administrative infrastructure.

Ind AS 16 does not prescribe what constitutes an item of property, plant and equipment. Therefore, an entity would have to assess whether toolings meet the definition of property, plant and equipment.

The second challenge relating to toolings in the automotive sector is who should capitalise toolings – whether the OEM or the component manufacturer. Under Ind AS, both OEM and the component manufacturer would have to understand the underlying master supply agreement. A master supply agreement is often a multiple-component agreement that comprises a bundle of services that may include developmental activities, construction or acquisition of tools from a third party and delivery of the final manufactured components. These agreements may also include a variety of remuneration mechanisms, including upfront payments, progress payments at key milestones and/or payments through the component price as part of the series of production. Therefore, each separate component should be assessed according to its economic substance rather than its legal form.

One should assess whether the contribution received from the OEM for development of the toolings is a pure financing arrangement or for the purchase of the tool or towards the commitment made by the supplier for a continuous supply of the products. Accordingly, toolings would be capitalised in the books by the party that has control of these assets.

C. Consolidation of structured entities

The standard on consolidation is another area in which the adoption of Ind AS is expected to impact the automotive sector. This standard is different in many respects and has wider concept of control in comparison to current Indian GAAP standard. Ind AS focusses on the concept of control and moves away significantly from the current Indian GAAP requirements of evaluation of voting rights and composition of the board with respect to consolidation.

Under Ind AS 110, Consolidated Financial Statements, an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee, and has the ability to affect those returns through its power over the investee. To have power, the investor needs to have existing rights that give it the current ability to direct those relevant activities which significantly affect the investee’s returns. An investor can have power over an investee even if other parties have existing rights to participate in the direction of the relevant activities – e.g. significant influence over the investee arising from one or more contractual arrangements.

Under Ind AS, the power is analysed with the help of voting rights that are substantive, (including substantive potential voting rights), rights arising from other contractual arrangements, de facto power, and through special relationships e.g., structured entities.
The control model in Ind AS 10 is complex and includes numerous indicators to consider; the investor would need to reflect upon all the relevant facts and circumstances in assessing whether it controls an investee and no specific hierarchy for consideration is provided.

Under Ind AS 110, understanding the purpose and design of the investee is important, because it can play a role in the judgement applied by the investor in all areas of the control model.

In the automotive sector, the relationship between the OEMs and component manufacturer would have to be evaluated to consider that contractual arrangement to understand the purpose and design of the component manufacturer.

Assessing the purpose and design of the component manufacturer includes considering the risks that the component manufacturer was designed to create and to pass on to the parties involved in the transaction, and whether the investor (OEM) is exposed to some or all of those risks.

The risks considered include both downside risk and the potential for upside return. Other items to consider may include:

- involvement and decisions made at the investee’s (component manufacturer) inception
- contractual arrangements such as call rights, put rights or liquidation rights established at the investee’s (component manufacturer) inception
- circumstances in which the relevant activities occur e.g. only when particular situations arise or events occur, and
- investor’s (OEMs) commitment to ensuring that the investee continues to operate as designed.

Under Ind AS 110, to have control over an investee, an investor needs to be exposed to (have rights to) variable returns from its involvement with an investee. This exposure is provided when the investor’s returns from its involvement with the investee has the potential to vary based on the investee’s performance. The returns of the investee might either be positive or negative. The examples of returns include:

- dividends or other economic benefits, such as interest from debt securities and changes in the value of the investor’s investment in the investee
- remuneration for servicing an investee’s assets or liabilities, fees and exposure to loss arising from providing credit or liquidity support
- tax benefits
- residual interests in the investee’s assets and liabilities on liquidation and/or
- returns that are not available to other interest holders, such as the investor’s ability to use the investee’s assets in combination with its own to achieve economies of scale, cost savings or other synergies.

The contractual arrangement may give power to the OEM to take decisions about the significant relevant activities of the component manufacturer i.e. may qualify as a structured entity of the OEM.

Generally, the OEMs do not have any equity stake but support the component manufacturer to a great extent by way of working capital. OEMs have power to make component price adjustments, are involved in the design of the component and output specification and in some situations, are involved in procuring land and leasing out to component manufacturers or alternatively actively facilitating the land procurement.

Often, a component manufacturer’s units may operate exclusively for an OEM and hence, they may have substantial decision making rights over the significant relevant activities of the component manufacturer.

An OEM would be exposed to variable returns through achieving economies of scale, cost savings or other synergies.

The concept of control for the purposes of consolidation need careful evaluation for the purpose of applying Ind AS 110 in the automotive sector. A collective assessment of all facts and circumstances and other contractual arrangements need to be considered in an objective manner before deriving a conclusion on consolidation of component manufacturers by the OEMs.

D. Embedded lease

Another area that would require careful evaluation is the concept of ‘embedded lease’. The assets of the component manufacturer may be customised to manufacture products only for a specific OEM.

In certain arrangements a component manufacturer could set up a factory in the business park of the OEM. For example, as per a contractual agreement, component manufacture may agree to supply goods to a particular OEM as per agreed schedule and component manufacturer cannot supply to any other OEM. In such cases, the tools used for production could be owned by the OEM. In case of unutilised capacity the OEM may agree to pay a compensation. Component pricing could also be linked to commodity prices like steel and/or forex rates and are trued up or down periodically.

In some other cases there could be a clause in the agreement whereby the OEMs agree to purchase a ‘minimum agreed’ quantity of production of the component manufacturer; and on failure, OEM agrees to pay the component manufacturer an amount that is based on agreed upon formulae which includes recovery/return on capital investment made by the component manufacturer which is settled either in cash/credit notes.

Ind AS 17, Leases, Appendix B provides guidance on ‘Evaluating the Substance of Transactions Involving the Legal Form of a Lease’.

According to Ind AS, an arrangement may contain a lease even though it is not in the legal form of a lease. For example, outsourcing arrangements may contain a lease of the underlying assets. The assessment of the substance of an agreement is carried out at its inception. The assessment depends on whether:

- fulfilment of the arrangement is dependent on the use of a specific asset or assets, and
- the arrangement conveys a right to use the asset(s).

Fulfillment of the arrangement is dependent on the use of a specific asset or assets.
The asset under the arrangement may be identified explicitly in the arrangement or it may be specified implicitly - e.g. if the supplier owns or leases only one asset with which he/she is to fulfil the obligation and it is not economically feasible or practicable for the supplier to use alternate assets to fulfil the arrangement.

Arrangement conveys a right to use the asset(s).

If a buyer agrees to buy 100 per cent of the output of a specified asset and requires the asset to be operated at full capacity, then there is a strong presumption that the buyer has effective control over the asset and therefore that the arrangement is or contains a lease.

This presumption can be rebutted only when the operator, although it is obligated to operate at maximum capacity, retains significant operational flexibility to influence the profitability of the arrangement e.g. the mix of product quality/composition can be varied at the operator’s discretion.

Generally, under Ind AS a buyer controls an asset and a lease exists when the buyer is taking substantially all of the output, because others cannot obtain the output from the specified asset. However, an exemption relating to arrangements in which the price is either contractually fixed per unit of output or equal to the market price per unit of output at the time of delivery, are not accounted for as leases. This exemption for fixed or market prices should be applied narrowly and only for arrangements in which the buyer clearly pays for the actual output.

Component manufacturers may come under the purview of the embedded lease concept and hence could meet the criteria for financial lease/operating lease.

E. Other impact areas

In addition to the above, there are several other differences between Indian GAAP and Ind AS which may have a significant impact on the automotive sector after the transition. Some of these impact areas are:

- property, plant and equipment including any enabling assets capitalised
- debt equity classification
- investments under Ind AS 109, Financial Instruments
- business combinations
- mandatory use of fair value accounting for share based payment transactions
- segment reporting disclosures
- timing of recognition of proposed dividend
- discounting of provisions
- additional disclosure on related parties
- extensive disclosures on income taxes (component of taxes, tax rate reconciliation)
- government grants
- restatement of financial statements for prior period errors, etc.

Sources:
1. Ind AS 115, Revenue Contracts with Customers.
2. IFRS 15, Revenue Contracts with Customers.
4. KPMG’s Publication: Issues-in-depth Revenue Contracts with Customers, September 2014.
Conversation with
Mr. V S Parthasarathy
Group CFO, Group CIO & President (Group Finance and M&A),
Mahindra & Mahindra
As per the Ind AS adoption road map, Mahindra & Mahindra (M&M) would be adopting Ind AS from 1 April 2016, with the date of transition being 1 April 2015. How are you addressing the following issues:

i. technical challenges
ii. capacity and infrastructure challenges such as capacity building of the finance department and creating awareness both internally/externally, changes to contracts/business practices, changes to IT systems/processes
iii. non-technical challenges such as managing expectations and communication with stakeholders, both internal and external.
iv. What learnings or insights are you developing as you gear up to meet these challenges?

