Accounting and Auditing Update

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Building, Construction and Real Estate

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In continuance with our current series of the Accounting and Auditing Update, we focus this month on the Building, Construction and Real Estate (BCRE) sector.

Indian Accounting Standards (Ind AS), which are largely converged with International Financial Reporting Standards (IFRS), are bringing about a paradigm shift in financial reporting in India. However, very importantly for the BCRE sector, the guidance under IFRS relating to revenue recognition from sale of real estate will not be applicable currently and this represents a potentially significant breather for this sector. In this publication, we seek to highlight current Indian GAAP guidance on revenue recognition relevant to the sector and the guidance under IFRS, along with related potential challenges following the adoption of Ind AS. The Institute of Chartered Accountants of India (ICAI) is also expected to issue a guidance note to provide further direction on revenue recognition from the sale of real estate.

We also cover this month two aspects of revenue recognition in detail. We cover the accounting for construction costs and principles to consider while allocating costs that should form part of the calculation of the percentage of completion in a construction contract and we also cover the principles that should be considered while determining when to combine a group of contracts and when to segment a contract for the purposes of revenue recognition.

The publication also features an interaction with Mr. Govinder Singh, International Business Head and Ex-Chief Financial Officer, Tata Housing Development Company Limited, and explores some key accounting, reporting and other topical matters relevant to the industry.

Ind AS also provides specific guidance on the accounting and presentation for an investment property. Our article on this topic highlights the rationale behind classifying an item of property as an inventory, property, plant and equipment, or investment property under Ind AS. In addition, fair valuation of investment properties is another critical performance metric for the BCRE sector, but it has its own set of implementation and operational challenges. Our article provides an overview on the current practices for fair valuation of investment properties and key challenges encountered in their valuation.

We also explore in this Accounting and Auditing Update a number of financing structures prevalent in real estate companies and provide an overview on the evolution of funding instruments and structures in the real estate organisations. Our publication also explores an important concept of Real Estate Investment Trusts (REITs) and provides an overview of the amendments in the Finance Bill, 2016 and potential benefits of establishing a REIT in India.

Finally, our publication provides a regular round up on regulatory updates.

As always, we would be delighted to receive any kind of feedback or inputs on the topics that we have covered.
Overview

In 2013-14, the real estate sector constituted 78 per cent of India’s GDP. In the last few years, the sector growth has been muted in the range of 1 to 2 per cent against a Compound Annual Growth Rate (CAGR) of 8 per cent since the year 2000.

Commercial office space: Maintained its positive momentum through 2015, led by heavy leasing activities from e-commerce, telecommunication and healthcare sectors. In 2015, about 36 million square feet of office space was absorbed, the second best after 2011 and against a new supply of about 35 million square feet. The vacancy level fell from 19 per cent in 2013 to 15 per cent in 2015. Over the next two years, absorption is expected to match the new supply of about 100 million square feet reducing the vacancy level to about 13 per cent. Major markets for commercial office space are expected to be Bengaluru, Delhi-NCR, Hyderabad, Mumbai and Pune. The transactions during the first nine months totalled to about INR21.9 billion, 28 per cent lower Year on Year (Yo-Y).

Hospitality: More than 15,000 rooms were added since 2013, taking the total inventory to more than 90,000 rooms in 2015. The average occupancy rate surged to more than 60 per cent and is expected to remain at this level in the medium-term, despite a supply of about 30,000 rooms. Major additions are expected in the cities of Delhi-NCR and Mumbai.

Retail: Since 2011, the sector has remained weak and the supply of quality retail space has been limited. High competition between e-commerce firms and a focus on profitability has resulted in retail brands shuffling their store portfolio by closing loss-making stores. The supply of quality retail space is expected to remain tepid in the medium-term. Though, about 30 million square feet of retail space is expected to get operational by 2018, there are chances that some of the supply may get delayed unless retailers are fully confident about the quality of retail space.

Residential: The slowdown in the sector has significantly affected residential housing, the biggest asset class, pushing the inventory of unsold housing units to reach 0.7 million units, which might take about three years to get absorbed at the current rate of sales. Rising inventory has put pressure on property prices as well and it is estimated that property prices have directly or indirectly (through promotions, schemes, etc.) been corrected by about 10 to 15 per cent nationally. The luxury segment (generally priced above INR30 million/unit), which is generally immune to a slowdown, also witnessed a weakness. Since 2013, the launch of luxury flats has decreased by two-thirds, while sales have almost halved.

Important reforms: Several policy initiatives taken in 2014-15 to help this sector include the amendment of the Foreign Direct Investment (FDI) policy removing the minimum floor area and minimum capital requirement provisions. The Reserve Bank of India also reduced the risk weight for individual housing loans of up to INR75 million from 50 to 35 per cent. Further, it increased loan-to-value of up to INR3 million ration to 90. The government also announced plans to build 60 million houses by the year 2022 under the ‘Housing for All’ vision. Further, the government has recently released the list of the first 20 smart cities out of the 100 proposed cities.

Funding: The flow of capital has been significant last year, especially in the office and hospitality segment. It is estimated that since the beginning of 2015, about USD8 billion or INR53 billion was invested by domestic and foreign investors, which was the highest witnessed in the last seven years. A lot of this investment has come via structured deals (USD3 billion) and non-convertible debentures (NCDs) (around USD4.5 billion). These investments are largely debt in nature and FDI inflow in the construction development sector (which is equity in nature) has only been USD81 million between April-September 2015.

Challenges: Procedural delay is a major constraint in this sector. According to the World Bank’s ‘Doing Business 2015’ index, India ranked 184 (out of 189 economies) in terms of construction permits, requiring on an average 27 procedures to get permits as compared to an average of 14 in South Asia and 12 in OECD (Organisation for Economic Cooperation and Development) countries. It is estimated that about 25 per cent of housing projects in India are delayed, largely due to poor project management and delays in regulatory approvals. For a building project, it is estimated that over 40 different kind of approvals are required which can take anywhere between two to three years before construction can start.

4. Since the source is the same as above, please rectify by inserting the same source number. Please do not repeat sources.)
10. FDI Statistics, The Department of Industrial Policy & Promotion, accessed December 2015

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Revenue recognition in the BCRE Sector
- Key considerations

This article aims to:
- Provide an overview of the relevant framework with respect to revenue recognition for real estate and construction type contracts
- Highlight some of the key challenges related to revenue recognition for real estate and construction type contracts
- Impact of transition to Ind AS on the real estate and construction companies related to revenue recognition.
Real estate and construction contracts can be divided into two broad categories:

- Contracts wherein an entity builds/constructs and sells the products, which could be the completed apartment, house, or condominiums
- Contracts wherein the entity builds/constructs the product (project) in the capacity of a contractor engaged by the buyer and delivers to the contractee/buyer, therefore, the contract in this case is a contract of selling a service i.e. construction service.

Real estate developer who builds/constructs a project, and on completion thereof, sells the developed product to the buyers performs acts as a ‘principal’. Revenue from selling products in normal course is recognised on delivery of the product unless services are provided, in which case, the revenue would be recognised based on a percentage-of-completion (POC). In the latter case, revenue from rendering services would be recognised on a POC method basis as the construction progresses.

With this background, this article discusses the framework and key challenges for recognition of revenue for a real estate developer constructing and selling a completed product i.e. flat/apartment/condominiums and that for a contractor rendering construction services.

### Revenue recognition by real estate developers under current Indian GAAP

Currently, in India, we do not have an accounting standard which primarily focusses specifically on the recognition of revenue from real estate transactions. The accounting and reporting for such transactions is based on principles enunciated in AS 9, Revenue Recognition and AS 7, Construction Contracts prescribed in the Companies (Accounting Standards) Rules, 2006, as supplemented by the Revised Guidance Note (GN 2012) on Recognition of Revenue by Real Estate Developers, issued by the Institute of Chartered Accountants of India (ICAI) in 2012.

Let us understand the accounting treatment for sale of real estate assets by the entity engaged in such business under the current Indian GAAP first.

In accordance with principles of transfer of risks and rewards of ownership as enunciated in AS 9 read with the GN 2012, the recognition of revenue by a real estate developer is summarised in the diagram below:

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**Real estate transactions**

**Single element transactions**

- Transferable development rights
  - Is there a transfer of risks and rewards?
    - Yes
      - Revenue recognition on transfer of risks and rewards
    - No

- Sale of land or plots and units similar to delivery of goods
  - Is there a transfer of risks and rewards?
    - Yes
      - POC method
    - No

- Construction type contracts
  - Is there a transfer of risks and rewards?
    - Yes
      - Revenue recognition on transfer of risks and rewards
    - No

**Multiple element transactions**

- Split the contract in separate components and apply revenue recognition criteria separately to identified components

(Source: KPMG in India analysis, 2016)
Though the real estate sector has evolved over the years, with the ever-increasing complexity of the underlying transactions, this has resulted in diversity in practice for revenue recognition. Some of the key areas of inconsistencies are:

- Completed contract vs POC method

### Completed contract vs POC method

For recognition of revenue in case of real estate sales, it is necessary that all the conditions specified in paragraphs 10 and 11 of AS 9 are satisfied.

Paragraph 10 of 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 AS 9 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’.

Real estate sales take place in a variety of ways and may be subjected to different terms and conditions specified in an agreement for sale with customers.

The terms and conditions in the contractual agreement with the customers are vital in determination the point of time at which all significant risks and rewards of ownership would be considered to be transferred to the buyer.

In case of real estate sales, the seller usually enters into an agreement for sale with the buyer at initial stages of construction. This agreement for sale is considered to have the effect of transferring all significant risks and rewards of ownership to the buyer provided the agreement is legally enforceable and subject to the satisfaction of conditions which signify transferring of significant risks and rewards even though the legal title is not transferred or the possession of the real estate is not given to the buyer.

Completion of revenue recognition process is usually identified when all the following conditions are satisfied:

- All significant risks and rewards of ownership should have been transferred.
- The seller should retain no effective control of the real estate transferred to a degree usually associated with ownership i.e. the nature and extent of continuous involvement of the seller should not be such that risks and rewards of ownership are not transferred, e.g. sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period.
- There should be no significant uncertainty regarding the amount of the consideration that will be derived from the real estate sales.
- It should not be unreasonable to expect ultimate collection. When the aggregate of the payments received, including the buyer’s initial down payment, or continuing payments by the buyer, provide insufficient evidence of the buyer’s commitment to make the complete payment, revenue should be recognised only to the extent of realisation of the consideration provided other conditions for recognition of revenue are satisfied.

For determination of transfer of risk and rewards of ownership, the customer should have a legal right to sell or transfer his interest in the property without any condition or subject to only such conditions which do not materially affect his right to benefits in the property.
• the purchaser has paid all the dues payable by him to the developer under the agreement and he has not breached any of the terms of the agreement.

