Accounting for sales contracts in the real estate and construction sectors is likely to change due to the application of a new revenue recognition standard. Ind AS 115, *Revenue from Contracts with Customers* introduces a single comprehensive model of accounting for revenue arising from contracts with customers and will supersede the current revenue recognition guidance. Our article in this edition of Accounting and Auditing Update (AAU) highlights the significant areas where revenue recognition by real estate and construction companies is expected to change due to implementation of Ind AS 115. This standard is applicable to Indian companies covered in the Ind AS roadmap from 1 April 2018.

From 1 April 2018, a new Standard on Auditing, 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* would be applicable to listed companies and certain other companies. The new Standard on Auditing opens the door for an auditor to give users more insight into the audit and improve transparency. In the article, we have explained significant changes expected in the auditor’s report due to communication of key audit matters.

On transition to Ind AS, banks would need to determine whether securitisation transactions entered through trusts or special purpose vehicles would need to be derecognised or consolidated. Our article describes with the help of an illustrative whether certain securitisation transaction would meet the criteria for derecognition of a financial instrument and application of control definition on such special purpose entities or trusts.

Accounting for income taxes is complex, therefore, our article on this topic covers two practical scenarios. The first one relates to accounting for income taxes in any interim period and second one is accounting for deferred taxes in a business combination involving entities under common control.

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

We would be delighted to receive feedback/suggestions from you on the topics we should cover in the forthcoming editions of AAU.
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Ind AS 115 – Impact on the real estate sector and construction companies

This article aims to:
- Highlight key areas of impact of Ind AS 115 on the real estate sector and construction companies.

Summary

Assessment of collectability is important as entities cannot recognise revenue from a contract until collection is probable.

When applying ‘distinct test’, think about land, building, common areas, car parks, management services, golf memberships.

When recognising revenue over-time, assessment is required whether sales contracts meet one of the three criterias.

Significant financing element could lead to complex calculations for contracts recognised over-time.
Background

Globally IFRS 15, Revenue from Contracts with Customers is applicable for accounting periods beginning on or after 1 January 2018. Ind AS 115 being the equivalent standard to IFRS 15, Revenue from Contracts with Customers is effective in India for accounting periods beginning on or after 1 April 2018.

Currently, companies in the real estate sector in India applying the Indian Accounting Standards (Ind AS) recognise revenue using the principles of the Guidance Note on Accounting for Real Estate Transactions issued by the Council of the Institute of Chartered Accountants of India (ICAI) (GN on Real Estate).

This new standard will supersede all the existing guidance available under Ind AS with respect to revenue recognition i.e. Ind AS 18, Revenue, Ind AS 11, Construction Contracts and GN on Real Estate.

The GN on Real Estate provides guidance on:

- Application of the principles of Ind AS 18 in respect of sale of goods to a real estate project when the revenue recognition process is completed
- Application of the percentage of completion method based on the methodology as per Ind AS 11, where the economic substance of the transaction is similar to construction contracts.

The core principle of Ind AS 115 is based on the five-step model prescribed in the standard:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognise revenue when (or as) the entity satisfies a performance obligation

Ind AS 115 will change the way in which many real estate developers account for their sales contracts.

For the purpose of this article, real estate sector includes entities that i) own, operate and sell real estate ii) provide property management services, and iii) construct and sell residential property.

The key impact areas for real estate sector on transition to Ind AS 115 are discussed below:

1. Assessing collectability

Generally, when relevant, one of the most difficult criteria to assess for real estate developers is whether the consideration is collectible. This is due to the fact that there could be certain conditions that would be outside an entity's control, both during the construction phase and subsequently e.g. economic conditions that result in increases or decreases in property prices.

In making the collectability assessment, an entity would consider the customer's ability and intention (which includes assessment of its credit worthiness) to pay the consideration when it falls due. All other relevant facts and circumstances are considered – for example:

- The buyer’s rights to cancel the contract for no penalty
- Any prior experience with the buyer
- Historical data on buyers with similar characteristics
- The importance of the property to the buyer’s operations
- Contractual terms (e.g. small down payment without sufficient collateral)
- Whether the seller is providing non-recourse finance (i.e. seller only has a right to the property in the event of default) to the buyer.
2. Identification of performance obligations

As per the new standard, once a contract has been identified, an entity has to evaluate the contractual terms and the general business practice to identify whether the entity has promised one or several distinct goods or services to its customer. These distinct goods or services are identified as performance obligation(s).