M&M embarked on the IFRS journey about three and half years ago. We did a detailed impact assessment and invested in skilling our teams, identifying gaps, creating IT infrastructure, etc. In order to implement IFRS, we had developed a parallel system through IT by linking it into our ERP system that takes care of about 120+ companies in a single instance. We instituted a Corporate Centre of Excellence for implementation which acted as an important toggle to this system. This team conducted a mammoth task, worked long hours and completed the entire transition exercise. However, in 2011 the conversion to IFRS was called off, but we did not want to unwind the work done. Hence, the team continued to work on for transition to Ind AS and tasked with instituting all systems and processes ready to make a smooth transition to the new regime. A dedicated IT team is currently working to ensure all the IT infrastructure is in place at all the companies for a smooth transition to IND-AS.

We are a diverse group; each business has different challenges (e.g. IT, time share holidays, etc.), thus, revenue recognition accounting for each business is different. Therefore, in implementation of Ind AS, one of key challenges is capacity building, i.e. how to equip teams with the technical skills, to keep it updated, and to motivate teams to keep working on the transition challenges.

As a part of our team upskilling initiatives, we run a ‘Finance Academy’ where one of the courses is about Ind AS, and finance employees from various businesses attend these trainings. These courses have been designed on the basis of the level of the audience. One very important aspect we are ensuring is that the knowledge transmission happens at the ground level staff. They should be equally excited about the transition to Ind AS; it should not remain an exercise at the corporate office level. We are now aiming to build a seamless approach, so that the requirements of Ind AS financial and reporting requirements are incorporated in the IT system, which is in turn approved by the auditors.

Next item on our agenda is managing expectations of the stakeholders. We have discussed our transition plan with our Board of Directors. However, each business will have a different impact on the statement of profit and loss and the balance sheet and the same would have to be understood. Therefore, we plan to prepare quarterly financial statements from this year on the basis of Ind AS. Though these Ind AS set of quarterly financial statements would not be published, they would be available as comparatives next year. Secondly, as we go through the process of preparing the Ind AS quarterly financial statements, we would collect all the expected issues on its implementation and discuss their solutions. This exercise will help stimulate discussions at the investors’ meet. Hence, we are not waiting for June 2016 quarter to communicate the implications of adopting Ind AS to the market.

However, we would like to have clear directives from the government on some of the contentious issues like applicability of Ind AS 115, Revenue Contracts with Customers, etc. before we start having any such conversations with the external stakeholders.
The Income Computation and Disclosure Standards (ICDS) has been notified and is applicable from Assessment Year 2016-17 onwards. The adoption of ICDS is expected to significantly alter the way companies compute their taxable income, as many of the concepts from the existing Indian GAAP have been modified. This may also require changes to existing processes and systems. What are the key implementation challenges of ICDS that you foresee? Do you believe that adequate implementation time and guidance has been provided by the Government for the same?

In addition to the accounting records we have always maintained additional details for tax purpose and we are going to continue with this practice in the future as well. Before, ICDS was issued, tax books started with the accounting base, i.e. starting point was accounting profit and then after taking certain set of tax adjustments, we prepared tax profits.

Introduction of ICDS will change the way we compute tax, and probably will require technological changes like parallel tracking of information, etc. Applying ICDS would entail large number of challenges and these challenges are compounded by the fact that there is no precedence (on the application of ICDS). Further, the interaction of ICDS with the Income tax Act, the Supreme Court judgements, several positions taken in the past, etc. would evolve over a period of time. When there is precedence, it helps settle many issues by applying the law, rules, as a matter of convention.

One of the objectives behind the introduction of ICDS was to reduce tax litigation, and there are some differences between the accounting standards and ICDS. However, I do not think that the objective is being met, as reflected in ICDS regulations. It appears that the regulations are drawn with the perspective to further the tax department’s revenue and that is what is causing a lot of challenges. For instance, ICDS, in general do not have prudence as a fundamental assumption, and accordingly, in several situations this would result in earlier recognition of income or gains, or a later recognition of expenses or losses as compared to that under the accounting standards. This would potentially have a direct impact on the timing of tax related cash outflows. For example, capitalisation of borrowing costs has significant differences from AS 16, Borrowing Costs standard, ICDS does not address areas such as financial instruments, share-based payments, etc.

The Companies Act 2013 (2013 Act) has introduced Section 134(5)(e) of the 2013 Act which requires the directors’ responsibility statement to state that the directors, in the case of listed companies, have laid down Internal Financial Controls (IFC) to be followed by the company and that such internal controls were adequate and operating effectively. How have you approached this areas and what have been the key considerations relating to the implementation of reporting on IFC?

We as a company hold a very high threshold for internal control standards. In the year 2003, the company received the prestigious Deming Prize by the Union of Japanese Scientists and Engineers (JUSE). This is a globally recognised award which honors businesses that have successfully implemented Total Quality Management (TQM) practices in both financial and non-financial areas. While preparing for the Deming Prize, the entire eco system of controls has been developed and our operational processes continue to deliver consistent results. So, we are quite happy and the prize provides us with a validation on our process level controls, even in the case of start-up companies with in our group.

In substance, the group has not just been focusing on financial reporting controls but also the business level operating controls. We did not wait for somebody from outside to require us to establish such controls.

We have implemented a framework called ‘House of Excellence’ under which we have taken various initiatives to ensure future readiness of our function. One such initiative is a legal compliance tool, an online tool that monitors compliance with various laws across the entire group.

Hence, we believe that we are well prepared for the IFC implementation.

Have there been other areas such as related party transaction approvals required under the 2013 Act that have been challenging to implement?

Our group believes in prudence and it is very important to be careful and get into only those transactions that are in the ordinary course of business and at an arm’s length because we are holding ourselves to shareholders. In case of related party transactions, we make sure that we take the necessary approvals from the audit committee, independent directors and other minority partners.

We believe that in order to avoid substantial workload, approval should be at the principle level of the arrangement rather than an omnibus approval, for which in practice, it is difficult to estimate a cap for the approval limit, e.g. a multiple of revenue, etc.

There are also differences in requirements of the Securities and Exchange Board of India (SEBI) and Companies Act, 2013 and we hope, there will be quick alignment in these requirements.

What has been your overall evaluation of the 2013 Act and are there any learnings on how such significant economic legislation should be implemented for the country?

I just want to take a step back and reflect on the process of formulation of laws in our country. I would like to put the ideal law making process in three phases:

- Participative phase: Companies and trade bodies like Federation of Indian Chambers of Commerce and Industry (FICCI), Confederation of Indian Industry (CII), should collaborate early enough in the process and give their valid inputs during the process of law making.

- Transition phase: The law makers should give an adequate transition time to apply the new laws, accounting standards, etc. It will allow companies to better prepare for the new laws and regulations.

- Correction phase: As there is no precedence to new laws or requirements, the government should form a group of government officials, SEBI, industry bodies, etc. that collects the problems and challenges arising during implementation of a new law.

Unfortunately, historically companies have not been very participative in the process. Despite being given the option to review the exposure draft and provide comments, barely few companies comment on it.
Goods and Services Tax (GST) is a path breaking business reform, and not just a tax reform for India. It is likely to trigger a major ‘business transformation’. Despite the setback of the monsoon session of the parliament which ended on 13 August 2015, the general view is that GST will soon become a reality and the target date may not get deferred by more than a few months. Viewed from this perspective, how are you approaching this area and how are you framing your plans in order to achieve significant efficiencies of business and even yield a competitive edge in the market?

We are preparing for GST assuming 1 April 2016 as the go live date. However, it is a huge challenge and, unfortunately, we cannot completely prepare for it ahead of time. The law needs to be approved first then we will have some clarity. We are expecting a clarification in three or four months on this topic, following which our central GST implementation team would be ready to implement the GST requirements. We have estimated the strategic impact areas based on various scenarios. However, the GST project will require precision planning akin to a factory layout i.e. step by step layout of the requirements.

The government has introduced mandatory Corporate Social Responsibility (CSR) requirements in the 2013 Act, which mandates companies to spend on social and environmental welfare, making India perhaps one of the very few companies in the world to have such a law. What were the key considerations and challenges your company faced in implementing this law for the first time? Could you please elaborate the CSR programs being undertaken by the company?

We understand the importance of CSR and support our communities through various environment and social initiatives. We strongly support the need for educating girl child and run a project called ‘Nanhi Kali’. Mahindra Pride School that conducts livelihood training programme for youth from socially and economically disadvantaged groups. Other projects like Lifeline Express which is our mobile hospital services, provides medical interventions and surgeries in remote rural areas. We also support ‘Swachh Bharat’ Abhiyan, which is an important initiative of the Government of India. Under this initiative we are constructing a block of 1,000 toilets for girls in government schools. As part of the Mahindra Hariyali project, our afforestation initiative, our aim is to improve green cover and protect bio-diversity in the country. We additionally contribute to the livelihood of farmers.

One of our important initiatives is our ESOP arrangement, which means Employee Social Option Programs, where employees volunteer four days of physical time for a social cause.

What are the new learning initiatives that the M&M group is undertaking to take as capacity building initiatives in order to equip its finance department/ internal auditors/stakeholders/Board of Directors to build their knowledge base is areas of change?

My motto for my team is that they need to unlearn, learn and relearn.

We are facilitating this through our ‘Finance Academy’ which runs various training initiatives for the finance team and also for business teams.