Our views

The exact connotation of the words ‘all dues payable’ would be relevant to determine transfer of risks and rewards of ownership.

If the words in the agreement refer to 100 per cent of the price, then the buyer does not get any right to sell or transfer his rights under the agreement until he pays the full purchase price. This pre-condition would then be significant since it would mean that merely on execution of an agreement to sell, the buyer would not get a legal right to sell or transfer his interest in the property.

On the other hand, if the words in the agreement refer to all the dues payable by the buyer based on the demands raised by developer till date under the milestone basis, then the pre-condition may relate to the protective rights to secure the collection.

The evaluation of the above mentioned conditions and other conditions in an agreement to sell (the conditions would need a careful evaluation on a consolidated basis) would be crucial to determine whether the risks and rewards have been transferred to the buyer on execution of the agreement even though the legal title and possession may be transferred at a later date.

Method for determining the POC – Input method vs output method and thresholds for revenue recognition under POC method

There is a rebuttable presumption that the outcome of a real estate project can be estimated reliably and that revenue should be recognised under the POC method only when the events in (a) to (d) below are completed.

a. All critical approvals necessary for commencement of the project have been obtained. These include, wherever applicable:
   - Environmental and other clearances.
   - Approval of plans, designs, etc.
   - Title to land or other rights to development/construction.
   - Change in land use.

b. When the stage of completion of the project reaches a reasonable level of development. A reasonable level of development is not achieved if the expenditure incurred on construction and development costs is less than 25 per cent of the construction and development costs.

c. At least 25 per cent of the saleable project area is secured by contracts or agreements with buyers.

d. At least 10 per cent of the total revenue as per the agreements of sale or any other legally enforceable documents are realised at the reporting date in respect of each of the contracts and it is reasonable to expect that the parties to such contracts would comply with the payment terms as defined in the contracts.

On meeting all the above criteria, the entity would recognise revenue based on the POC method.

Stage of completion can be arrived at based on input method or output method. The method in which the actual project costs incurred (including borrowing costs, construction and development costs) to the expected total costs of the projects is determined is commonly referred as the input cost method. Whilst the method of determination of stage of completion with reference to project costs incurred is the preferred method, the GN 2012 does not prohibit other methods of determination of stage of completion, e.g., surveys of work done, technical estimation, etc. commonly referred to as output method. However, computation of revenue with reference to other methods of determination of stage of completion should not, in any case, exceed the revenue computed with reference to the ‘project costs incurred’ method.

Revenue recognition for construction contract by contractors under current Indian GAAP

Revenue recognition in case of a construction contract is governed by AS 7. AS 7 covers the contracts wherein the developer/contractor is rendering construction services by executing the contract as per the specifications of the buyer. The contract may be a fixed price contract or a cost plus contract.

When the outcome of a construction contract can be estimated reliably, the contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract.

Stage of completion is determined based on input method and output methods (as discussed above in the article).
Accounting under IFRS

Under International Financial Reporting Standards (IFRS), the following standards and interpretations govern the revenue recognition for real estate developers and contractors:

IAS 18, Revenue Recognition
IAS 11, Construction Contracts
IFRIC15, Agreements for the Construction of Real Estate (deals with accounting of real estate contracts).

Determining whether an agreement for the construction of real estate is within the scope of IAS 11 or IAS 18 depends on the terms of the agreement and the facts and circumstances and requires judgement with respect to each agreement.

An agreement for the construction of real estate could meet the definition of a construction contract only when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not he/she exercises that ability). For example, a buyer may ask the real estate contractor to construct a villa on a land owned by the buyer and as per design and specification approved by the buyer. In such a scenario, the buyer controls the work-in-progress on an ongoing basis, and has the ability to change the contractor and hire a new contractor. In such situations, the contractor will have to apply IAS 11 to recognise revenue.

In contrast, an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate, e.g. to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods within the scope of IAS 18. The entity may transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. In this case, if all the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, the entity shall recognise revenue by reference to the stage of completion.

In accordance with the principles of IAS 18 and IFRIC 15, the construction of real estate should be treated as sale of goods and revenue should be recognised when the entity has transferred significant risks and rewards of ownership and retained neither continuing managerial involvement nor effective control.

An agreement for the construction of real estate could meet the definition of a construction contract only when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not he/she exercises that ability). For example, a buyer may ask the real estate contractor to construct a villa on a land owned by the buyer and as per design and specification approved by the buyer. In such a scenario, the buyer controls the work-in-progress on an ongoing basis, and has the ability to change the contractor and hire a new contractor. In such situations, the contractor will have to apply IAS 11 to recognise revenue.

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Transition to Ind AS

The initial plan of the regulators in India such as the Ministry of Corporate Affairs (MCA) and ICAI was to implement the new revenue standard ahead of the global roll-out. However, post the deferral of IFRS 15 to 2018 internationally, ICAI in October 2015 proposed a deferral of Ind AS 115. This has been confirmed by MCA through its draft notification issued on 16 February 2016, which proposes that Ind AS 115 shall now be effective from accounting periods commencing on or after 1 April 2018. Consequently, MCA has issued the following exposure drafts (EDs) for comments:

- Ind AS 11, Constructions Contracts along with the appendices corresponding to IFRIC 12, Service Concession Arrangements, SIC-29, Service Concession Arrangements: Disclosures
- Ind AS 18, Revenue, along with the appendices corresponding to IFRIC 13, Customer Loyalty Programmes, IFRIC 18, Transfers of Assets from Customers, SIC-31 Revenue- Barter Transactions Involving Advertising Services.
- Consequential amendments.

Currently, the EDs do not provide guidance on revenue from real estate transactions. Instead, they state that revenue would be recognised by real estate developers in accordance with a Guidance Note that will be issued by the ICAI on this subject. We expect that this new Guidance Note will retain the application of the percentage of completion method for revenue recognition as in the current guidance note.

We expect that the transition to Ind AS, may give rise to certain accounting complexities relating to:

- Thresholds of revenue recognition that the new guidance note may prescribe
- Determination of stage of completion using the input or output method
- Whether land/development rights costs would be included for determination of minimum thresholds for revenue recognition
- Accounting of joint development agreements.
Combining and segmenting of contracts

This article aims to:
- Discuss the indicators that should be considered while determining when to combine a group of contracts and when to segment a contract.
In today’s scenario it is not uncommon to find contracts (multiple or single) for undertaking construction involving at least two components – one for the supply portion and the other for installation and commissioning portion. These contracts could be structured/entered into considering various key elements like legal requirements, taxation, litigations, entity’s legal structure, access to resources from various economies/countries, budgeting process, etc. These factors could lead to situations where it becomes difficult for a company to assess whether two contracts are to be combined together or a single contract contains multiple elements and hence, need to be considered as separate contracts.

Under Indian GAAP, in order to recognize revenue, the onus is on the company to understand the substance of the contracts and either segment or combine them using accounting principles on a consistent basis.

In our experience, while awarding a construction contract, companies undertake a tendering/quotation submission process wherein tenders/quotations may be invited from three or more parties. The tenders/quotations could comprise of a technical bid, financial bid, credentials, etc.

**Accounting guidance under AS 7, Construction Contracts**

According to AS 7, components of a contract are accounted for as separate contracts if each segment functions on a stand-alone basis and all of the following criteria are met with:

- Separate proposals were submitted for each component;
- Each component was subject to separate negotiation and could have been accepted or rejected; and
- The costs and revenue for each component can be identified.

According to AS 7, a group of contracts (whether with a single customer or not) is treated as a single construction contract if they do not function on a stand-alone basis and:

- They were negotiated as a part of a single package;
- The contracts are effectively a part of a single project with an overall profit margin; and
- The contracts are performed concurrently or in a continuous sequence.

Further, if for example, an equipment sold by a company is not ‘plug and play’ type and requires installation through technicians or loading of software or significant installation activity, then such an installation activity would be considered while evaluating the criteria for combining and segmenting of contracts.

Determination of combining and segmenting of a construction contract from an accounting perspective requires evaluation of all parameters/aspects in a contract and other facts and circumstances that are relevant for making this assessment. Certain examples of these parameters that could be considered are as follows:

- Evaluation of the tender document from the customer i.e. whether the customer has floated the request for a separate deliverable or combined
- Vendor ability in quoting for the tender/purchase order i.e. whether the vendor has quoted for an individual item in a contract or for the entire contract(s)
- Profitability of the project i.e. whether determined for a single component in a contract or on the entirety of the contract
- Degree to which customisation is required to be carried out based on the instruction of the customer and whether individual products/goods in the contract have a stand-alone value to the customer

- Installation activity in the contract i.e. whether the installation can be performed by any other vendor independently
- Penalty charges for cancellation/non-performance of the contract

The above list is not exhaustive and there is no hierarchy available to assess the above parameters. Therefore, judgement is required to determine when to combine or segment a contract based on an overall assessment of all the facts and circumstances taken into consideration. Further, whether to combine or segment a contract is not an optional step in accounting. This judgement is expected to impact the recognition, measurement and presentation of revenue in the financial statements of an entity. Additionally, the principles of combining and segmenting a contract under Indian GAAP are in line with Ind AS and IFRS.
Construction costs

This article aims to:
– Highlight the principles to consider while allocating the costs that should form part of the calculation of the percentage of completion in a construction contract.
Accounting for construction contracts involves assessing various judgements and estimates e.g. combining or segmenting of contracts, estimate of total project costs, percentage of completion based on either the input/output method, cost to complete the project, cost variations and its recoverability, costs that would form part of the contract cost incurred, etc. These estimates require the exercise of judgement and careful consideration of various attributes of a construction contract.

At a boarder level, there are various types of costs relating to a contract, for example:

- Those that are directly related to a contract e.g. labour, material, direct design and assistance, cost of rectification and guarantee work, royalties paid for the use of intellectual property and depreciation of property, plant and equipment used directly in a contract.
- Those that are general in nature/pertaining to common activities and can be allocated to the contract e.g. insurance and overheads and that can be allocated to a contract on a systematic and rational basis on a normal contract activity.
- Those that are specifically chargeable to the customer under the terms of the contract e.g. general and administrative and development costs that are reimbursed under the terms of the contract.

While accounting for conraction contracts, it is important to determine the costs that should form part of the contract costs while determining the stage of completion. Common challenges when determining the percentage of completion using the input method could be as follows:

- Whether all material sourced upfront for the project should be considered as part of cost incurred
- Only material installed on the project should be considered as part of cost incurred
- Will material sourced/fabricated/customised for the particular project be considered as part of the cost incurred.

While the answer to the above implementation issues may be different from project to project/stage of the contract, certain basic principles to be considered while exercising judgement are discussed in AS 7, Construction Contracts.