The standard provides the following criteria to identify performance obligations:

- **Criterion 1:** Can the customer benefit from the good or service either on its own or together with other resources that are readily available to the customer?
  - Yes
  - Distinct performance obligation

- **Criterion 2:** Is the promise to transfer the good or service separately identifiable from other promises in the contract?
  - Yes
  - Not-distinct - combine with other goods and services
  - No

If these criteria are not met, the entity would need to combine promised good or service with other promised goods or services until a distinct bundled goods or services has been identified. While assessing distinct goods and services, it is important to analyse these from the customer’s perspective.

In the case of a real estate developer, a key consideration would be whether land and building elements are separate performance obligations. This assessment is critical as different performance obligations may have different patterns over which the control is transferred and as a consequence the timing of revenue recognition would have a significant impact. In the case of residential apartments, the customers also receive the undivided share (commonly referred to as UDS) of the land on which the apartment blocks are constructed. In such a case, since the title to the UDS of land is transferred to the customer separately, it would need to be evaluated if the land would be considered as highly inter-related with the apartment constructed and hence, both together would constitute a single performance obligation, or, will the UDS of land and the apartment constructed cost be considered as separate performance obligations.

Issues on identification of separate performance obligations would also arise with respect to common areas/amenities that are provided by the developers to its customers such as car parks, recreational centers, etc.

In certain other cases, identification of separate performance obligations would be straight forward such as property management services, golf memberships, etc. since these services are not significantly customised, integrated with, or dependent on the underlying property.

To summarise, the identification of performance obligations would require an in-depth understanding and analysis of the terms of the contract and the property laws which are different across the different states in India.
3. Variable consideration
For entities in the real estate sector, variable consideration includes price concessions, incentives, performance bonuses, claims, variations, discounts, refunds, right of return, credits, or other similar items. However, the variable consideration would be included in the transaction price only to the extent that it is highly probable that significant revenue reversal will not subsequently occur (the constraint).

Under Ind AS 115, an entity is required to determine the transaction price and reassess the same at each reporting date. The transaction price may vary depending upon the variable consideration included in the contract. The approach and accounting of the variable consideration is significantly different from the existing requirements.

For example, assume that in addition to the fixed transaction price of INR100 lakh, the real estate developer will also be eligible for a bonus of INR5 lakh for each month of early completion of the project. Under the existing standard, an entity would either include the bonus as part of total contract revenue or exclude it in entirety. Under Ind AS 115, an entity would estimate the variable consideration using the most likely amount and include the same in the transaction price to the extent that significant reversal will not subsequently occur.

It is important for the entity to consider all facts and circumstances while applying the constraint as it might result in understatement or overstatement of revenue. And, the assessment of the estimate has to be updated at each reporting date.

For any claims or variations to be accounted by an entity as part of transaction price, they need to give rise to enforceable rights and obligations. This threshold could be different from what was applied earlier by entities resulting in acceleration or deferment of revenue recognition from these claims and variations.

4. Timing and measurement of revenue
Timing of revenue recognition
For the purpose of revenue recognition, an entity must determine whether the performance obligation is satisfied over time or at a point in time.

The new standard requires an entity to recognise revenue progressively over time if any of the following criteria are met:

1. Customer simultaneously receives and consumes the benefits as the entity performs.
2. The customer controls the asset as the entity creates or enhances it.
3. The entity’s performance does not create an asset for which the entity has an alternate use and there is a right to payment for performance to date.

The most relevant indicator to analyse for real estate developers would be criterion no. 3. This includes assessment of two parts (i). No alternative use of asset and (ii) Right to payment.

When applying the first part of the test – ‘no alternative use’ – is generally met when a real estate developer enters into a contract with a customer that includes a clause that the property cannot be sold to another party. These types of clauses are sufficient for the asset to be considered as having no alternative use to the entity.