Our concept of ‘House of Excellence’ directs new initiatives by employees and promotes a culture of innovation. Some of the initiatives that we have rolled out are:

- CFO plus program which helps develop 5 Star CFOs who can create value for the business, i.e. who are business partners.
- We also believe in initiating job rotations at regular intervals for employees to develop their capabilities.
Identification and accounting of research and development activities

This article aims to:

- Provide an overview of the identification and accounting treatment of various stages of research and development activities
- Highlight related key accounting challenges relating to capitalisation of development costs.
In an industry that is changing fast, companies must continually evolve and bring new products to the markets. New products more often than not are drivers of growth and serve as crucial factor for the survival of a company.

The automotive industry is one such sector where Research and Development (‘R&D’) is an important element of growth. It is directed by changing customer preferences, competition and future regulatory norms leading to a shorter life span of models and upgrading of the existing ones.

Accordingly, intensive research and development activity around vehicle components, systems, production processes and new technologies gives rise to a variety of intangible assets in the automotive sector. As the industry makes high amount of investments in R&D activities, the related costs impact an entity’s earnings and cash flows. Thus, managing R&D costs is crucial for this industry.

Accounting of research and development activities as per current Indian GAAP

As per Accounting Standard 26, Intangible Assets (AS 26), ‘research’ is defined as an original and planned investigation undertaken with the prospect of gaining new knowledge and understanding. The automotive sector continuously innovates to bring down costs, meet the regulatory, safety requirements as well as to improve customer comforts and convenience. A decision to proceed from research to the development phase would be taken only after considering the results of such research. Some of the examples of research activities are:

- Use of sintered products/composite materials for reducing the weight of the engine/other body part resulting in reduced cost and improved fuel efficiency.
- Research on engines with low emission and use of alternate fuels for greener and cleaner environment.
- Improved customer comforts and safety features like auto pilot technologies.

At the research stage, the entity may not be able to identify a project or a product and the relationship between the cost being incurred and the expected future benefits. An expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. In the research phase, an entity cannot demonstrate that an intangible asset exists from which future economic benefits are probable. Accordingly, the expenses incurred are charged to the statement of profit and loss.

In AS 26, ‘development’ is defined as the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes systems or services prior to the commencement of commercial production or use.

Some of the example of developmental activities can be:

- Use of engineering plastics for body structure parts to reduce manufacturing costs
- Improvements in brakes, suspensions and steering for improving performance and user comfort
- The design, construction and testing of pre-production or pre-use prototypes and models
- The design of tools, jigs, moulds and dies involving new technology
- The design, construction and operation of a pilot plant that is not of a scale that is economically feasible for commercial production and
- The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.
An intangible asset arising from a development (or from the development phase of an internal project) should be recognised if, and only if, an entity can demonstrate all of the following:

- The technical feasibility - must be explained and substantiated and should be capable of answering the question as to whether the project is technically feasible and how it can be implemented.
- The intention to complete the development activity and use or sell it can be substantiated by a management assessment of the project and a project plan detailing the phases of development and the use or sale of the outcome.
- The ability to use or sell the result of a development activity depends on the technical capability of the entity since in many cases development projects are for internal use.
- The expected future economic benefits can be demonstrated by the anticipated cash flow which may arise from the development projects.
- The availability of adequate technical, financial and other resources to complete the development depends on the entity’s financial position, adequately qualified employees and sufficient resources.

The ability to measure the expenditure attributable to the intangible assets during the development phase includes all the costs directly attributed or allocated on a reasonable basis.

**Specific challenges**

Since the R& D expenditure could constitute a significant portion of an entity’s cash outflows, the accounting of such expenditure may have a substantial impact on the financial statements of the entity. Many challenges arise due to judgements being exercised at various stages of R&D. It is essential to be able to recognise whether the expenditure is being incurred at the research phase or the development phase. Theoretically, development would start from where research ends. However, practically it may require a careful examination and thorough documentation to be able to assess when the research activity has ended and when the development activity has commenced.

According to AS 26, if an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase itself.

Once the development activity commences, the entity should determine whether an identifiable asset would result from this activity. To meet this criterion, the asset should be separable from the entity to be sold, transferred, licenced, rented, etc. Identifiability is critical to figure the resource from which/from the use of which, future economic benefits will be available to the entity. The asset could be with a physical substance (e.g. a prototype) or without (e.g. technical know-how). However, even in the case of an asset with a physical substance, the physical element of the asset would be secondary to the intangible component - i.e. the know-how which is present in it.

The entity should be able to assess how future economic benefits may be generated by the asset or by the use of such an asset. This involves considering the technical feasibility, an identifiable market, restrictive regulatory/licensing barriers, dependencies on direct/indirect input costs, etc. With so many considerations, estimation of the probable future economic benefits to the entity would involve exercising judgments and making estimates. Practically, multiple developmental projects (some internal and some acquired) when in combination with each other might result in a marketable product. In such cases, the future economic benefits may have to be estimated for the cash generating unit as a whole.

**Cost of outsourced projects to be capitalised**

In case of an outsourced project there can be two scenarios:

- The entire development project has been outsourced.
- A part of the project has been outsourced.

If the project meets the criteria of internally generated intangible, the outsourced cost should be included in the cost of development as directly attributable cost.

**Is the cost of the new generation product or facelift or special edition eligible for capitalisation**

**New generation product**

The cost incurred in the development phase of a new generation product would typically be capitalised if it leads to a completely new product.

**Facelift**

These are generally minor revisions to the existing model of a vehicle, so as to adapt to current trends and customer expectations. It does not always result in a new product.

For accounting, the entity should assess whether the cost of a new generation product or a facelift meets the criteria for capitalisation.

**Special edition**

Generally costs relating to special editions are not capitalised as there is no technical upgradation. Special edition of vehicle contain few special features which are not a part of the standard model.
Key difference from IFRS/Ind AS

AS 26 provides a rebuttable presumption that the useful life of an intangible asset should not exceed 10 years from the date on which when the asset is available for use.

However, in some cases, there may be persuasive evidence that the use of an intangible asset will be for a specific period that is longer than 10 years. In such scenario, the presumption that the useful life generally does not exceed 10 years is rebutted and the entity:

a. Amortises the intangible asset over the best estimate of its useful life
b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss
c. Discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset.

On the other hand, IFRS/Ind AS does not mention a rebuttable presumption with reference to the useful life of an intangible asset. An intangible asset may have an indefinite useful life when, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity, after an analysis of all of the relevant factors has been done. An intangible asset with a finite useful life is amortised over its useful life. An intangible asset with an indefinite useful life is not amortised but will be tested for impairment annually and whenever there is an indication that the intangible asset may be impaired.
Competition regulations - Impact on financial reporting

This article aims to:

- Highlight accounting and disclosure requirements with respect to legal or disputed cases.
With increasing globalisation, the supply and distribution chain in the automotive industry is becoming technologically driven, with an increased focus on specialisation and delivering a unique value proposition to the end consumers. The components and assembly procurement process in addition to the end distribution of vehicles in an efficient, effective and timely manner can make or break the competitive positioning of the Original Equipment Manufacturers (OEMs). The supply and distribution model, therefore, requires considerable investment and involvement of OEMs right through the initiation (conceptual development), and needs the supply and distribution channel to stand out and remain ahead of the competition. While the structure has created many advantages (e.g. innovation in technology, improved product quality, competitive pricing of vehicles, etc.), there are also some perceived threats. The recent orders of the CCI dated 25 August 2014 and 27 July 2015 brings into fore one such threat – the operational set up in the aftermarket sales of spares parts distribution and servicing system of the OEMs, component manufacturers and their dealers; resulting in restrictive and anti-competitive practices. While one could debate and argue over the validity of the structure and its effects on competition as enunciated in the CCI order, the direct implication that the order has on financial reporting obligations of the OEMs, cannot be undermined.

CCI order

In 2011, a petition was filed before the CCI alleging monopolistic practices followed by OEMs resulting in controlled price determination for spare parts and services against the market forces and denial of market access to independent repairs workshops.

Main grounds of argument were that: i) the genuine spare parts of automobiles manufactured by these OEMs are not freely made available in the open market, ii) the technological information, diagnostic tools and software programmes required to maintain, service and repair these high-tech vehicles are not readily available to independent repairs workshops and iii) the OEMs restrict, formally or informally, the component manufacturers from making these products available in the open market.

Remedies were sought for from the CCI by holding inquiries against the OEMs and passing necessary orders, including cease and desist from such monopolistic trade practices and misusing the dominant position held by OEMs and making available spare parts, technical information, diagnostic tools, software, etc. for repairs, maintenance and servicing to independent repairs workshops and also in the open market.

The CCI levied significant penalties on 17 OEMs which was based on a benchmark of 2 per cent of average turnover.

The OEMs have sought an injunction/a stay on the order of the CCI from the Delhi High Court on various grounds, including challenging the jurisdictional authority of the CCI to undertake such an investigation, which is since then been granted.

Given the fact that the sector is already reeling under pressure due to negative consumer sentiments, high interest costs, and subdued growth in overall business conditions in India and in the infrastructure sector in particular, the order of CCI could not have come at a time more pressing than this. The Society of Indian Automobile Manufacturers (SIAM) was quick to react against the order and termed it as one that completely ignored consumer safety while deciding the matter against the OEMs.