Para 30 of AS 7 provides:

- When the stage of completion is determined by reference to the contract costs incurred up to the reporting date, only those contract costs that reflect work performed are included in costs incurred up to the reporting date. Examples of contract costs which are excluded are:
  - payments made to subcontractors in advance of work performed under the subcontract.
  - contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and
- payments made to subcontractors.

(Emphasis added)

From the above, it seems that the factor which should be considered is only those contract costs that reflect work performed and are included in costs incurred to date when measuring contract progress. Further, those costs should be excluded that relate to a future contract activity ‘such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied’. Therefore, procurement of materials by itself might not constitute ‘work performed’. However, there may be situations where materials have been manufactured specifically for a project considering its specific requirements (such as size, design, quality, etc.). In such cases, the manufacture of materials could in itself be a contract activity that needs to be considered while applying the percentage of completion method. Where the work of manufacture of such materials is entrusted to a third party, the said party is in the nature of a subcontractor rather than a mere material supplier. The progress made by a subcontractor should also be taken into account while assessing the overall progress (or stage of completion) on a project. (Para 30(b) of AS 7 clearly seems to imply that costs incurred on work performed by subcontractors are to be included).

Further, while considering the cost incurred by a subcontractor, only a certificate of stage of completion might not be sufficient evidence to consider the cost incurred and therefore, the contractor should be involved on a regular basis to ensure the stage of completion throughout the period of the work subcontracted. The degree of involvement is dependent on the customisation of the work subcontracted.

Material which is generally available and those materials which have not been specifically fabricated/made for the contract become a part of the work performed only when they are installed, used or applied during contract performance. Examples of such materials are purchase of cement, sand or certain cables of given technical parameters which are not unique and are specifically manufactured for the contract. Such materials would not form part of the contract work-in-progress till they are installed, used or applied during the contract.

Certain examples from practical situations are as follows:

- If a contractor has procured cement for the purposes of building a dam and the material (in bulk) has been delivered at the construction site but is yet to be used in the construction work as on the reporting date, the same should not be considered while determining the cost incurred on the reporting date; this should instead be included as part of the closing inventory.
- If a contractor is constructing a flyover and building blocks, which connects one pillar to another, duly fabricated by a third party based on the specifications of the flyover are delivered at the project site, then assuming the risk and rewards of ownership are transferred to the contractor on a continuous basis, the cost of such fabricated building blocks yet to be installed would be considered as cost incurred on the reporting date.

Thus to determine the stage of completion by reference to the contract costs incurred up to the reporting date, only those contract costs that reflect work performed are included in costs incurred up to the reporting date.
Q

As per the Ind AS adoption road map, Tata group would be adopting Ind AS from 1 April 2016, with date of transition being 1 April 2015. How are you addressing the challenges in the following areas:

- technical challenges
- Capacity and infrastructure challenges such as capacity building of finance department and creating awareness both internal/external, changes to contracts/business practices, changes to IT systems/processes
- Non-technical challenges such as managing expectations and communication with stakeholders both internal and external.

What learnings or insights are you developing as you gear up to meet these challenges?

We will be transitioning to Ind AS soon, and on a practical front, we see three to four significant areas impacting the group:

Firstly, the opening balance sheet of 1 April 2015 will be impacted, wherein many adjustments will be routed through reserves and surplus, which may have a significant impact on the net worth of the company.

Secondly, many real estate companies have project special purpose vehicles which are subsidiaries, joint ventures and partnerships. Under Indian GAAP, the consolidation was based on the shareholding of more than 50 per cent voting power, which now will undergo significant changes due to the control and the de-facto control definitions. For example, if a minority shareholder has controlling rights over appointment/ removal of auditors or key managerial personnel, etc, this could be construed to have control or joint control.

The interpretation of controlling rights definition is going to be a tricky and painful area.

In addition, the entire fair value measurement will bring significant changes to the financials as we move forward. Measuring fair value, for items of the balance sheet is a new concept and could bring about significant changes from the values at which assets and liabilities are recorded today.

There have been challenges in building the technical capabilities and we have recruited many professionals and are also engaging consultants to build the awareness towards these changes.

From the stakeholders' point of view, the major impact will be subsidiary consolidation. Under the current accounting, the subsidiary revenue was consolidated with the parent, which if changed based on the control definition, could impact the results and thereby performance of the company. Managing the expectations, particularly of the internal and external stakeholders would be really challenging.

The real challenge will be post completion of the 31 March 2016 audits, and as we move towards 2016-17 which will be the first year of Ind AS financials with the re-statement of opening balance sheet of 1 April 2015.
The Income Computation and Disclosure Standards (ICDS) have been notified and are 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 existing Indian GAAP have been modified. This may also require changes to existing process 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 ICDS?

Since the ICDS are applicable, we did not have major challenges in computing income as per those standards, except in particular on the standard on revenue recognition on construction contracts, due to the lack of clarity on whether it is applicable only to construction companies or will this extend to the real estate companies. Currently under Income Tax, many companies offer income from sale of properties on project completion method, rather than percentage completion method. If the standard on percentage completion applies to real estate companies, the impact would be significant on cash flow for payments of taxes.

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 company, have laid down internal financial controls (IFC) to be followed by the company and that such internal controls are adequate and were operating effectively. How have you approached this areas and what have been the key considerations relating to the implementation of reporting on IFC?

As far as IFC reporting is concerned, we as a group are comfortable. During the last year, part of management reporting, we have already established the framework and have got the controls verified through an external agency as well. Being part of Tata group, we have well laid out processes and controls which were reviewed and verified by an external firm and that gave us good comfort that the controls are effective. In addition, we now have a good internal team, which is monitoring the processes and controls regularly to ensure these continue to operate effectively.

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

The last two years have been challenging particularly due to the changes in the 2013 Act and the requirements have been increasing multifold making implementation difficult. We have now settled with most of the requirements of the 2013 Act.

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?

In my view, in a country like India those who are abiding by the law, before or after the changes in law, do not see a significant impact. However, those who take an advantage of a lacuna in law, would grapple with the changes. By all means, the changes are significant and the last two years have been challenging. Most important role would be of a monitoring and enforcement agency to ensure compliance with these laws and regulations, as specifically for unorganised sectors, if there is no enforcement of the laws, the consumers may not really benefit. Transparency, theoretically sounds good, but many companies need to have the necessary infrastructure and capabilities to move towards the same. The timelines for implementation of the amendments of the 2013 Act have been challenging, including getting independent directors, woman directors, approvals from Board, related party transactions etc. To provide the necessary data to the Registrar of Companies within the timelines has been challenging as well.
Q Goods and Service 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?

GST according to me is a wonderful Act. This will eliminate a lot of day to day hassles of multiples taxes and everyone will be aware of the tax element in every transaction. However, what is not known today is whether real estate will be covered under GST ambit or not. GST will make routine operations easier by eliminating intermediary taxes as well as make assessments faster.

Q The Government has introduced mandatory corporate social responsibility (CSR) requirements in the 2013 Act. The 2013 Act 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 and order. What were the key considerations and challenges your company is facing in implementing this law for the first time? Could you please elaborate the CSR programmes being undertaken by the company?

Being a Tata company, before these regulations of mandatory compliance with CSR came into existence for every project we would set aside some amount per square feet for a CSR activity. Hence, once the contribution was made mandatory, it was not difficult for us to reflect this amount as CSR contribution. At Tata, we focus on the society needs first and therefore, this requirement was not challenging for us to comply with. We meet the provision requirements thereunder.

Q With the inevitable growth in housing in India, do you see more foreign players coming into India in architectural, Engineering, Procurement and Construction (EPC) contracting, Material Supply and Project Management Consulting? Do you believe that with the norms for External Commercial Borrowings (ECBs) and Foreign Direct Investment (FDI) relaxed by the Government of India, the inflow of foreign funds in India could increase in the BCRE Sector?

Yes, with the Union cabinet approval of the Amendments to the Real Estate (Regulation and Development) Bill, 2013, certainly there could be more foreign investments in India. With more confidence in real estate, the foreign investments will certainly be attractive in India again.

Q Which one of the three: residential accommodation, commercial space or retail malls do you see growing fastest in India for the next two to three years?

I look after mostly the residential part of real estate, and as ‘Roti, Kapda and Makaan’ are vital, of which Makaan, being place to live is going to be of vital importance. And with government support on the housing for people, there is no iota doubt that, there will be undisputed growth in residential for the next 20 years. However, with the focus on the economic development in India, the commercial, retail and hospitality segments also promise good growth in the coming years.
Q Do you think the Government’s steps in regulating the BCRE Sector – streamlining of approval mechanism, setting up of Real Estate Regulatory Authorities in each state, allowing setting up of Real Estate Investment Trusts (REITs) and escrow accounts for developers, etc. are sufficient or more needs to be done in this direction?

The Finance Bill 2016 clarification which came now, was being awaited for the past two years. Now with this clarification on the tax position for developers, REIT from being theoretical, will be more practical now. REITs will be very effective now and we should see some REIT structures in India.

The other steps for the BCRE sector such as, the Real estate bill would definitely benefit the customers, but for developers, the financing/funding/business models will need to change. Certain requirements of depositing 70 per cent of collections in escrow account, etc. are stringent.

Q What are the key challenges that you believe are facing the Indian BCRE sector?

The key challenges affecting the Indian BCRE are:

- Supply is outweighs demand
- Cost of construction has risen with a shortage of skilled manpower/labour availability
- Cost of financing is high
- Obtaining approvals is difficult.

Q In your view, do we have adequate resources in terms of qualified and skilled manpower in the BCRE Sector – Engineers, Accountants, Project Managers, Architects etc. who will be able to cater to the growth in the Sector?

- The most important challenge in India is innovation. Though the labour is available today, their numbers shall become scarce day-by-day. Until new technology is not be implemented, delivery within the deadlines is expected to be challenging.
- Technical resources are available, though technical development is missing today. Conventional methods are followed today, however, we are not moving towards innovative methods. At Tata Housing, we are working towards technical development and innovation, to lead real estate towards being more organised and transparent.

The views and opinions expressed herein are those of the interviewee and do not necessarily represent the views and opinions of KPMG in India.
Classification and presentation of the real estate property in the financial statements

This article aims to:

- Discuss the classification and presentation of assets (developed property or property under development) held by real estate developers in their financial statements under the current Indian GAAP and the impact on transition to Ind AS.
Companies that are engaged in real estate development normally deal with assets comprising land, building, machinery and equipment, fittings and fixtures and other assets, which depending on the business model can be, held:

- for own use
- held in the course of rendering services to customers
- held for outright sale of the asset to the customers
- held for letting them out on rental basis, or
- held for capital appreciation.

The judgement of underlying factors can be tricky and would require a careful consideration of usage for which an asset is held. The accounting policy would depend on such judgement which may also be impacted at a later stage in case there are changes to the business model or the intended purpose of holding the asset.