However, one of the most challenging areas would be assessing the right to payment criteria in cases where the contract is terminated for reasons other than non-performance by the developer. As per Ind AS 115, the right to payment needs to be enforceable and should approximate the selling price of goods or services transferred i.e. should at least cover performance to date including a reasonable profit margin. A mere reimbursement of cost would not qualify for over-time satisfaction of performance obligation. Hence, this is likely to be an area of significant debate and would require careful evaluation of whether the developer is entitled as per the contract to recover his/her costs of performance plus margin from the customer and would also need an assessment of the local property laws to check on the legal precedent on enforceability of rights and the past practice with respect to enforcing these rights. The general practice of repossessing the property in case of default in payment will not again meet this criteria since a right to repossess a property will not qualify as a right to payment for performance.

As per the new standard, if the above criteria for recognising revenue over time are not met, then the revenue has to be recognised at a point in time i.e. when the customer obtains the control of the asset.
This guidance under Ind AS 115 will be in contrast to the current GN on Real Estate that permits real estate developers to recognise revenue using the percentage of completion method.

### Measuring progress

Under the current requirements, some entities recognise work in progress balances that may include both amounts related to uninstalled materials and amounts that may be deferred until the next milestone is reached. Under Ind AS 115, these practices are no longer appropriate because when control of the property is transferred over time, it is assumed that the transfer is continuous such that no material amounts of work in progress are recorded. As a result, the recognition of work in progress as a balance sheet ‘true up’ to ensure a smooth margin is no longer permitted. Ind AS 115 provides specific guidance on the treatment of uninstalled materials which requires revenue recognition at a zero margin when control of these materials is passed to the customer. Under the current guidance, materials that have not yet been installed are excluded from contract costs when determining the stage of completion of a contract and are recognised as part of work in progress.

Thereby under the new standard an entity can capitalise only the following costs:

- Cost of inventory for which the control has not been passed on to the customer
- Cost of obtaining a contract (discussed subsequently)
- Cost of fulfilling a contract i.e. set up costs.

### 5. Significant financing element

Currently Ind AS 18 requires revenue to be recognised at fair value for arrangements with deferred credit that provide a financing arrangement for a customer. Under Ind AS 115, the concept of significant financing element needs to be looked at from both deferred credit and receipt of advance basis and would result in recognition of interest income and interest expense respectively over the period of the contract with a corresponding adjustment to revenue (reduction in case of deferred credit and gross up in case of advance). While the computations of these can be straight-forward in cases where revenue is recognised at a point in time, in case of real estate where the revenue recognition would be over-time, the computations could get complex and would require exercise of judgement.

### 6. Costs of obtaining a contract

There is no specific guidance under current Ind AS on accounting for the costs to obtain a contract. Ind AS 11 states that costs that relate directly to a contract and are incurred in securing the contract are included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained.

Ind AS 115 provides specific guidance on accounting for costs incurred for obtaining the contract. An entity can capitalise costs that are directly attributable and incremental in nature for obtaining a contract and are expected to be recovered. Costs are considered as incremental in nature if they are incurred only as a result of obtaining the contract.

The asset recognised based on the above guidance shall be amortised on a systematic basis over the contract period in a pattern matching the transfer of promised goods or services. The standard provides a practical expedient by allowing to recognise such costs as expenses when they are incurred if the amortisation period would be less than 12 months.

As there is now specific guidance under Ind AS 115, it could result in fewer or more costs being capitalised as compared to the current practice. In the real estate sector, many entities incur significant costs as sales commission, bonus paid to staff on targets, etc. Therefore, such entities would need to assess if such costs would qualify for capitalisation under Ind AS 115.
Impact of Ind AS 115 on construction companies

The issues discussed above for real estate developers would also be relevant for construction contractors to a large extent. The determination of whether recognition of revenue should be at a point in time or over-time would be less of a challenge for construction companies since such contracts are likely to meet criteria 2 discussed above under the heading ‘timing and measurement of revenue’.