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1. CCI Order dated August 25, 2014 and 27 July 2015, Case No. 03/2011
Financial reporting analysis

The accounting and disclosure requirements for legal/disputed cases are largely driven by AS 29, Provisions, Contingent Liabilities and Contingent Assets. Each case presents unique facts and circumstances and hence, there cannot be a single answer. While evaluating each case, companies may seek inputs from legal counsel on interpretation of the provisions of law.

For any given case (including the one above pertaining to the CCI order), there could be three accounting situations depending upon the evaluation of conditions and factors that exist at the balance sheet date – recognise a provision, disclose a contingent liability or do nothing (i.e. neither recognise a provision nor disclose a contingent liability).

An initial step is to determine whether the respective case needs recognition as a provision. As per AS 29, a provision is defined as a liability which can be measured only by using a substantial degree of estimation. The provision should be recognised when an entity has present obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

Whereas, a contingent liability is defined as a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events (not wholly within the control of the enterprise) or a present obligation that arises from past events for which it is not probable that an outflow of resources will be required to settle an obligation or the amount of obligation that cannot be reliably measured. Thus, a provision/contingent liability assessment is based on a combination of three factors i.e. existence of present/possible obligation arising from past event, probability of outflow of resources and reliability of measurement.

Therefore the next logical step is to determine whether there is a present obligation. AS 29 defines the present obligation is an obligation, whose existence at the balance sheet date is considered probable, i.e. more likely than not. Whereas, when the existence of an obligation at the balance sheet date is considered possible and not probable (i.e. 50 per cent or less), there exists a possible obligation. In both mentioned cases, present or possible obligation, the critical evaluation factors are: a) an obligating event and b) probability of its existence at the balance sheet date.

An obligating event is one that results in an enterprise having no realistic alternative to settling that obligation. It may arise due to many factors such as legislation or legal obligations. In almost all cases it will most often be clear whether a past event has given rise to a present obligation. However, in a legal case it may be disputed whether certain events have occurred or those events result in a present obligation. Sometimes, there is an uncertainty over matters regarding questions with respect to facts or questions of law or both and the outcome cannot be judged with reasonable prediction.

Situations like the CCI order that is disputed in the court of law falls into such a category. It requires interpreting the provisions of the Competition Act to the underlying business conditions and operations conducted by the OEMs to determine whether or not a breach of law has occurred and hence, whether or not there is an obligating event (non-compliance of law) arising from a past event (conduct of business operations in a manner that is anti-competitive), the existence of which is probable.

Available evidence and factors such as the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions/views of the legal counsel and other advisers, the experience of the entity in similar cases as well as those of other entities, and any other decision of the entity’s management as to how the entity intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement), etc. would be key sources of information in such determination if there is a present obligation. The fact that legal counsel may be unable to express an opinion that the outcome will be favourable to the entity should not necessarily be interpreted to mean that there exists a present obligation.
There could be two probable outcomes from such an evaluation, either a present obligation or a possible obligation (in rare situations one could argue that there is ‘no’ obligation, e.g. when there is a frivolous claim). The decision tree based on the outcome has been described above in a diagram.

Existence of a present obligation alone does not require a provision to be recognised. The next criterion to be met before an entity records a provision is whether or not the outflow of resources to settle the obligation is probable. Again, this assessment needs careful evaluation of various factors (similar as stated above for the existence of an obligation), including an opinion from the legal counsel. When it is more likely than not (probable) that the outflow is required, the provision is recorded (unless a reliable estimate cannot be made). It is important to note that an evaluation of the probability of ‘existence’ of the obligation is different from the probability of ‘outflow’ for settling the obligation.

On the other hand, when the outflow is not probable, it triggers the assessment for disclosure of a contingent liability. Similarly, when the obligation is determined to be possible (and not probable) it triggers the assessment for disclosure of a contingent liability. If the possibility of an outflow is remote, then no disclosure is required by AS 29. This determination (remote possibility) requires a robust assessment and is expected to occur less often.

Whether an entity determines recording a provision or disclosure of a contingent liability, the best estimate of the management at which the obligation is expected to be settled needs to be determined. In practice, the amounts of penalties finally settled and paid could differ from the entities own estimates or the amounts initially demanded by relevant authorities. An entity needs to consider its historical experience in settling similar obligations, similar or relevant industry experience, its assessment of the probability of an out-of-court settlement, legal advice, etc. while determining the extent of provisions or disclosures to be made. The amount may vary compared to the claim made, based on various considerations, e.g. historical experience in settling similar obligations, same or other industry experience, probability of out-of-court settlement, lawyer’s assessment of superior court’s judgement of award money, etc.

**Summing up**

Thus, one would see that there is a high degree of judgement involved in determining the treatment to be followed for the matter pending in the court due to the uncertainties involved. Each case will need a thorough evaluation of facts, circumstances and legal opinion to conclude whether it requires recording as a provision or a mere disclosure of a contingent liability or no mention in the financial statements because there is a remote possibility of an outflow.

Ind AS 1, *Presentation of Financial Statements*, would require that the companies disclose information for the assumptions made for the future as well as highlight major sources of estimation uncertainty that have a significant risk of resulting in material adjustments to the carrying amount of assets and liabilities within the next financial year. Such assumptions and other sources of estimation uncertainty relate to the estimates that require management’s most difficult, subjective or complex judgements.

Another issue is that the supply and distribution model followed by commercial vehicle and two wheeler manufacturers is also very similar to that followed by passenger car manufacturers against which the CCI is up in arms. Do these entities (in the commercial and two wheeler space) need to consider the judgement and its effect on their financial statements though they are not the direct recipient of the judgement? This is worth thinking over.
Accounting for product recalls in the automotive sector

This article aims to:

- Provide an overview of the accounting considerations relating to product recalls in the financial statements of a manufacturer.
Product recalls is one of the key commercial obligations for a manufacturer, especially for those which are in the pharmaceutical or automotive industry. With the intensifying pressure on meeting the safety and quality standards, the focus on and instances of product recalls is on the rise. Despite a manufacturer’s best efforts to produce and sell products which meet acceptable quality standards, one cannot rule out the possibility that products which do not meet those standards may reach the end consumer. Failure of these products may cause discomfort and/or accidents to the consumer.

Product failures which leads to their recall can largely be the result of failure in either the product design, the manufacturing process, inadequate description of safety features or quality standards. A recall by manufacturer can give rise to substantial litigation costs, loss of revenue, incurrence of replacement/reprocessing cost and most importantly reputational damage.

**Background**

Product recall is a request or effort initiated by the manufacturer to return a product sold after the discovery of defects and/or safety issues with the whole or a part of the product initially sold, that might put the consumer into danger or put the manufacturer/seller at risk of legal action.

The general perception is that any company engaged in manufacturing of a product can never completely rule out the possibility of an inadvertent shipment of a defective product into the market. However, it can definitely reduce the probability thereof. Recalls by a manufacturer to remove a product from the market could arise voluntarily or as per the country’s consumer protection laws or at a regulator’s request. Consumer protection laws of a country may have specific requirements with regard to product recalls. Such laws/regulations can include a framework to determine the amount of cost the maker will have to bear, situations in which a manufacturer has to compulsorily recall a product or penalties/fines for a failure to recall a product.

Generally, it is a difficult and an elaborate process to determine the cost involved in recalling a defective product, which have been released to the market/consumer and the economic loss resulting from potential bad publicity. Product recalls, in many cases, can cost a company significantly, primarily due to costs involved in having to handle the recalled product and as well as due to the possibility of being held financially liable for the consequences of the products called back.

The financial impact is generally reduced in case the manufacturer has taken an insurance cover in relation to the product recall/product liability or has entered into an agreement/arrangement with the vendor/supplier for recovering the cost involved in a product recall due to an error/issue from the vendor/supplier side.

In India, there are no specific government regulations governing product recalls. As things stand currently, product recalls do not find any particular mention in the Indian Motor Vehicles Act, 1988. Until recently, automobile recalls were not a common phenomenon in India. However, with an increased focus on customer safety and quality standards and with the roll out of voluntary recall guidelines (Voluntary Code on Vehicle Recall, 2012), released by the Society of Indian Automobile Manufacturers (SIAM), many manufacturers have voluntarily started announcing policies around faulty components resulting in product recalls.

Further, provisions of the Road Transport and Safety Bill, 2015, intends to bring into existence an independent regulator (i.e. the ‘Motor Vehicle Regulation & Road Safety Authority of India’) for regulation of vehicles with a focus on improving road safety. The bill also provides a framework around product recalls like providing this authority the power to recall a vehicle if 100 or more people complain about a particular defect in a vehicle that can cause harm to occupants or other road users.
Accounting for product recall cost and the related recoveries

Once a product recall is announced, customers start returning the product for the defective parts to be replaced. In such cases, a company would recognise provision for the related cost at the time of announcement of product recall and estimation thereof may require a detailed analysis of the particular facts and circumstances and generally is presented as a separate item of expense in the statement of profit and loss.