Companies may hold assets for more than one use or an undetermined use during initial stages. We will try and cover the guidance prevalent under current Indian GAAP which could help determine appropriate presentation of assets in the financial statements of real estate developers and the guidance under Ind AS and aim to analyse necessary changes based on the change of end use of the asset.

Relevant accounting standards under the current Indian GAAP

Under Indian GAAP, following accounting standards can be relevant from a real estate company point of view:

- **AS 2, Valuation of Inventories.** This standard defines inventories as assets: (a) held for sale in the ordinary course of business (b) in the process of production for such sale or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

- **AS 10, Accounting for Fixed Assets.** This standard defines a fixed asset as, an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

- **AS 13, Accounting for Investments.** This standard defines investments as assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. It defines an investment property as, an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. The Schedule III of the Companies Act, 2013 lays down the disclosures, wherein fixed assets and investment property are required to be disclosed separately under non-current assets and inventory under current assets.

Bearing in mind the above definitions and the nature of real estate assets held by the company, we have tabulated below certain illustrative scenarios:

<table>
<thead>
<tr>
<th>Sr. no.</th>
<th>Scenario</th>
<th>Classification</th>
<th>Governing accounting standard and rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Assets constructed for own purposes i.e. own factory administrative property</td>
<td>Fixed assets</td>
<td>AS 10: Asset held for production of goods or provision of services and not held for sale in the normal course of business.</td>
</tr>
<tr>
<td>2</td>
<td>Assets constructed/developed for sale to third party</td>
<td>Inventory</td>
<td>AS 2: Asset is held for sale in the ordinary course of business.</td>
</tr>
<tr>
<td>3</td>
<td>Assets held with a specific intention to benefit from capital appreciation</td>
<td>Investment property</td>
<td>AS 13: Investment (held for capital appreciation) and not intended to be occupied substantially for use by or in operations of the enterprise.</td>
</tr>
<tr>
<td>4</td>
<td>Asset constructed/developed for leasing/letting out and earn rentals on a continuing basis</td>
<td>Investment property</td>
<td>AS13: The definition of investments under AS 13 include assets held for earning income by way of rentals and the definition of investment property under AS 13 is investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. The rationale for this classification is that the developer has invested in real estate assets and earns return on such investments by way of rental income. OR OR</td>
</tr>
<tr>
<td>OR</td>
<td>OR</td>
<td>Fixed asset</td>
<td>AS 10: The asset is held with the intention of being used for the purpose of providing services (services being lease of property and related ancillary services) and is not held for sale in the normal course of business. AS 19, Leases states that an assets given on operating lease should be presented under fixed assets. It may be noted that while “land” is not covered by AS 19, “buildings” are covered.</td>
</tr>
</tbody>
</table>
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<tbody>
<tr>
<td>5</td>
<td>Property time-sharing units</td>
<td>Fixed assets</td>
<td>In case such units are held with the intention of being used for the purpose of providing services, for example, as a facility to its employees, and are not held for sale in the normal course of business, these might be considered as fixed assets.</td>
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<tr>
<td>OR</td>
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<td>OR</td>
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<tr>
<td>6</td>
<td>Dual use property (Part of the property is used for own use and part for earning lease rentals or capital appreciation.)</td>
<td>Fixed asset or investment property</td>
<td>A portion of the said property can be classified as an investment property only if it is possible to segregate that portion to be sold or leased out separately. When it is not possible to segregate the portion of the property leased out or own use separately, the entire property might be classified as an investment property only if an insignificant portion is held for use in the production of supply of goods or for administrative purposes.</td>
</tr>
<tr>
<td>7</td>
<td>Office building for which security and maintenance services are provided by the owner</td>
<td>Investment property</td>
<td>Primary intention is to earn revenue through rentals (as an investor) with the services being ancillary.</td>
</tr>
<tr>
<td>8</td>
<td>In case a company owns and manages the developed property (for example, a hotel or retail outlets)</td>
<td>Fixed assets</td>
<td>Primary intent changes to provision of services i.e. hospitality for which the asset/property was constructed.</td>
</tr>
<tr>
<td>9</td>
<td>Property with mixed use or undetermined use</td>
<td>Fixed asset/ investment property/ inventory</td>
<td>When it is possible to segregate the portion of the property into various uses, the respective portions need to be classified separately. In absence of the segregation, the company would classify based on its business model, and re-classify on a triggering event which determines the probable end use.</td>
</tr>
</tbody>
</table>
The general position regarding accounting for property developed and under development as per the above can be postulated as below:

a. If the company is in the business of selling real estate i.e. it constructs and holds a building with the intention to sell it, it represents an inventory of the company and should be carried at the lower of cost and net realisable value as required by AS 2.

b. If the company's intention is to use the building for its own operations, it would be classified as 'fixed asset' and should be carried at cost less depreciation as per AS 6, Depreciation Accounting and impairment loss, if any, as per AS 28, Impairment of Assets.

c. If the company's intention is to hold a building with a view to benefiting from capital appreciation, it represents an investment property within the meaning of AS 13 and should be carried at cost less any other-than-temporary diminution in value.

d. If the company's intention is to give out a building on rent on a continuing basis, the position regarding its classification becomes somewhat complicated (unless the rental arrangement is a finance lease which would be treated as a sale as per (a) above).

- One possibility is to classify it as an investment property on the basis that the definition of 'investment' as given in AS 13 includes assets held for earning income by way of rentals.

- Another possibility is to classify it as a fixed asset. In this regard, though the definition of the term 'fixed asset' as given in AS 10 does not specifically deal with assets held for rental to others. However, since renting out is a service, such assets can be considered to fall within the definition of fixed asset. Investment property is classified as a long-term investment and carried at cost less any other-than-temporary diminution in value.

In practice, companies that let out properties on rent provide for depreciation. This is supported by AS 6 which defines depreciation as a measure of 'wearing out, consumption or other loss of value......arising from use, effluxion of time or obsolescence through technology and market changes'. Additionally, a circular of the Department of Company Affairs (now the Ministry of Corporate Affairs) requires depreciation to be charged on all immovable properties: 'Since immovable properties unless they are acquired for re-sale, represent fixed assets, it would be obligatory to provide for depreciation on such immovable properties in accordance with the provisions of section 205 of the Act read with section 350 which contemplates that depreciation should be provided at the rates specified for the asset comprised in the immovable property in question by the Indian Income-tax Act and the rules framed thereunder. Rates for different classes of buildings and other immovable properties have been prescribed under the Income-tax Rules, and the rates prescribed in these rules have to be adopted for the purpose of providing for depreciation under section 205(2) irrespective of the section of the Income-tax Act under which income arising from these assets becomes assessable to income-tax.'

As we move to Ind AS, one of the significant changes for the companies engaged in real estate development is the accounting standard on investment property (Ind AS 40), that prescribes the accounting treatment for an investment property. Ind AS 40 differentiates between an investment property and an owner occupied property as below and also provides illustrative examples of properties covered under the standard:

Investment property is, property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

a. use in the production or supply of goods or services or for administrative purposes or

b. sale in the ordinary course of business and

Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

It may be noted that AS 13 under the current Indian GAAP was primarily focussed on recognition and measurement principles of investments and included investment property as a type of investment, while Ind AS 40 specifically focusses on the recognition, measurement and disclosure of an investment property and distinguishes the same from owner occupied property.

The examples of investment property covered under Ind AS 40 are:

- land held for a long-term capital appreciation rather than for short-term sale in the ordinary course of business
- land held for a currently undetermined future use
- a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases
- a building that is vacant but is held to be leased out under one or more operating leases, and
- property that is being constructed or developed for future use as investment property.

Investment property under Ind AS 40 will be measured at cost and will determine fair value for the purpose of disclosure in the financial statements, though under IFRS, IAS 40, the entity could measure the investment property at cost or fair value (an accounting policy choice).

To conclude, it is important to understand definition of fixed assets, investment property, inventories under the respective standards, as the recognition, measurement and presentation in the financial statements would be determined on the basis of the end use of the property, which could be divergent across companies and similar type of assets and could significantly impact the carrying value and disclosure of such assets in the financial statements.
Funding instruments and prevalent investment themes in the real estate private equity market

This article aims to:
- Provide an overview on the financing structures prevalent in the real estate companies.
Post the global financial crisis of 2008, the real estate private equity market increasingly witnessed project-level funding and saw many investors refraining from entity-level funding in order to elude risks associated with defaults or failures by the developer group. Equity was the preferred investment instrument to benefit from higher returns while being exposed to market risks. However, subdued market conditions and grim exit prospects seem to have led to substantial capital erosion for investors.

This fall saw the emergence of debt structured deals in the real estate sector that permit investors to fully securitise their investments and provide an assured return with a possible upside on achievement of certain laid-out conditions. The structure gained attention from a plethora of domestic and offshore private equity funds among others and has dominated the private equity real estate market since then. However, the gradual recovery of the Indian economy fuelled by a decisive political mandate, improved sentiments and optimistic growth outlook has paved way for renewed interest in entity-level/joint-venture equity deals in the real estate sector in the past two years.

Despite a subdued market, many global financial institutions and fund managers are confident about the long-term growth prospects of the Indian real estate sector and are actively tying-up with developers with strong fundamentals for development of greenfield projects across the country.

Such new born faith in the sector seems to have shaped the funding scenario introducing or renewing alternative modes or themes of investment prevalent in the market today. We briefly discuss the structures associated with debt deals and each of these alternate modes of investments, hereunder.

### Structured debt in residential projects

Structured debt deals have dominated the real estate private equity transaction market since 2010. Strapped for money to either complete projects or refinance existing debt, developers have been availing structured debt from financial institutions and private equity funds. The share of debt structured deals has increased significantly over the years and peaked in 2014. However, in 2015, the share of debt structured deals fell owing to investments vide alternate funding options.

The structure allows private equity funds to restrict lending to projects with good location and saleability, effectively ring fencing project cashflows. Such transactions are typically structured in the form of non convertible debentures (NCDs) issued by project companies. The NCDs have a fixed tenure of three to five years and carry a coupon payable at regular intervals with a back-ended redemption premium, if any, to provide the investor with an overall commercially agreed IRR in the range of 18 to 24 per cent. Further, the issuances are secured through a charge on the asset being funded with a security cover of around two times the size of the investment.

The NCDs may also be structured to provide for preferred cash flows to the investor or may include a put option permitting the investor to exit prior to completion of tenure of the NCDs on achievement of certain conditions (in cases where all apartments are sold or completion certificate is received prior to completion of the tenure of the NCDs).
Bulk apartment units

Steered by domestic funds, 2014-15 witnessed an institutionalised way of underwriting under construction projects. While, certain fund managers initiated a dedicated fund approach towards investing in bulk apartment units with a three to four year investment horizon, many others are earmarking a part of their existing or proposed funds for such bulk apartment investment modules.