A couple of topics more specific to the construction industry for which there could be an impact under Ind AS 115 are discussed below:

Contract modifications

A contract modification can happen either because of a change in price or scope and/or of both. Ind AS 115 would require a contract modification to be accounted only if the same has been approved i.e. when it creates legally enforceable rights and obligations on parties to the contract.

A contract modification could be accounted as:
1. A separate contract
2. A part of the original contract
3. As termination of existing contract and creation of a new contract.

These would require analysis to determine whether any distinct goods or services are being delivered to the customer and whether the same are priced at their stand-alone selling prices.

Is the contract modification approved? No

Do not account for contract modification until approved

Yes

Does it add distinct goods or services that are priced commensurate with stand-alone selling prices?

No

Are remaining goods or services distinct from those already transferred? No

Account for as part of the original contract

Yes

Account for as termination of existing contract and creation of new contract

Account as separate contract

(Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016)

These contract modifications could get complex and involve significant administrative efforts, if these occur frequently. Further since the assessment focusses on enforceability, this would require significant judgement particularly in cases where the parties to the contract could dispute the scope or the price.

Loss making contracts

As per the new standard there is no specific guidance on loss making contracts. Therefore, the same has to be accounted based on the general guidance provided for onerous contracts under Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

Transition approaches

Ind AS 115 provides the following transition options:

1. Retrospective method: Under this method, an entity would recognise the cumulative effect of the new standard at the start of the earlier comparative period. As part of this method, an entity could use certain practical expedients to ease the transition process.

2. Cumulative effect method: Under this method, an entity would recognise the impact of the new standard from the date of initial application with no requirement to restate the comparative period i.e. the comparative year would be presented under the current guidance (GN on Real Estate/Ind AS 18/Ind AS 11). An entity using this method would also need to disclose for the current period the quantitative effect of the new standard and an explanation of the significant changes between the results as per the new standard and those that would have been reported under the current guidance.

Both these approaches would have their pros and cons and hence, would require a careful evaluation before implementation.
New auditor’s report requirement - Communication of key audit matters

This article aims to:
- Explain the concept of key audit matters that are part of new auditor’s report.

Summary

New style of audit reports:
Without changing the scope of an independent audit, the new Standard on Auditing opens the door for the auditor to give users more insight into the audit and improve transparency.

Key Audit Matters:
This is the most significant change introduced by the new requirements i.e. the auditor to include descriptions of key audit matters in the auditor’s report.

Effective date:
The new Standard on Auditing would be effective for audits of financial statements for periods beginning on or after 1 April 2018.

The Institute of Chartered Accountants of India (ICAI), on 17 May 2016, issued a new Standard on Auditing (SA) 701, Communicating Key Audit Matters in the Independent Auditor’s Report. This standard on auditing is expected to provide greater transparency about the audit that would be performed and increase in the communicative value of an auditor’s report.

SA 701 requires an auditor to describe in the auditor’s report of listed entities about the key areas it focussed on in the audit and the procedures performed in those areas.

SA 701 applies to audits of complete sets of general purpose financial statements of listed entities (with securities listed in India or outside India) and in circumstances when the auditor otherwise decides to communicate Key Audit Matters (KAMs) in the auditor’s report. It is also applicable in case the law or regulation requires an auditor to communicate KAM in the auditor’s report.

Recently, ICAI has also issued an implementation guide to SA 701 (implementation guide) in the form of Frequently Asked Questions (FAQs) and provided guidance on key issues relating to the application of SA 701.

This article aims to provide an overview of the new reporting requirement comprised in SA 701 along with highlighting the additional guidance provided by the implementation guide.

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01. Entities which are in the process of listing are not covered under SA 701. They will get covered from the financial year in which they are listed.
Inclusion of KAM - Significant change in the auditor’s report

• The most significant change introduced by SA 701 in the auditor’s report of listed entities is the communication of KAMs.

• KAMs have been defined to mean those matters that, in the auditor’s professional judgement, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated with those charged with governance.