If the recoveries of the cost of recall are contractually agreed with the vendors then the recoveries are accounted as reimbursement under Accounting Standard 29, Provisions, Contingent Liabilities and Contingent Assets (AS 29). However, if the company recovers an insurance claim, then the cost of recall and insurance claim would be presented gross i.e. as other income and expenses respectively.

Contractual claims

Customer contracts may contain a clause for reimbursement by the manufacturer for any loss incurred by the customer due to any supply disruption/recalls made by the manufacturer or when the customer substitutes the product due to supply disruption/recall (cost differential, if product is procured from other vendor by the customer due to supply interruptions/recall). To illustrate, when a mining company purchases customised trucks from a truck manufacturer, the contract entered into between the two parties may have a compensatory clause to the effect that any production loss or loss of revenue to the mining company arising from the recall of those trucks by the manufacturer has to be compensated for by the manufacturer.

This being a contractual claim, recognition of loss is required from an accounting perspective when recall is announced and if it is expected that there would be a situation of supply disruption. The estimation of such claims is dependent upon what the expected losses to the customer due to supply interruption are, which may pose a challenge in estimating the loss in the financial statements.

Customer claims

Recall of a product where there is a reasonable probability that the use of or exposure to the defective product may have a detrimental impact on health or possibly death, may trigger end-user claims in the form of class action suits or otherwise. Depending on the probability of the outcome of the legal matter, a provision may be required and thus, again posing a challenge to estimate a particular claim in accordance with the provisions of AS 29.
Disclosure in financial statements

Depending on the nature of the recall and its impact on the company’s business as well as financial statements, product recalls would require due considerations for appropriate disclosures as required by AS 29. Under Indian GAAP, the cost of the product recall is generally included in ‘other expenses’ in the statement of profit and loss.

Consequential impact

If the product recall is caused by a serious product defect and expected to have severe impact on the company’s performance, it may have consequential impact on areas where evaluation is performed on the basis of current and future business performance of the company such as impairment assessment, going concern evaluation, compliance with laws and regulations, liability on directors of a company, recoverability of deferred tax assets and minimum alternate tax, etc. Therefore, reassessment of these aspects should be performed before the finalisation of the financial statements for that period.

To conclude, product recalls may pose significant challenges from an accounting perspective in the form of significant estimates, etc., however, these can be addressed by performing a thorough impact assessment of the event.
Challenges relating to transfer pricing

This article aims to:

- Highlight major Transfer Pricing (TP) challenges for an entity in this sector and important updates relevant to the automotive sector.
TP was not a part of an Indian tax consultants’ everyday jargon till beginning of the twenty-first century; but since then has completely changed the way several Multinational Enterprises (MNEs) look at the Indian direct tax regime. TP has unquestionably emerged as a critical topic on any CFO’s tax agenda.

**Unique attributes of the automotive sector**

This industry is capital and technology intensive, highly competitive and is subject to significant price and market risk. The automotive sector players globally have large fixed costs; make meaningful investments in research and development each year coupled with the creation of significant Intellectual Property (IP); have complex supply chains and undertake high volumes of intragroup cross-border transactions including those of technology transfers. Such intercompany transactions have extensively been a subject matter of scrutiny by the tax authorities.

**When TP meets the automotive sector**

The auto sector has been facing high pitched TP assessments in India.

TP refers to what related entities charge each other in transfer of goods/services and an analysis of whether it is akin to a third party uncontrolled transaction i.e. at an arm’s length. The primary objective of all TP regimes is to ensure that cross-border transfers between MNEs are not influenced to unjustly shift taxable profits from any jurisdiction resulting in a ‘tax base erosion’. This can best be achieved by mapping the functional and risk profile of the taxpayer vis-à-vis the related parties, and the identification of comparable uncontrolled transactions or profitability therefrom; technically termed as benchmarking. In some cases, TP is also applied to domestic transactions within India.

**Key TP challenges in the automotive sector**

Recent proliferation of TP disputes and the scale of amounts involved, have resulted in India being considered as an aggressive TP jurisdiction. The scope of transactions on the radar of the Indian TP legislation has been snowballing. The definition of ‘international transactions’ has been expanded to include guarantee, advances, business restructuring/reorganisation, etc. However, there is a lack of clear guidance on how to benchmark these transactions. There are also grey areas in situations, where a transaction that would normally not affect taxable income, fails the arm’s length test. Then there are transactions between unrelated parties that fulfil certain criteria, which can also come under the purview of TP regulations as ‘deemed international transactions’. There are certain domestic transactions1 as well which have been brought under the purview of TP. We have covered certain key challenges faced by the automotive sector in this article.

**Lack of good comparables**

One of the major hurdles for a robust and sustainable TP analysis is the non-availability of relevant and uncontrolled data for fair comparison. Most of the comparables have ownership arrangements resulting into significant Related Party Transactions (RPTs) that are not ideally suitable for comparison.

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1. ‘Specified Domestic Transactions’ under Section 92BA of the Income-tax Act, 1961 - TP provisions applicable only where aggregate amount of SDTs exceeds INR5 crore (INR20 crore from FY 2015-16 onwards)
Royalty payments

The transfer of technology/know-how is another common occurrence in many of the MNEs in the auto sector. Major Original Equipment Manufacturers (OEMs) develop technology centrally and customise it to meet the local needs for each country. While there are relatively simpler supply chains that avoid technology transfer issues (e.g. direct sale of finished products), the more sustainable options generally involve substantive manufacturing in India and local product designing activities that customise products for the Indian market. When one obtains technology, more often than not it results into royalty transactions. Benchmarking of royalty payments along with satisfaction of the ‘need, receipt and benefit’ test has become controversy-prone.

Payment of fees for centralised operations

Another key element of this is the centralisation of various functions for the MNE as a whole. For instance, central material purchasing, quality control, logistics management and other support services viz. administration, controlling, HR development, etc. This centralisation gives rise to standardisation and economies of scale. The central entity providing these services usually allocates these costs (at times, with a markup) as service charges to all MNE subsidiaries. These payments from the Indian taxpayers have been closely scrutinised and challenged by the tax authorities who question the arm’s length pricing and require satisfaction of the ‘need, receipt and benefit’ test for such service payments.

Creation of marketing intangibles

This concept involves identifying the expenditure of the Indian taxpayer on ‘Advertisement Marketing and Promotion’ (AMP), which tax authorities have been deducing, that it creates or improves the value of the brand owned by its related party (typically registered outside India). The TP authorities tend to compare the AMP spends of the taxpayer with those of the external comparables; and seek compensation for any excessive spend with markup, deeming it to be a service and thus leading to long drawn litigation.

Risk adjustments

Certain auto ancillary companies in India function as risk mitigation contractors/ manufacturers for their foreign affiliates. These arrangements involve the Indian companies manufacturing goods for the foreign affiliates under a guaranteed sales arrangement. These companies typically bear low risks, do not own any significant intangibles, and are compensated on a cost-plus basis. For facilitating a comparison, uncontrolled data of full-fledged manufacturers is available, requiring adjustments to the account for the difference in functions and risks. The Indian TP regulations provide no guidance on the adjustments which would be accepted and thus leading to litigation.

Loss-making entities

An auto-sector company, especially in its start-up phase, normally incurs significant operating losses. This situation may continue if there is a lower than anticipated demand for the particular product leading to underutilisation of capacity. Losses/low profitability could also be due to a high import content which leads to a sizeable levy of indirect taxes/duties, market penetration pricing, etc. However, tax authorities have been presuming that losses/low profits are attributable to transfer pricing which in turn leads to high pitched tax adjustments. Hence, it is imperative to identify and clearly document the reasons for operating losses/lower profits.

Accounting issues

Many auto sector entities adopt margin-based methods for benchmarking. In such cases, the effects of the differences in accounting policies (e.g. depreciation) are common. Furthermore, the uncertainty in an entity’s ability to sustain its TP stand can push it into an uncertain tax position, having an impact on its tax provision and deferred tax disclosures.
Important updates on TP which would be relevant to the auto sector as well

Base Erosion and Profit Shifting (BEPS)

BEPS has been a key priority for governments around the globe. On 19 July 2013, the Organisation for Economic Co-operation and Development (OECD) members along with the G20 countries adopted a 15 point action plan to address BEPS. India as a part of G20 countries and is actively involved in the action plan. The MNEs operating in India and Indian headquartered companies having international operations including those in the automotive sector, now have to adhere to compliance obligations that may be required under the report. The important actions from the action plan relevant to transfer pricing:

Action 8
TP aspects of intangibles

The objective of this action plan is to prevent BEPS that may result from the abuse of TP rules related to cross-border relocation of intangibles and other transactions involving the use of intangibles and also to ensure that transfer pricing outcomes are in line with value creation.

Action 13
TP documentation and Country-by-Country (CbyC) reporting

This action plan’s intention is to improve transparency for tax administrations and increase certainty and predictability for taxpayers through improved TP documentation and a template for CbyC reporting. The guidance recommends a tiered structure to documentation consisting of a master file, a local file and a CbyC report. This would be applicable for the fiscal years beginning on or after 1 January 2016. MNEs would be given one year from the fiscal year end to file their CbyC report. Indian Competent Authority has commented that the Indian Government expects that companies should provide information relating to CbyC reporting starting from FY 2016-17.