Under this structure, funds negotiate an agreement with developers to pre-purchase stock in under-construction projects at a discount, usually in the range of 20 to 30 per cent, and seek to benefit from appreciation in the value of the apartments in the medium-term.

The capital is infused either upfront or in tranches based on the construction schedule of the project. Developers use the funds to complete construction of the project and are required to sell the fund’s stock of apartments in proportion to the rest of the apartments in the project after a stipulated time.

The investments are usually structured to provide for a minimum assured return (ranging upwards of 20 per cent) to the investor at a pre-determined exit date, giving it a flavour of mezzanine finance. In case of failure to do so for any reason including delays in construction or stocks going unsold, the developer would be required to buyback the stock from the investor. On the flip side, in case the sale price of apartments to end users is higher than the minimum assured return, the upside may be shared by the developer and the investor in an agreed ratio as per the terms of the agreement.

To address the risk of non-execution of the project, the agreements may also include clauses such as personal and corporate guarantees among others.

From a developers perspective, offloading inventory in bulk at discounts provides them with the necessary funds to advance the construction of projects and increase visibility of site progress. Further, the capital neither appears as equity or debt in the books of the project company encouraging developers to increasingly opt for bulk deals.

Commercial pre-leased yield assets

Commercial pre-leased yield assets have garnered significant institutional investor interest over the past three to four years backed up by stable yields and expectation of capital value appreciation.

As real estate focused private equity funds look for guaranteed returns, a sizeable amount of capital is being invested in pre-leased projects, including IT parks and special economic zones. Although such projects do not typically generate returns as high as residential developments, they are generally perceived to be a safer bet as investors are assured of a fixed annual return on investment in the form of rental yield.

Further, with the introduction of REITs in India, private equity investments in these assets is expected to grow significantly. The year 2014-15 witnessed many fund managers aggressively acquiring good quality yield generating realty assets for REIT listing in the coming years. During the past 12 months, deals worth USD390 million³ were sealed in this space.

Typically, the transaction involves the investor buying-out the entire or a majority equity stake of the developer in the project company. Further, any debt at the project level is assumed by the private equity investor in 100 per cent acquisitions. Investors typically look for a capitalisation rate ranging from 9 to 11 per cent and an overall return of 14 to 16 per cent over a three to five year investment horizon.

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³ KPMG in India’s analysis based on information procured from Private Equity in Real Estate Transaction Database, Venture Intelligence, accessed 18 March, 2016

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Minority equity stake at entity level

Optimistic growth outlook with respect to the Indian economy coupled with improved investor sentiments and proposed reforms by the government to simplify regulations and eliminate supply side bottlenecks in the real estate sector has drawn several global investors to place strategic bets on Indian real estate. The year 2015 witnessed a resurgence in holding company level deals by marquee private equity players signifying renewed faith in the sector. Over the past 12 months, deals worth USD 536 million were sealed in this space. Investments were witnessed within the corporate developer fraternity which have demonstrated strong values and governance and are credited with an established track record. Further, developers engaged in delivering affordable and mid-income housing have seen entity level investments as well. Such structures typically involve investment vide plain vanilla equity or quasi equity instruments (compulsorily convertible into equity at a prospective valuation date) on a private placement basis for a minority stake in the holding company which may range from as low as three per cent to as high as 49 per cent. Exits may be structured either through an initial public offering, promoter buyback, sale to third party or sale of General Partner (GP) interest among other options. Investable projects may or may not be identified at the time of investment.

Platform deals

Driven primarily by sovereign and pension funds, platform deals have been gaining ground in the Indian real estate space over the last few years. Hitherto, participation by sovereign and pension funds in the Indian investment scenario was restricted through investments vide private equity funds. However, with several funds seeking increased exposure to real estate as an asset class, the past two to three years witnessed such funds to increasingly partner directly with Indian developers with strong fundamentals for development or acquisition of residential, mixed-use and commercial segments across the country. Over the past 12 months, three deals aggregating to a capital commitment of USD 1,137 million were sealed in this space.

A typical platform-level deal involves the creation of a joint pool of capital between a global investor and a developer with an established track record. The investor’s capital contribution to the platform ranges from 50 to 75 per cent of the total capital committed by both the parties. The developer assumes responsibility as the exclusive development manager of the projects and receives a development fee for the same. The portfolio may comprise a mix of existing and proposed projects as may be identified by the parties. Profit-sharing is in proportion to the capital contributed by the investor and the developer till the returns touch the hurdle rate post which sharing may be aligned in the favour of the developer.
Key challenges and approaches to valuation of investment properties in India

This article aims to:
- Provide an overview on the current practices for fair valuation of investment properties in India
- Highlight key challenges encountered in valuation of investment properties in an attempt to comply with the relevant Ind AS
The real estate valuations market in India is highly unstructured, with no regulations built around the aspects of compliance required for valuation of investment properties. There are a number of players (small local companies as well as Multinational Companies (MNCs)) providing valuation services across the investment property domain in India. Many of these companies align their valuations with International Valuation Standards (IVS) as well as the Royal Institute of Chartered Surveyors (RICS) India Red Book. With there being no regulatory body governing the principles of valuation in India, several valuation firms follow their own individual methods for valuing investment properties for clients.

The absence of a repository of data (government and/or private) providing information regarding various critical valuation assumptions is also one of the key challenges faced by the sector (currently as well as probably going forward as well). In addition to that, in almost all the major real estate markets in the country, there is a significant differential between the guideline/circle/registration values and the actual market price. The guideline value is the minimum value at which the sale or transfer of a plot, built-up house, apartment or a commercial property can take place. Market price is the value of this asset as determined by the market forces of supply and demand and agreed upon between the buyer and the seller. The guideline value determines the stamp duty and registration charges to be paid for the transaction. This is called the ‘floor price’ and the actual transaction price can be higher than this, resulting in higher stamp duties. There is a concern that real estate transactions (especially the ones in which corporates entities are not involved) are registered at the minimum guideline values or slightly above, which may be lower than the actual transaction price. The result is a loss to the exchequer in terms of stamp duties. This creates a challenge from the perspective of appropriateness of the comparables from the market during the process of conducting a fair value estimation exercise. These are some ground level challenges faced by valuation professionals operating in India in terms of data sources and their credibility.

However, over the last six to seven years, a number of real estate developers and construction companies have raised capital by either going public or through private equity/NBFC2 funds for investment in their real estate projects. This institutionalisation of capital markets in the real estate sector has improved the overall transparency levels as well as provided valuers with relatively more number of comparable data points in terms of valuation assumptions.

With the expected entry of Real Estate Investment Trusts (REITs) in India, valuation guidelines around the same would need to be compiled with. These guidelines are relatively different in terms of aspects like appointing of valuers, roll over of valuers (every two years), mandatory annual and half yearly valuation, rules around related party transactions, disclosures to exchange/trustees/investors, etc. These stringent guidelines shall help the valuation practice in India in terms of setting benchmarks for valuation engagements and the associated compliances for the valuers as well as real estate corporates.

From an Ind AS/IFRS perspective, ‘replacement of the depreciated expense’ method is expected to be altered to ‘mark-to-market’ or ‘fair value accounting’. Mark-to-market or fair value accounting refers to accounting for the ‘fair value’ of an asset based on the current market price, or for similar assets, or based on another objectively assessed fair value. Mark-to-market accounting can change values on the balance sheet as market conditions change. Mark-to-market accounting can become volatile if market prices fluctuate greatly or change unpredictably. This change in the accounting methodology would mean that businesses would be mandated to report the fair value in their financial statements. With this change, valuation requirements are expected to become more arduous and considering the restrictions mentioned earlier, the challenges for valuers in India might only increase. As per Ind AS 40, Investment Property requires entities to provide disclosure of the fair value of investment properties.

Generally, when measuring the fair value of investment property, an entity shall ensure that the fair value reflects, among other things, rental income from current leases and other assumptions that market participants might use when pricing investment property under the current market conditions. Under Ind AS 40, there is a rebuttable presumption that an entity can reliably measure the fair value of an investment property on a continuing basis. In the case of under construction of investment property, if an entity determines that the fair value is not reliably measurable but expects the fair value of the property to be reliably measurable when construction is complete, it shall measure the fair value of that investment property either when its fair value becomes reliably measurable or construction is completed (whichever is earlier). If an entity determines that the fair value of an investment property (other than an investment property under construction) is not reliably measurable on a continuing basis, the entity shall make necessary disclosures in the financial statements.

There is also a requirement for ‘disclosure of assumptions or estimates’ for carrying out a valuation exercise, which is currently not a market practice in real estate valuation engagements. It is relevant to note here that Ind AS 113, Fair Value Measurement states that for some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of fair value measurement in both cases is the same, to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). When the price for an identical asset or liability is not observable, an entity measures its fair value using another valuation technique that increases the use of relevant observable inputs and reduces the use of unobservable inputs. Since fair value is a market-based measurement, it is measured using the assumptions that market participants shall use when pricing the asset or liability, including assumptions about risk, cash flows and measurement uncertainty. As a result, an entity’s intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value.

Therefore, even with the advent of policy regulations like the Real Estate Regulatory Bill and the Securities Exchange Board of India’s (SEBI) vision document for REITs, considering the size of the Indian real estate sector, it could take some time to achieve a goal of having a structured valuation environment in the country.
Real Estate Investment Trust

This article aims to:
- Provide an overview on the concept of REIT and the various regulations governing it
- Highlight the potential benefits of establishing a REIT in India.
Global REIT

The concept of a Real Estate Investment Trust (REIT) was first started by the U.S. Congress in 1960 followed by Australia in 1971. Several countries like Canada, Japan, Singapore followed soon, with the U.K. being the latest one to introduce it in 2002. REITs were extremely popular in 2001 and 2002 when the stock market declined, and investors saw them as safe-haven investments. REIT has been very successful globally; with Australia standing first, followed by Japan and Singapore in the ranking of successful REITs.

A REIT entitles an investor to participate in property ownership by the REIT and related income streams, without having to fund the entire property value himself/herself as well as without actually owning or managing real estate.

Globally REITs are either open ended or close ended companies/business trusts that hold, manage, lease, develop and/or maintain properties for investment purposes. Units of REITs allotted to the investors based on their Net Asset Value (NAV) are often, but not necessarily, traded on a stock exchange. REITs largely invest in real estate directly, through properties or mortgages, or indirectly through subsidiaries. Invariably, REITs are fiscally tax transparent whereby the REIT is not taxable but the investors are taxed on the income earned and distributed by the REIT, provided that almost 90 to 95 per cent of the income of the REIT is distributed to its investors/unit holders. In many countries, REITs are established, managed and operated by private fund managers but are regulated by the regulators to protect the investors’ interest.

There are three types of REITs: equity REITs, mortgage REITs and hybrid REITs. The investment risks are not the same for each form of REIT, so care should be taken while evaluating the different types of REITs before investing. Equity REITs buy, operate and sell real estate such as hotels, office buildings, apartments and shopping centres. They generally tend to be less speculative than mortgage REITs, although the risk level depends largely on the makeup of the actual assets in the trust. Mortgage REITs make construction and mortgage loans available to developers, which involve greater risk. Consequently, shares of mortgage REITs tend to be more volatile than those of equity REITs, particularly during periods of recession.

Global real estate companies have the size, scale, expertise and access to capital to compete and capture market share in a highly competitive global marketplace. Over recent years, public real estate companies have invested heavily in the systems and technology that make them extremely efficient in areas such as asset management, accounting, construction/development and capital markets. These advancements make for logical partnerships with highly sought-after municipalities, tenants and various other constituents. These features make a REIT structure attractive and successful, thereby facilitating the growth of the real estate market as also providing a safe and mature environment for investors.

There are several commercial real estate markets around the world that could be considered as under-securitised - namely parts of Europe and emerging markets, such as China and India. While a lot of markets in Europe now have a REIT structure, it is expected that there is ample opportunity for these markets to continue to grow as more and more real estate is securitised.

Globally, where REITs have been introduced without attractive tax structures, it has been difficult for these REIT markets to gain any traction. This has been experienced by many countries like the U.S., the U.K., Philippines, etc. The success story of REIT began only after a fiscally tax transparent status was accorded to REITs.

Indian REIT

India realised the potential of REITs and attempted to introduce it in the year 2002 by setting up the Satvalekar Committee, which provided its first draft report in that year. While the REIT concept was being formalised, India introduced a new investment vehicle regime called Domestic Venture Capital Funds (DVCF) in 2004, which experienced fair success in India. The Securities and Exchange Board of India (SEBI) released its first draft report on REIT in the year 2008, followed by many changes and finally, it formally notified the REIT regime in 2014.

The REIT regime is similar to that of many developed countries and is like a mutual fund, formed as a business trust where money from investors is pooled in and then invested in a pre-defined asset class with certain pre-determined objectives. The regulations are fairly detailed and contain provisions with regard to establishment of a REIT, qualifications and eligibility criteria (for sponsors, trustees, fund managers, valuers, etc.), registration of various stakeholders, raising of funds, listing of REIT on a stock exchange, permissible investments by a REIT, operation and management of a REIT, valuation aspects, distribution of income to investors, governance and audit requirements, valuation requirements and methodologies, and finally, winding up of REITs.

In India, REITs are permitted to invest in completed revenue generating properties as well as under construction properties subject to such the terms and conditions, as provided under the REIT regulations. A REIT can make investments, either directly or through Special Purpose Vehicles (SPVs) which invest more than 80 per cent of its assets in properties. If a REIT is investing through a SPV, then the REIT has to hold controlling interest with not less than 50 per cent of the equity share capital or interest in such a SPV. Further, a REIT should distribute 90 per cent of its distributable income to its investors.

In order to provide an impetus and make it successful, imbibing their learnings from global experiences, the Indian government introduced various fiscal incentives for REITs in the Finance Budget 2014 whereby an attempt was made to provide a partial fiscally pass through status to the REIT. The taxation regime was further liberalised by the Finance Budget 2015 whereby taxation on initial transfer of shares of an SPV owned by the promoter sponsors to the REIT was deferred till the final sale of units of REITs. MAT taxation removed for the initial transfer of shares of SPV or property to REIT, lower withholding taxation of 5 per cent was introduced for non-resident investors, etc.

1. Guide to Global Real Estate Investment Trusts
Despite these attempts of the Indian government, unfortunately REIT did not materialise and India did not witness emergence of a single REIT in the last two years. Albeit, there were many expectations that remained unfulfilled and few changes were required in the regulations like facilitating foreign investment in Indian REITs, providing a complete fiscally pass through status, making units of the REIT at par with any other tradable securities, removal of stamp duty on initial transfer of property by the promoter sponsor to a REIT, etc. Apart from these regulatory aspects, the economic scenario of commercial real estate was also not favouring the REIT structure, given that the commercial estate has been at the bottom of the pyramid in the past few years.

Expectations from Budget 2016 on REIT regime

In order to facilitate foreign investments in REIT, during the fiscal year 2015-16, the government permitted foreign investment in REITs. Further, the policy framework for External Commercial Borrowings (ECBs) was also amended in November 2015, which permits REITs to raise ECB, which is expected to facilitate access to foreign markets at a cheaper rate.

As mentioned, there were couple of expectations from Budget 2016 i.e. to provide a complete fiscally tax transparent status to a REIT that could make REIT in India, a reality soon. To name a few expectations, exempt capital gains on initial transfer of property by a promoter sponsor to a REIT, exemption from payment of stamp duty on transfer of such a property to a REIT, capital gains not to be taxed in the hands of a REIT, exempt SPVs distributing dividend to REITs from payment of Dividend Distribution Tax (DDT) proposes to remove the Dividend Distribution Tax (DDT) on them.

These were eagerly expected by real estate developers as well as investors, so that it could offer commercial developers a liquidity option and to retail investors an opportunity to participate in the office realty market’s growth. The final hurdle in the way of successful listing of REITs in India was expected to be removed in this budget. Did this really happen?

REIT amendments in the Finance Bill 2016

With the objective of brining tax efficiency in the REIT structure, the Finance Bill, 2016 proposed to remove DDT on distribution of dividend by an Indian SPV to a REIT, subject to certain conditions. As a result, any amount of income declared, distributed or paid by way of dividend by an Indian SPV to a REIT from 1 June 2016 is likely to be not subject to payment of DDT (current DDT is almost 20 per cent on such dividend). Further, such dividend received by a REIT is expected to be exempt in the hands of the recipient REIT.

The first condition is that such an exemption from levy of DDT would be applicable only in cases where the business trust either holds 100 per cent of the share capital of the SPV or holds all of the share capital other than which is required to be held by any other entity as part of any direction of any government or specific requirement of any law to this effect or which is held by government or government bodies.

The second condition is that the exemption from levy of DDT is expected to be available only in respect of dividends paid out of current income after the date when the business trust acquires shareholding in the SPV. The dividends paid out of accumulated and current profits upto 1 June 2016 are expected to be liable for levy of DDT as and when any dividend out of such profits is distributed by the SPV either to the business trust or any other shareholder.

Impact of the above amendments

The expected removal of DDT has found favour by both retail investors and in particular institutional investors, who view India as an untapped market for commercial asset class given the growth story of India in light of various recent policy pronouncements by the Indian government. Removal of DDT for REITs and Infrastructure Investment Trusts (InvIT) should facilitate investments in the sector as well as encourage many players to opt for REITs as a tool to raise money and bring in liquidity in the market. The exemption from payment of DDT is expected to substantially enhance the income and returns in the hands of unit holders. This is a welcome and positive move by the government and hopefully it should clear the path of REITs in India.

Will REIT become a reality in India

There are mixed reactions from the industry on these significant tax exemptions proposed in the Finance Bill. Therefore, a question still remains whether REITs in India may become a reality in the coming fiscal year?

The market scenario on the commercial real estate class front is improving gradually on the back of the expected growth in the Indian economy, given the various policy announcements and the steps taken by the Indian government namely, significant thrust on inclusive growth of the Indian economy through rural development, roll out of the 100 smart cities development plan, ‘Make in India’ initiatives, ‘Start-Up India, Stand-Up India’ policy, fostering growth in the manufacturing sector and many more such policy announcements and initiatives.

Clearly, still there are few hurdles on the way of REIT viz

- Taxation of capital gains for promoter sponsors on transfer of property to REITs is another area of concern and the government should consider providing exemption at least for initial transfer of property by the promoter sponsor to a REIT.
- Levy of stamp duty ranging from 5 to 12 per cent on transfer of property by the promoter sponsor to a REIT in exchange for units of Business Trusts (BTs). This makes any direct transfer of assets commercially unviable for sponsors as well as REITs. Jurisdictions such as Singapore provides for specific remission of stamp duties to REITs.
Presently, the income tax law provides that when a REIT sells any assets or shares of an SPV holding the assets, REIT is liable to pay a capital gains tax on such transfer/sale. This results in taxation at the REIT level, thereby resulting in reduction of the distributable surplus for investors; again one more dampener for the regime to take shape. Further, this does not provide a level playing field to Mauritian or Singapore investors as this is expected to result in additional tax cost as compared to their direct investment in the SPV, wherein they may not be liable to such a capital gains tax in view of a beneficia tax treatment available under the tax treaty with Mauritius and Singapore. The government should provide a complete tax pass through status to a REIT to enable Indian REIT to emerge as well as compete with other jurisdictions like Singapore, China, etc.

The SEBI regulations makes it mandatory for both the SPV and REITs to distribute 90 per cent of their operating income to the investors by way of dividend, whereas in the case of a normal real estate company, there is no requirement of such annual distribution of dividends. The SEBI should consider relaxing this condition at the SPV level and ensure distribution at the REIT level to really facilitate a pass through status to REITs. Making aforesaid last mile changes by the Indian Government is expected to clear the pathway for Indian REIT and India shall then emerge as one of the successful REIT destinations for foreign investors. This might also provide an opportunity to retail investors to participate in the growth story of real estate, without taking the risks of owning and managing real estate. This may also facilitate broad basing of the real estate market apart from providing liquidity, transparency and governance to the sector. In fact, it could act as a catalyst to establish a robust and matured real estate market for both the investors and developers.

Many large Indian developers and foreign fund houses are keen to launch their REIT in India, given the change in the market outlook for commercial real estate and valuations; but are waiting for further relaxations from the government as discussed above. Market Buzz indicates that there are few developers and fund houses which are gearing themselves to launch their REIT in the next six to twelve months.

Can Indian REITs compete with global REITs

The removal of DDT at the SPV level has certainly improved the sentiment and provided a level playing field to Indian REIT to a large extent.

In the past, a few Indian developers established their BTs in Singapore by transitioning their real estate asset portfolio to Singapore and also listed such BTs on the Singapore® Stock Exchange. Couple of developers were actively looking at following the path and registering their BTs at the Singapore exchange.

Given the DDT exemption and the recent relaxations in the exchange control regulations, developers have started evaluating and comparing Indian REIT with overseas REITs say Singapore REIT, given the commercial considerations, especially the cost of establishment and maintenance of overseas structures as well as recent introduction the Place of Effective Management (POEM) regime in India. In fact, on similar developments, developers in Indonesia are actively looked at migrating their REIT structure from the Singapore exchange to the Indonesian exchange, post Jakarta’s announcement on lower taxation tariff on REITs property acquisitions3.