The guidance on intangible and intragroup services would assume significance from an Indian perspective especially considering that the Indian TP regulations do not contain any specific guidance on TP aspects of intangibles and the amount of litigation the automotive industry has been facing on such issues. At the same time, considering the requirement of maintaining the master file, a local file and a CbyC report would instead increase the compliance cost and burden on the taxpayer.

Action 10
Intragroup services

The purpose of this action plan is to focus on developing rules to prevent BEPS through the use of transactions (management fees, head office expenses, etc.) which would not, or would only very rarely, occur between independent parties.

Draft scheme regarding the ‘Range Concept’ and the ‘Use of Multiple Year Data’

The Central Board of Direct Taxes (CBDT) on 21 May 2015, has issued the draft scheme on the implementation of range and multiple year data concepts for computation of the Arm’s Length Price (ALP). However, the arithmetic mean concept would continue to apply where the number of comparables is inadequate. The final rules are yet awaited.

Alternative dispute resolution mechanisms

Considering the ongoing TP controversies in the automotive sector and the fact that the appeal process in India is generally rule-based and time consuming, companies can proactively consider alternative dispute resolution mechanisms such as the Advance Pricing Agreement (APA) and the Mutual Agreement Procedure (MAP) route to manage controversy.

The following paragraphs explain the requirements in each case:

APA: The APA scheme has proved to be a popular controversy management tool due to the flexibility afforded and the rational and pragmatic approach of the team. With the introduction of the rollback provision, the APA may provide protection from litigation for the past four years and future five years. The APA can be extended to certain other jurisdictions through bilateral and multilateral agreements. The results have been encouraging with 14 APAs already signed.

MAP: The use of MAP under the tax treaties can be invoked as an alternative dispute resolution mechanism. India has entered into various double taxation treaties to avoid tax disputes, whether jurisdictional conflicts or matters on interpretation. In matters pertaining to potential double taxation or taxation not in accordance with a double tax convention, there is an option available before or after the exhaustion of any domestic administrative appeals process to apply for MAP under the relevant tax treaty.

Arm’s length requirements under other Indian legislations

The arm’s length requirement is also covered in the recently introduced Companies Act, 2013 as well as Clause 49 of the Equity Listing Agreement of stock markets under the auspices of the Securities and Exchange Board of India (SEBI)! (New SEBI Listing Regulations Clause 23(3)(c)). These requirements are primarily intended to address corporate governance issues. RPTs also need to meet the arm’s length requirements under these norms.

TP aspects are also applied by the customs authorities while dealing with imports from related parties. For those companies where a cost audit is applicable, the cost audit rules require the maintenance of records for transactions with related parties indicating the transfer price and normal price (analogous to ALP) along with the basis for determination of such normal price.

2. Minutes of Tax officers’ offsite organised by Ministry of Finance and CII’s presentation at the meeting on 25 November 2014.
Way forward for the auto MNEs

The automotive sector players need to speed up on and start planning their TP policies proactively. A well-defined TP policy and clear identification and measurement of risks, functions has become the need of the hour. It is worthwhile that thorough TP planning be carried out before entering into any new intercompany transactions. Also, considering the in-depth scrutiny of royalty and management payouts by the tax authorities, sufficient documentation must be maintained to satisfy the “need, receipt and benefit” tests.

Considering high pitched assessments, the importance of a well thought-out litigation strategy cannot be overstated. Companies have an option of going the traditional appeals way via the Commissioner of Income-tax (Appeals), Income Tax Appellate Tribunal and so on. An alternative approach through the Dispute Resolution Panel route, provides a timebound process at the first level and may expedite the overall litigation process.

For companies who do not wish to proceed through the tedious litigation route, an APA provides a prudent mechanism to achieve tax certainty. Bilateral APAs could nullify any double taxation exposures. For past litigations, MAP (where available) can also provide a relief from double taxation.

The accounting aspects associated with related parties should be closely monitored and accurately reported. Apart from the tax essentials, the requirements under the Companies Act also assume great significance, and they need to be addressed on priority, considering the consequences in case of any defaults.

To sum up, a robust documentation supporting transfer prices, which is meticulously put together along with an appropriate litigation strategy could go a long way in determining a smooth ride for the MNEs in the automotive sector.
GST and the automotive sector

This article aims to:

- Provide an overview of the ‘Goods and Services Tax’ (GST) with respect to the automotive sector
- It highlights key impacts and opportunities which GST purports to bring in the automotive sector.
The Indian economy is gearing up for the biggest tax change in the country’s history with GST set to replace the prevailing excise duties, service tax and the state Value Added Tax (VAT). The automotive sector is also expected to be affected by this significant change.

Would four meter matter anymore

Today passenger vehicles (‘cars’ in common usage) have a differential central excise duty structure which are as follows:

<table>
<thead>
<tr>
<th>Vehicle category</th>
<th>Excise Duty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small cars</td>
<td>12.5 per cent</td>
</tr>
<tr>
<td>Length&gt;4m but engine capacity less than 1500cc</td>
<td>24 per cent</td>
</tr>
<tr>
<td>Length&gt;4m and engine capacity more than 1500cc</td>
<td>27 per cent</td>
</tr>
<tr>
<td>SUVs/MUVs (length &gt;4m, engine capacity &gt;1500cc and Ground clearance &gt;170mm)</td>
<td>30 per cent</td>
</tr>
<tr>
<td>Hybrid cars</td>
<td>12.5 per cent</td>
</tr>
<tr>
<td>Electric cars, 2W &amp; 3W</td>
<td>6 per cent</td>
</tr>
</tbody>
</table>

Source: The Society of Indian Automobile Manufacturers’ report on excise rate tariffs

As seen from the above table cars of a smaller engine capacity and length less than four meters are subjected to an excise duty of 12.5 per cent and this duty almost doubles once the length crosses four meters and further increases if engine capacity goes up. GST is expected to work on the principle of minimum variations in tax rates, somewhat similar to VAT today where all cars are generally taxed at a standard rate, mostly of 12.5 per cent. If the rate differential between a less-than-four-meter car (quite often a hatchback) and longer car (like a sedan) goes away, the consumer preferences can suddenly shift in favour of a sedan from a hatchback which today seems to enjoy bigger patronage because of the lower tax rates and consequently, lower prices. Since rates and tariff under GST regulations are not known yet, and there is no certainty that differential rates would go away, Original Equipment Manufacturers (OEMs) need to factor this scenario in their strategic business plan if they intend to introduce any new models of their passenger vehicles.

Revamping the distribution network

Ordinarily, models of passenger vehicles and commercial vehicles are structured differently from tax perspective. Thus impact on these models differs.

More often than not, OEMs sell their passenger vehicles through their dealers across the country. A concessional Central Sales Tax (CST) paid by the OEM on such supply at the rate of two per cent becomes cost in the supply chain as dealers do not get any credit for paying such a tax.

Commercial vehicles like trucks generally follow a consignment transfer model wherein, they are moved to warehouses in different states, and from where they are sold to dealers who in turn sell to customers in that state. OEMs typically have warehouses in each of the bigger states of India, to enable supplies to dealers in that state from the depot itself. This helps in minimising the CST cost as any supplies to a dealer from a depot outside the state would attract such cost.

Stock transfers made by the OEM from a factory to a depot does not attract CST. However, the credit of VAT paid by the OEM on its inputs is restricted (called ‘input tax retention’ in tax parlance) to some extent and adds to the cost in the supply chain.

GST is expected to replace costs such as CST and VAT retention as all taxes paid would be available as credit to the next person in the supply chain. In fact, it is expected that the number of depots of an OEM may be reduced e.g. if currently an OEM has 25 to 30 depots, it may require less than 10 depots if the business needs are adequately addressed by such a reduced number. Taking the example further, a single depot in Gurgaon or Noida may cover four to five states in the GST scenario i.e. it may remove the need for more depots that is felt today due to tax aberrations. This consolidation is expected to reduce the overall inventory level at all depots in totality.
On the flip side, it is expected that consignment/stock transfers may also attract GST at full rate, which might lead to an increased cash flow lock up. Stock transfers at present by OEMs, incur a tax expenditure in the form of excise duty at 12.5 per cent. This cash outgo may go up to 20 per cent, if that is the GST rate for commercial vehicles. In such a scenario, OEMs may need to understand the new working capital requirements to make payments for the GST on consignment/stock transfers.

In case of passenger vehicles, the concessional CST of two per cent would be replaced by a higher tax outgo on account of a higher rate charged under GST. Therefore, on one hand the OEMs will potentially save on CST paid to vendors from outside the state, but may have to bear the burden of the interest cost on higher working capital requirement for interstate procurement and sales.

In totality, it is the net effect of interest cost and the tax cost savings that the OEMs will have to work out, which in all likelihood would be positive in the GST scenario. However, OEMs need to ruminate over this impact well in advance, considering different tax rate scenarios and revisit these computations once the tax tariffs are known.

**Cash flow monitoring**

Today at standard excise¹ and VAT rate², goods are subject to a tax rate of more than 26 per cent at the wholesale stage. If the standard GST rate is around 20 per cent, then the tax impact on the final price to the customer is likely to go down, especially with savings in a tax cost as explained above. Gains in lower tax outgo would be partially offset by additional cash flow requirements.