Indian developers still need to evaluate and compare Indian REITs against Singapore REITs, given other considerations namely:

- The emerging market as compared to the established market and Singapore being the Asian gateway for investors
- Corporate tax in Singapore is 17 per cent as compared to India of 34 per cent for the SPV owning and operating commercial real estate
- With respect to access to international funding and cost of funding, India has higher risk-free interest rates as compared to Singapore, resulting in expectation of higher returns of Indian investors, thereby creating pressure on the fund managers
- With respect to a flexible regime and compliance requirements, albeit, Singapore has stricter compliance norms and governance requirements.

Conclusion

The efforts made by the Indian Government, that too within a short span of time, are commendable and worth appreciating. Introducing the REIT regime in line with some of the leading global regimes, simplifying taxation aspects and providing significant tax transparency at the REIT level, allowing foreign investments as well as the ECB at the REIT level and further liberalising taxation laws in the Finance Bill 2016 has certainly provided positive indications. These, relaxations have provided the Indian REITs a competitive edge and shall go a long way in establishing a robust and mature real estate market. This is also expected to help in fostering the vision of developing affordable housing and realising the government’s vision of ‘Housing for all by 2022’.
The RBI revises prudential guidelines on revitalising stressed assets

Overview

The Reserve Bank of India (RBI), through its notification DBR.BP.BC. No.82/21.04.132/2015-16 dated 25 February 2016, issued certain revisions and clarifications to its prudential guidelines on Strategic Debt Restructuring (SDR). It reiterates the requirement for banks to stringently adhere to previously-issued guidelines including those relating to:

- triggers for invoking SDR
- effecting a change in the management of borrower companies
- invoking personal guarantees obtained from existing promoters and
- conversion of debt into equity shares of the borrower within the specified timeframe.

In addition, the notification prospectively modifies some of the previously-issued guidelines on SDR as described below.

Significant modifications

Minimum equity divestment to obtain asset classification benefit

This notification states that the minimum quantum of equity to be divested by banks within 18 months to new promoters, in order to retain the benefit relating to the classification of the asset as ‘standard’, has been revised to 26 per cent from 51 per cent previously.

Lending banks will have the option of exiting their remaining holdings gradually, with an upside as the company turns around. However, lending banks will be required to grant a ‘Right of First Refusal’ to the new promoters for the subsequent divestment of their remaining stake.

Timelines for conversion of debt into equity

While the Joint Lenders Forums (JLFs) are required to adhere to the prescribed timelines during the SDR process, the notification permits flexibility in the completion of individual activities up to the conversion of debt into equity in favour of the lenders. However, it requires such conversions to be completed within a period of 210 days from the date a decision to invoke SDR is made (based on a review of the achievement of milestones/critical conditions by the borrower). If this timeline is not met with, the benefit of a ‘standstill’ in the asset classification which was available from the date the SDR was invoked (the reference date) ceases to exist. The loans will then be classified in accordance with the existing ‘Income Recognition, Asset Classification (IRAC) and Provisioning Norms’ prescribed in the RBI’s Master Circular dated 1 July 2015.

Additional provisioning requirements

Previously-issued guidelines on the SDR scheme, as defined in the RBI Circular dated 8 June 2015, exempted banks from the requirement of a periodic mark-to-market of the equity shares of the borrower received on the conversion of debt, for the 18 month period until divestment to the new promoters. The notification now requires banks to periodically value and provide for depreciation on these equity shares as per IRAC norms for investments. However, banks have the option of distributing the depreciation in value, if any, over a maximum of four calendar quarters from the date of conversion of debt into equity i.e. the provisioning held for such depreciation should not be less than 25 per cent of the depreciation during the first quarter, 50 per cent of the depreciation as per the current valuation during the second quarter, and so on. If banks desire a longer period for making provisions (e.g. six quarters), they can start doing so from the reference date itself.

In addition, banks are required to ensure that they hold a provision of at least 15 per cent of the residual loan by the end of 18 months from the reference date. This is to avoid a sharp deterioration in the asset classification if the banks are unable to divest a minimum equity stake to new promoters within the stipulated 18 month period. This provision is also to be made in equal instalments over four quarters and can be reversed only when all the outstanding facilities in the account perform satisfactorily after the transfer of ownership and management control to the new promoters.

(Source: RBI notification DBR.BP.BC. No.82/21.04.132/2015-16 dated 25 February and KPMG in India Firs Notes: The RBI revises prudential guidelines on revitalising stressed assets dated 1 March 2016)
The IRDA issues directions to insurers on Ind AS implementation

Background
The Ministry of Corporate Affairs (MCA) notified the Ind AS road map for corporates on 16 February 2015. The Insurance Regulatory and Development Authority of India (IRDA), through its order on 17 November 2015 stated that the insurance sector in India would be converging with International Financial Reporting Standards (IFRS) and subsequently on 7 December 2015, IRDA had also issued a discussion paper on Ind AS implementation in the insurance sector with key recommendations. Further, MCA also issued a press release on 18 January 2016 outlining the road map for implementation of Ind AS in the financial services sector, including insurance companies.

The IRDA circular issued on 1 March 2016 now provides certainty on the mandate for implementation of Ind AS for all insurers.

Overview of the recent circular
This circular requires all insurers to comply with the Ind AS for financial statements for accounting periods beginning on or after 1 April 2018, with comparatives for the periods ending 31 March 2018. Early adoption is not permitted. Ind AS will be applicable to both separate and consolidated financial statements.

The IRDA has advised insurers to set up a steering committee headed by an official of the rank of an Executive Director (or equivalent) comprising members from cross-functional areas of the insurer to immediately initiate the implementation process. The audit committee of the board shall oversee the progress of the Ind AS implementation process and report to the board at quarterly intervals. The circular also identifies critical issues, which need to be considered in the Ind AS implementation plan, as follows:

- Technical accounting issues involving the entire financial reporting process, including an analysis of differences between the current accounting framework and Ind AS, determination of significant accounting policies, preparation of proforma Ind AS financial statements as well as disclosures, related documentation and a dry-run of accounting systems.
- Evaluation of changes to systems and processes, identifying issues that have a significant impact on information systems and developing systems to capture relevant data.
- Determining business impacts, including those on profits, taxation, capital planning and impact on solvency.
- Evaluation of resources to ensure adequate staffing for a comprehensive training strategy and implementation.
- Project management to ensure effective coordination between accounting, systems, people and business, in addition to managing communication with stakeholders.

Insurers also need to assess the impact of Ind AS implementation on their financial position including the adequacy of capital, taking into account the solvency regulations and place quarterly progress reports to their boards. Insurers also need to be prepared to submit proforma Ind AS financial statements to IRDA from the quarter ending 31 December 2016 onwards as per the timelines prescribed in the IRDA circular dated 28 January 2010.

Next steps
The IRDA has stated that the boards of the insurers shall have the ultimate responsibility in determining the Ind AS direction and strategy and in overseeing the development and execution of the implementation plan. Beginning with the financial year 2015-16, until implementation, insurers are required to disclose in the annual report, the strategy for Ind AS implementation, including the progress made in this regard.

In order to facilitate the implementation process, IRDA shall hold periodic meetings with insurers from July 2016 onwards. The IRDA has stated that it would issue further instructions, guidance or clarifications on relevant aspects as and when required.

(Source: IRDA notification: IRDA/F&A/CIR/IFRS/038/03/2016 dated 1 March 2016 and KPMG in India IFRS Notes: The IRDA issues directions to insurers on Ind AS implementation)

The SEBI issues a discussion paper on ‘bright-line tests for acquisition of control’ under SEBI Takeover Regulations, 2011

Background
Regulation 2(e) of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 [SEBI Takeover Regulations, 2011] defines ‘control’ as follows:

‘control includes the right to appoint a majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner:

Provided that a director or officer of a target company shall not be considered to be in control over such target company, merely by virtue of holding such a position’.

The above control definition is a principle-based definition rather than rule-based and assessment of control requires a consideration of the facts and circumstances of each case.

The definition of control is also written under other laws in India such as the Companies Act, 2013, Insurance Laws (Amendment) Act, 2015, Consolidated Foreign Direct Investment (FDI) Policy Circular of 2015.

The SEBI received representations from various stakeholders to seek guidance on the definition of control and to define bright-lines while assessing the various factors leading to control.

Accordingly, SEBI on 14 March issued a DP seeking comments from the general public on its proposals defining the bright-line tests for the acquisition of control under the SEBI Takeover Regulations, 2011.
Overview of the DP

The DP broadly lists down two options to determine ‘control’

Option 1
Framework for protective rights: Veto rights not amounting to the acquisition of control may be protective in nature rather than participative in nature i.e. such rights may be aimed with the purpose of allowing the investor to protect his investment or prevent dilution of his shareholding. At the same time, the investor should neither have the power to exercise control over the day-to-day running of the business nor the policy making process. Having rights in decisions involving a significant change in the current business activity or that apply on exceptional circumstances would also be treated as protective rights.

Under this framework, the DP has provided an illustrative list of protective rights which would not amount to the acquisition of control. For example,

- Appointment of the chairman, vice-chairman, observer provided such individuals do not carry any casting vote or other voting rights.
- Rights conferred under commercial agreements provided mutual commercial benefit flows from both the sides i.e. not one-sided, board of the target company approves the decision to enter into such an agreement, the board of the target company has the right to terminate the agreement and have the right to enter into similar agreements with any other party.
- Veto rights/affirmative rights that are not part of the ordinary course of business or involve governance issues would be considered as protective in nature and would not amount to the exercise of control over the target company.
- Quorum rights for meetings involving the matters of veto rights/affirmative rights. If two meetings are not quorate, the next meeting would be deemed to have quorum despite the absence of the investor nominees.

Under this framework, the DP specifies three conditions to be fulfilled before the above rights can be given and they are as follows:

- The investor bestowed with the above rights, must invest at least 10 per cent or more in the target company.
- Every company would be required to formulate a policy defining the parameters that will be ‘material’ or ‘outside the ordinary course of business’ and the same should be disclosed to the shareholders. Additionally, grants of the protective rights would be subject to obtaining the public shareholders’ approval (majority of minority). Such rights would also be required to be incorporated in the Articles of Association of a company after obtaining shareholders’ approval.
- In case of initial public offers, the existing agreements would need to be cancelled/modified or suspended till the approval of public shareholders (majority of minority) is taken post-listing of the shares.

Option 2
Adopting a numerical threshold:
Under this approach, the definition of control would be amended such that control is defined as:

- The right or entitlement to exercise at least 25 per cent of voting rights of a company irrespective of whether such holding gives de facto control and/or
- The right to appoint majority of the non-independent directors of a company.

Advantages and disadvantages of both options highlighted in the DP

The DP highlights the advantages and disadvantages of both the options as follows:

Option 1
An investor having protective rights would continue to be a public shareholder and the acquisition of these rights would not amount to an acquisition of ‘control’ under SEBI Takeover Regulations, 2011. However, option 1 provides an illustrative list, therefore, the acquisition of other rights would be examined on the basis of the facts and circumstances of the case to assess if control definition has been met. In case such rights are deemed to be participative in nature, it would amount to ‘control’ and necessitate an open offer under SEBI Takeover Regulations, 2011. However, this approach may lead to further complexities in assessment of control and lead to further ambiguity in the interpretation of the definition of control.

Option 2
In case option 2 is adopted, the acquisition of control through other means such as special rights, etc. would not necessitate an open offer requirement under SEBI Takeover Regulations, 2011. However, it would reduce the uncertainty in the assessment of the acquisition of “control” and may bring clarity. Further, the extent of influence by an investor over the board of directors would also be ascertainable in all cases.

The DP is available on the website of SEBI and comments on the same are sought through email at control@sebi.gov.in until 14 April 2016.

The SEBI Board approves revised procedure for dealing with qualified audit reports

Background
The listed entities are required to disclose the cumulative impact of all the audit qualifications on relevant financial items in a separate form called ‘Statement on Impact of Audit Qualifications’ instead of present Form B.

- Applicable formats of the financial results
- Form A (for audit report with unmodified opinion), and
- Form B (for audit report with modified opinion).

The management shall have the right to give its views on the audit qualifications in the new form.

The Schedule VIII of the Listing Regulations lays down the manner of reviewing Form B accompanying annual audited results.

Additionally, SEBI through its circular dated 30 November 2015 prescribed the formats of Form A and Form B that would be filed by listed companies along with the financial results.
New development

The SEBI held its board meeting on 12 March 2016 and through a press release - PR No. 56/2016, approved a revised mechanism to ‘review the audit qualifications contained in the audit reports’ in order to disseminate the impact of the audit qualifications on the financial statements without any delay. In order to streamline the process, following would be the revised procedure:

The listed entities shall be required to disclose the cumulative impact of all the audit qualifications on relevant financial items in a separate form called ‘Statement on Impact of Audit Qualifications’ instead of present Form B.

• The management shall have the right to give its views on the audit qualifications in the new form.
• The existing requirement of adjustment in the books of accounts (as per Schedule VIII of the Listing Regulations) of the subsequent year shall not be necessary.

The new mechanism would be applicable from the financial year ended 31 March 2016, as well as for the earlier cases.

(Source: SEBI press release - PR No. 56/2016 dated 12 March 2016)

Amendments to SEBI ICDR Regulations, 2009 and SEBI Substantial Acquisition of Shares and Takeovers Regulations, 2011

Background

Section 138(1) of the Companies Act, 2013 (2013 Act) provides that a company, which has raised money from public through prospectus and still has any unutilised amount out of the money so raised, shall not change its objects for which it raised the money through prospectus or vary the terms of a contract referred to in the prospectus unless a special resolution is passed by the company. Further, Section 27(2) also provides that dissenting shareholders, shall be those shareholders who have not agreed to the proposal and they shall be given an exit opportunity by promoters and shareholders having control over the company, in such manner and conditions as may be specified by SEBI by making regulations in this behalf.

Further, SEBI in its board meeting on 11 January 2016 approved the proposal to amend the SEBI (Issue of Capital and disclosure requirements) (ICDR) Regulations, 2009 for laying down the framework in this regard.

New development

The SEBI through its notification dated 17 February 2016 issued SEBI (ICDR) (second amendment) Regulations 2016 (amended regulations) to provide framework of exit opportunity to dissenting shareholders. The amended regulations inserted Chapter VI-A to provide detailed guidance on conditions and manner of providing exit opportunity to dissenting shareholders.

The chapter VI-A, inter alia, provides following:

• Applicability: The provisions of this chapter will be applicable to an exit offer made by the promoters or shareholders in control of an issuer to the dissenting shareholders in terms of Section 138(1) and Section 27(2) of the 2013 Act, in case of change in objects or variation in the terms of contract referred to in the prospectus.
• Definitions: The chapter provides definition of dissenting shareholders, frequently traded shares and relevant date for the purpose of these provisions.
• Conditions for an exit offer: The chapter provides conditions which are required to be fulfilled for providing an exit offer to dissenting shareholders.
• Eligibility of shareholders for availing the exit offer: The chapter provides that only those dissenting shareholders of the issuer who are holding shares as on the relevant date shall be eligible to avail the exit offer made under this chapter.
• Exit offer price: The chapter provides conditions for calculating exit price payable to the dissenting shareholders.
• Manner of providing exit to dissenting shareholders
• The chapter provides that pursuant to completion of the exit offer, resultant shareholding should not exceed the maximum permissible non-public shareholding.

Also consequential amendments have been made in Regulation 3 of SEBI (Substantial acquisition of shares and takeovers) Regulations, 2011

(Source: SEBI (ICDR) (second amendment) Regulations 2016 and SEBI (Substantial acquisition of shares and takeovers) (Amendment) Regulations, 2016 dated 17 February 2016)

Companies (Share Capital and Debentures) Amendment Rules, 2016

Background

The Companies (Share Capital and Debentures) Rules, 2014 relating to buy-back of shares and securities by private companies and unlisted public companies provides that the audited accounts on the basis of which calculation with reference to buy-back is done is not more than six months old from the date of offer document.

New development

The Ministry of Corporate Affairs (MCA), vide notification dated 10 March 2016, has issued the Companies (Share Capital and Debentures) Amendment Rules, 2016 to amend the regulations. The amended regulation provides a clarification that where the audited accounts are more than six months old, the calculations with reference to buy-back should be on the basis of un-audited accounts not older than six months from the date of offer document which are subjected to limited review by the auditors of the company.

The notification will be effective from the date of its publication in the Official Gazette.

(Source: MCA notification dated 10 March 2016)
The government proposes the
Companies (Amendment) Bill
2016

Background
On 1 February 2016, the Companies
Law Committee (CLC) submitted its
recommendations to the government.

New development
Based on the recommendations of
the CLC report, on 16 March 2016, the
government proposed the Companies
(Amendment) Bill 2016 (the Bill) on the
issues arising out of the implementation
of the Companies Act, 2013 (2013 Act) in
Lok Sabha to amend the 2013 Act. The
Bill considered the suggestions made by
the CLC report and comments received
from the stakeholders and ministries/departments.

The Bill was introduced to propose
changes that are broadly aimed
at addressing difficulties in the
implementation owing to stringency of
compliance requirements
• facilitating the ease of doing business
in order to promote growth with
employment
• harmonisation with accounting
standards, the Securities and
Exchange Board of India Act, 1992
and the regulations made thereunder,
and the Reserve Bank of India Act,
1934 and the regulations made
thereunder; rectifying omissions and
inconsistencies in the Act, and
• carrying out amendments in the
provisions relating to qualifications
and selection of members of the
National Company Law Tribunal and
the National Company Law Appellate
Tribunal in accordance with the
directions of the Supreme Court.

Recommendations of the Bill
The recommendations cover significant
areas of the 2013 Act, including
definitions, raising of capital, accounts
and audit, Corporate Social Responsibility
(CSR) managerial remuneration,
companies incorporated outside India
and offences/penalties.

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<th>Area</th>
<th>Proposed amendments</th>
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<td>Definitions revisited</td>
<td>Changes recommended to definitions of subsidiary, associate, joint venture, financial year, holding company, net worth and Interim dividend, debenture, nominee director, related party, turnover, etc.</td>
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| Funding concerns and investment restrictions eased                  | • The Bill proposes that companies may give loan to any person in whom the director is interested, subject to a prior approval of the company by a special resolution and loans extended to persons, including subsidiaries, falling within the restrictive purview of Section 186 should be used by the subsidiary for its principal business activity only. The Bill also specifies the definition of ‘any person in whom the director is interested’.  
  • Further Bill proposes to remove restriction on layers of subsidiaries and investment companies in line with the suggestion made by CLC report.                                                                                   |
| Revised approval requirement for related party transactions         | Proposes to relax stringent requirements of Section 188. It proposes second proviso of Section 188 would not be applicable to cases where 90 per cent or more members, in number, are relatives of promoters or are related parties.                                                                                                                                                                  |
| Clarification/relaxation relating to financial statements of foreign subsidiary | • Proposes that every listed company having a subsidiary/subsidiaries should place separate audited accounts in respect of each of its subsidiary on its website currently the requirement is for every company. 
  • The Bill proposes in regard to foreign subsidiaries requirements of Section 136 would be considered to be met if local GAAP financial statements of foreign subsidiary are placed on the website in the statutory format. |
| Enhanced auditors independence                                       | • No requirement of annual ratification by shareholders.  
  • Definition of relative for determining auditors’ disqualification modified by restricting it to financially dependent relative.                                                                                                                                                                                                 |
| CSR                                                                 | • Composition of the CSR committee for ‘companies not required to appoint independent directors’ should be prescribed as ‘having two or more directors’.  
  • For determining the threshold of the specified net worth, turnover, or net profit to constitute a CSR committee, the words ‘any financial year’ should be replaced by words ‘preceding financial year’.  
  • Proposes an explanation to provide powers to exclude certain sums from net profit in Section 135(1) of the 2013 Act.                                                                                                                                                                                                 |
| Appointment and qualification of directors                          | • Introduces a test of materiality, for the purpose of determining whether pecuniary relationships could impact the independence of an individual for becoming an independent director.  
  • Section 149(6)(d) to be amended with respect to the scope of restriction on a ‘pecuniary relationship or transaction’ entered into by a relative and proposed to be made more specific by clearly categorising the types of transactions.                                                                                                                                 |

(Source: The Companies (Amendment) Bill, 2016 as introduced in Lok Sabha dated 16 March 2016)
KPMG in India’s IFRS institute

KPMG in India is pleased to re-launch its IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India. The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

IFRS Notes

Missed an issue of Accounting and Auditing Update or First Notes?

4 March 2016

The IRDA issues directions to insurers on Ind AS implementation

stated that the insurance sector in India would be converging with International Financial Reporting Standards (IFRS) and subsequently on 7 December 2015, IRDA had also issued a discussion paper on Ind AS implementation in the insurance sector with key recommendations. Further, MCA also issued a press release on 18 January 2016 outlining the road map for implementation of Ind AS in the financial services sector, including insurance companies. The IRDA circular issued on 1 March 2016 now provides certainty on the mandate for implementation of Ind AS for all insurers. This circular requires all insurers to comply with the Ind AS for financial statements for accounting periods beginning on or after 1 April 2018, with comparatives for the periods ending 31 March 2018. Early adoption is not permitted. Ind AS will be applicable to both separate and consolidated financial statements.

Our IFRS Notes provides overview of the recent circular.

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