GST on imports at 20 per cent³ would be marginally higher than the current rate of approximately 19 per cent⁴ of additional customs duties Countervailing duty and Special Additional Duty (CVD and SAD).

Any procurement from outside the state would require payment of full GST at the rate of 20 per cent as against 12.5 per cent excise duty and two per cent CST today.

An additional cash flow requirement of almost five percentage points on the interstate purchases may impact OEMs and component manufacturers alike. Services are likely to attract a higher GST rate than the current 14 per cent, which in turn will also impact the cash flows.

The dates of payment of taxes would also be different under GST as compared to those of excise, service tax and VAT. For example, excise and service tax is payable to the central government on the sixth of the following month. If the GST due date is say fifteenth of the next month, then there would be a positive impact on the cash flow requirement for a company. On the other hand, in many states VAT is to be paid to the state government by the twenty-first of the following month. A due date of fifteenth for GST in such a case will result in a negative impact on the working capital requirements.

**Sharing the benefits from GST**

GST will impact the tax cost of the company and also the cost of working capital. It together will have a positive or negative impact on the finances of the company. If the analysis hints at a net gain to the OEM, it will have to decide how much of that should be shared with the dealers and customers and in what manner. The price elasticity of the product and the strategies adopted by competitors have a big role to play in this decision.

OEMs may also ask their tier I and tier II suppliers to do a net impact analysis and insist on sharing the gains for making the product pricing more competitive. A similar exercise in the downstream supply chain, may require dealers to share gains from such credit of GST on input services with OEMs.

Presently, service tax is largely a cost to the dealers but in a GST scenario it would be a pass through. This exercise across the value chain will decide if product pricing will be impacted due to GST, how much of the impact would need to be shared by the players in the supply chain and how much of these benefits need to be shared to the final consumer.

Needless to say, the consumer, of course, would like to avail of all benefits across the value chain.

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1. Standard excise rate is assumed to be 12.5 per cent
2. Standard VAT rate is assumed to be 12.5 per cent though this may differ from state to state
3. GST rate is assumed at 20 per cent, although there is no clarity currently on what would be the standard GST rate
4. With 10 per cent basic customs duty and 12.5 per cent CVD and 4 per cent SAD, the aggregate customs duty works out to 29.44 per cent and CVD and SAD works out to be 18.73 per cent

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Opportunities might also spring up on the vendor side of the supply chain. OEMs may be able to look at vendors away from the plant location, if components of appropriate quality are available at acceptable prices within the required time. A canvass of vendor development may spread across India, making the country a unified market place.

Whether component manufacturers also find this proposition attractive and would build synergies with these logistics players, needs to be seen as and when GST is finally rolled out.

**State incentive schemes**

Many auto OEMs and component manufacturers could be claiming specific state tax incentives from the state they are located in. At times, all taxes paid by the manufacturer to the state for a specified period of 15 to 20 years are refunded. Such incentives reduce the payback period by improving the internal rate of return.

The automotive sector generates large number of direct and indirect employment opportunities, besides promoting ancillary industries which further increases employment levels. Many state governments, therefore, try to win over the auto OEMs to their state, to start the industrial snowballing effect.

Under GST, a state is expected to receive much lesser taxes from such manufacturers than under the current VAT regime. This is explained in the example below.

In the table below, looking at the existing scenario, the manufacturing state receives INR4.1 as inter-state tax i.e. CST is an origin based tax (i.e. revenue would accrue to the manufacturing state). In case of the GST scenario (which is a destination based tax), out of the total tax of INR10, only INR2 would accrue to the manufacturing state and the balance INR8 would be contributed towards interstate tax, accruing to the destination state. Hence, the benefit provided by the manufacturing state by way of incentive schemes might reduce more than 50 percent in the GST scenario.

Automobile companies might need to estimate such losses and factor it in their future projections. They may also need to discuss with the respective state governments on how they would be compensated for such losses; either by increasing the number of years of receiving the tax exemption or by any other means as considered appropriate.

**Discount structure and valuation issues**

Automobile companies usually have a robust incentive plan for their dealers. The discounts and incentives are so dynamic that the change itself is the only constant there.

Many of these discount schemes have been part of litigations especially on the central excise side. Various expenses like Pre-Delivery Inspection (PDI) and free after-sales services cost, advertising undertaken by a dealer, year-end discounts or discounts based on past performance have been a matter of dispute between the industry and the government ever since.

GST may help in the settlement of some of these disputes but might also rake up new issues.

Businesses would need to factor their new provisions of the GST law while framing their discount and incentive policies.

A greater clarity in the law and an easy availability of advance ruling can bring more certainty in the initial days of GST. The industry and the government will have to work in sync to achieve this in the coming days, if the new tax regime intends to be music to the ears of their industry.

**Looking at GST as a business change**

GST is a business change and not a mere tax change. The above are only a few examples of the indicative impact that GST may bring with it. It is easy to see that many of the impact areas would actually fall in the domain of value chain, operations and strategies of automotive companies. Each of these may have either a positive or a negative impact on the profitability of the business. Some may open up opportunities for businesses while some may create more competition and therefore, further threat. It is clear that implementation of GST will be a top priority item for most companies.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Current scenario</th>
<th>Post GST</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sales(INR)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax rate</td>
<td>Tax amount (INR)</td>
</tr>
<tr>
<td>Within manufacturing state</td>
<td>20</td>
<td>12.50%</td>
</tr>
<tr>
<td>Outside manufacturing state</td>
<td>80</td>
<td>2%</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Tax received by manufacturing state</td>
<td></td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: KPMG in India analysis

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5. SGST rate is assumed to be 10 per cent. The CGST component is not considered here since this would accrue as revenue to the central government.

6. All tax rates are assumed for this example.
ICAI releases revised guidance on Internal Financial Controls Over Financial Reporting

Background
Under Section 143(3)(i) of the Companies Act, 2013 (2013 Act), an auditor of a company is required 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. Explanation to Section 134(5)(e) of the 2013 Act defines IFC to include policies and procedures adopted by the company for ensuring orderly and efficient conduct of its business, accuracy and completeness of the accounting records, and timely preparation of reliable financial information.

The Institute of Chartered Accountants of India (ICAI) had issued a Guidance Note in November 2014. This Guidance Note has been revised subsequently and the ICAI issued a revised ‘Guidance Note on Audit of Internal Financial Controls Over Financial Reporting’ (Guidance Note) on 14 September 2015.

Reporting responsibility of the management
- Section 134(5)(e) of the 2013 Act (which deals with the directors’ responsibility statement) requires directors of listed companies to state whether they had laid down IFC to be followed by the company and that such IFC are adequate and were operating effectively.
- Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 (Rules) requires Board’s report of every company to state the details in respect of adequacy of IFC with reference to the financial statements.
- Though not specifically mentioned, the Guidance Note appears to suggest that for:
  - Listed companies: The directors’ responsibility statement to state that IFC are adequate and operating effectively. The Board’s report to state the adequacy of IFC with respect to financial statements.

Criteria to be considered for developing, establishing and reporting on IFC
- Similar to the 2013 Act, the Guidance Note does not prescribe a particular framework for IFC. Instead the Guidance Note states that a benchmark system of internal control, based on suitable criteria, is essential to enable the management and auditors to assess and state the adequacy and compliance of the system of internal controls.
- In the Indian context, e.g. Appendix I ‘Internal Control Components’ of Standards on Auditing (SA) 315 -Identifying and Assessing the Risk of Material Misstatement Through Understanding An Entity and Its Environment, provides the necessary criteria for IFC over financial reporting (IFC - FR) for companies.
- The components of internal controls under SA 315 takes into account control environment, entity’s risk assessment process, control activities, information system and communication and monitoring of controls.

Reporting by auditors – whether same scope as that of management
- The auditor’s objective in an audit of IFC - FR (which is generally carried out along with an audit of financial statements) is to express an opinion on the adequacy and operating effectiveness of the company’s IFC - FR. A company’s internal control cannot be considered effective if one or more material weakness exists. Paragraph A1 of SA 200 -Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, inter alia, states that the auditor’s opinion on the financial statements does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which the management has conducted the affairs of the entity.
- Globally also, auditor’s reporting on internal controls is together with the reporting on financial statements and such internal controls reported upon relate only to internal controls over financial reporting.
- The Guidance Note states that consistent with the requirements of the 2013 Act and the Rules as well as the practice prevalent globally, the term IFC wherever used in the Guidance Note in the context of the responsibility of the auditor for reporting on such controls under Section 143(3)(i) of the 2013 Act, per se implies and relates to IFC - FR.
- For the above purpose, the Guidance Note defines IFC - FR to mean a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Generally Accepted Accounting Principles.
How to audit IFC - FR

- Since the SAAs do not address the auditing requirements for reporting on IFC, though certain portions of the SAAs may still be relevant, the Guidance Note provides supplementary procedures that would need to be considered by the auditor for planning, performing and reporting in an audit of IFC - FR under Section 143(3)(i) of 2013 Act.

- The Guidance Note specifically states that since the audit of IFC is in connection with financial reporting, the concept of materiality will be applicable even in such audits. The auditor should use the same materiality considerations as would be used in planning the audit of the company’s annual financial statements as provided in SA 320 -Materiality in Planning and Performing an Audit.

Though the audit procedures mentioned in the Guidance Note have been framed for an auditor, these procedures could also be used by companies to perform a self-evaluation. The audit procedures would typically involve the following steps:

- **Step1 Planning**
  Under the planning stage, the auditor is required to establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. The planning stage involves identification of significant account balances/disclosure items, identification and understanding significant flow of transactions, identification of Risk of Material Misstatements (RoMM), identification of controls which will address RoMM including applications, associated IT environment and general IT controls.

- **Step2 Design and implementation**
  The auditor should test the design effectiveness of controls by determining whether the company’s controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company’s control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

- **Step3 Operating effectiveness**
  Operating effectiveness of a control is tested by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

  Testing of operating effectiveness involves planning the nature, timing and extent of procedures to be performed, assessing findings and concluding on operating effectiveness.

- **Step4 Reporting**
  Where there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor should evaluate the need to express a modified opinion i.e. qualified or adverse on the company’s IFC - FR, unless there is a restriction on the scope of the engagement in which case the auditors should either disclaim the opinion or withdraw from the engagement. The auditor should determine the effect of the modified opinion on IFC - FR has on his opinion on the financial statements. Additionally, the auditor should disclose whether his opinion on the financial statements was affected by the modified opinion on IFC - FR.

### IFC reporting on consolidated financial statements (CFS)

- Section 129(4) of the 2013 Act states that provisions of the 2013 Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the CFS. A strict reading of this Section might indicate that the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the IFC - FR, even in the case of CFS.

- The Guidance Note has clarified this by stating that reporting on the adequacy and operating effectiveness of IFC - FR would apply even in the case of CFS, for the respective components included in the CFS only if it is a company under the 2013 Act.

- Accordingly, in line with the approach adopted by the ICAI in case of certain other reporting matters on CFS, the reporting on adequacy of IFC would also be on the basis of the reports on Section 143(3)(i) of 2013 Act as submitted by the statutory auditors of components that are Indian companies under the 2013 Act.

### Specified date for reporting on the adequacy and operating effectiveness of IFC - FR

- Section 143(3)(i) of the 2013 Act does not specify whether the auditor’s report should state if IFC existed and operated effectively during the period under reporting of the financial statements or at the balance sheet date up to which the financial statements are prepared. Paragraph 57(k) of the Statement on the Companies (Auditor’s Report) Order, 2003 issued by the ICAI, inter alia, states that an auditor is required to assess whether the major weakness, if any, noted by him have been corrected by the management at the balance sheet date.

- Accordingly, the auditor should report if the company has adequate internal control systems in place and whether they were operating effectively at the balance sheet date.

### IFC reporting on interim financial statements

- It may also be noted that an auditor’s reporting on IFC is a requirement specified in the 2013 Act, and therefore will apply only in case of reporting on financial statements prepared under the 2013 Act and reported under Section 143 of the 2013 Act.

- Accordingly, reporting on IFC will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.
Foreign Direct Investment (FDI) – Reporting under the FDI Scheme on the eBiz platform

The Reserve Bank of India (RBI), through its circular no. 9, RBI/2015-16/157 A.P. (DIR Series) dated 21 August 2015, has enabled online filing of the Foreign Currency Transfer of Shares (FCTRS) returns for reporting transfer of shares, convertible debentures, partly-paid shares and warrants from a person resident in India to a person resident outside India or vice versa. The RBI has enabled online filing to promote ease of reporting of transactions under foreign direct investment, under the aegis of the eBiz project of the Government of India.

The design of the reporting platform enables the customer to login into the eBiz portal, download the reporting form (FCTRS), complete and then upload the same onto the portal using their digitally-signed certificates. The Authorised Dealer Banks (ADs) will be required to download the completed forms, verify the contents from the available documents and if necessary, call for additional information from the customer and then upload the same for the RBI to process and allot a Unique Identification Number (UIN). The FCTRS services of the RBI have been made operational on the eBiz platform from 24 August 2015.

Further, the online reporting on the eBiz platform is an additional facility to the Indian residents to undertake their reporting and the manual system of reporting as prescribed in terms of A.P. (DIR Series) Circular No. 6 dated 18 July 2014 would continue till further notice.


The Ministry of Corporate Affairs (MCA) modified Form MR-2

MR - 2 form is utilised when applying to the Central Government for:

- approval of appointment or reappointment
- remuneration or increase in remuneration
- waiver for excess or over payment to a managing director or whole time director or manager and commission or remuneration to directors.

The MCA modified the version of Form MR - 2 with effect from 14 August 2015. The MCA advised the stakeholders to plan accordingly pursuant to change of the version of the above mentioned form.

(Source: MCA Notice dated 14 August 2015 on the MCA website)

The MCA amends norms relating to the preparation of financial statements

The MCA has been issuing various amendments and clarifications to the Companies Act, 2013 (2013 Act) and to the corresponding Rules to remove practical challenges faced by companies while implementing certain provisions of the 2013 Act. Recently, the MCA amended the Companies (Accounts) Rules, 2014 (Rules) and Schedule III to the 2013 Act.

Amendment to definitions

The MCA has inserted a new Rule 4A which states that the financial statements should be in the form specified in the Schedule III to the 2013 Act and should comply with the Accounting Standards (AS) or Ind AS as applicable. Therefore, the items contained in the financial statements should be understood in accordance with the definitions and other requirements as specified in the AS or the Ind AS, as the case may be.

Currently, there is a conflict in the definitions used in the AS and the 2013 Act. The MCA has addressed these concerns and accordingly inserted the above mentioned rule.

Amendments to the above Rules and the Schedule III to the 2013 Act are expected to come into force from the date of publication in the Official Gazette.

Disclosures for micro and small enterprises in Schedule III to the 2013 Act

In the present Schedule III to the 2013 Act, 'Trade Payables' is being shown as a single line item under the head Current Liabilities under 'Equity and Liabilities'.

However, as per the recent notification issued by the MCA dated 4 September 2015, Trade Payables will now be further categorised into:

A. Currently, there is a conflict in the definitions used in the AS and the 2013 Act. The MCA has addressed these concerns and accordingly inserted the above mentioned rule

B. Amendments to the above Rules and Schedule III to the 2013 Act are expected to come into force from the date of publication in the Official Gazette.

Accordingly, under the head of ‘Notes: General Instructions for Preparation of Balance Sheet’, following details relating to micro, small and medium enterprises should also be disclosed:

a. The principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

b. The amount of interest paid by the buyer in terms of Section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

c. The amount of interest due and payable for the period of delay in making the payment (which has been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

d. The amount of interest accrued and unpaid at the end of each accounting year; and

e. The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under Section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.
The SEBI issues the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations)

The Securities and Exchange Board of India (SEBI) on 2 September 2015 notified the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations). For ease of reference, the SEBI has consolidated all requirements of the listing agreements relating to different segments of the capital market in a single document. These include:

- equity (including convertibles) issued by entities listed on the main board of the stock exchanges
- small and medium enterprises (SME) listed on the SME exchange and institutional trading platform
- non-convertible debt securities
- non-convertible redeemable preference shares
- Indian depository receipts
- securitised debt instruments
- units issued by mutual fund schemes.

The Listing Regulations have been sub-divided into two parts:

a. substantive provisions incorporated in the main body of the regulations
b. procedural requirements in the form of schedules to the regulations.

Applicability

The Listing Regulations are effective from 2 September 2015. The SEBI has provided a time period of 90 days for implementing the regulations. However, two provisions of the regulations which are facilitating in nature are applicable with immediate effect. The two provisions are as follows:

- passing of ordinary resolution instead of special resolution in case of all material related party subject to related parties abstaining from voting on such resolutions, in line with the provisions of the Companies Act, 2013 (2013 Act)
- re-classification of promoters as public shareholders under various circumstances.
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Missed an issue of Accounting and Auditing Update or First Notes?

ICAI releases revised guidance on Internal Financial Controls Over Financial Reporting
16 September 2015
Under Section 143(3)(i) of the Companies Act, 2013 (2013 Act), an auditor is required to state in their audit report whether the company has an adequate internal financial controls (IFC) system in place and the operating effectiveness of such controls. Explanation to Section 134(3)(e) of the 2013 Act defines IFC to include policies and procedures adopted by the company for ensuring orderly and efficient conduct of its business, accuracy and completeness of the accounting records, and timely preparation of reliable financial information.

The Institute of Chartered Accountants of India (ICAI) had issued a Guidance Note in November 2014. This guidance note was revised subsequently and the ICAI issued a revised ‘Guidance Note on Audit of Internal Financial Controls Over Financial Reporting’ (Guidance Note) on 14 September 2015.

Our First Notes provides an overview of the Guidance Note issued by ICAI.

KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

In this month’s call, we will cover key financial reporting and regulatory matters that are expected to be relevant for stakeholders as they approach the quarter ending 30 September 2015.

Our call will include updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), the Institute of Chartered Accountants of India (ICAI), the International Accounting Standards Board, etc.

We look forward to your presence and active participation on this call.

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Feedback/queries can be sent to aauupdate@kpmg.com

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