• As per the implementation guide, KAMs, in most of the cases, would relate to significant or complex matters disclosed in the financial statements. For instance, valuation of goodwill and other long-term assets, valuation of financial instruments, difficult or unique aspects of revenue recognition, assessment of impairment, taxation matters, accounting for significant acquisitions, etc.

Benefits of KAM

• Management and those charged with governance: Timely communication of KAM is likely to encourage management and those charged with governance to enhance or make new disclosures in the financial statements or other reports in light of the fact that the matter will be communicated in the auditor’s report. For instance, providing robust information about the sensitivity of key assumptions used in accounting estimates or an entity’s rationale for a particular accounting practice.

• Users of financial statements: KAM is expected to provide additional information that may assist users in understanding the entity and areas of significant management judgement in the audited financial statements.

Determination of KAM – a funnel approach

SA 701 and the implementation guide provided a funnel approach to determine which matters are required to be reported as KAM in the auditor’s report. According to the approach, following steps should be followed while determining a KAM:

Step 1: Matters communicated with those charged with governance

Step 2: Matters that required significant auditor attention

Step 3: KAMs (matters of most significance)

(Source: KPMG India’s analysis, 2018 based on the provisions of SA 701 and the implementation guide)

• Step 1: KAMs should be identified from the matters communicated with those charged with governance. These matters could, inter alia, include the auditor’s responsibilities in relation to the financial statements audit and significant findings from the audit.

• Step 2: From the matters communicated to those charged with governance, identify the matters that required significant auditor attention. These primarily relate to matters that pose challenges to the auditor in forming an opinion or obtaining evidence that in his/her judgement was sufficient and appropriate under the circumstances.

While determining such matters, an auditor is required to consider the following:

a. Areas of higher assessed risk of material misstatement, or significant risks identified

b. Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as areas of high estimation uncertainty

c. Effect on the audit of significant events or transactions that occurred during the period. For instance, matters which had significant effect on financial statements or the audit and significant economic, accounting, regulatory, industry or other developments that impacted the management’s assumptions and judgements.

• Step 3: An auditor needs to determine which of the matters identified in Step 2 were of most significance in the audit of the financial statements of the current period.

Determining which, and how many, of those matters that required significant auditor attention were of most significance in the audit is a matter of professional judgement. Further, the number of KAMs to be included in an auditor’s report may be affected by the following:

- Size and complexity of the entity
- Nature of its business and environment and
- Facts and circumstances of the audit.

The implementation guide clarified that there is no threshold for the number of KAMs that need to be communicated by an auditor. Different entities in the...
same industry can have different KAMs as the identification of KAM depends on the risk assessment process of the auditor and entity-specific conditions and circumstances. Similarly, it is possible for KAMs to be different in different years but cannot be entirely different.

SA 701 and the implementation guide provide certain factors that could be considered while identifying matters of most significance. These, inter alia, include:

- Areas where an auditor had more in-depth, frequent or robust interactions with those charged with governance on more difficult or complex matters
- Significant delays in management providing required information
- Management’s unwillingness to make or extend its assessment of the entity’s ability to continue as a going concern when requested
- Severity of control deficiencies.

**Manner of communicating KAM**

- The description of each KAM in the KAM section of the auditor’s report should include a reference to the related disclosure(s), if any in the financial statements, as to:
  - Why a matter was considered to be one of most significance in the audit and therefore, determined to be a KAM and
  - How the matter was addressed in the audit.
- It is important to note that communicating KAMs in the auditor’s report is in the context of the auditor having formed an opinion on the financial statements as a whole and not a separate opinion on individual matters reported as KAM.

**Going concern as a KAM**

- SA 701 highlights that a material uncertainty related to going concern is, by its nature, a KAM. These matters are to be reported in accordance with SA 570, Going Concern.
- In the KAM section, reference to the basis of qualified/adverse opinion or the material uncertainty related to going concern section should be given.

**Close call situations**

- There could be events or conditions which may cast significant doubt on an entity’s ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists. These are generally referred to as ‘close call situations’.
- In such a case, an auditor should evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. These may be fundamental to the understanding of the entity and can be considered and reported as KAM.

**Interplay between Emphasis of Matter (EOM), other matter and KAM section**

- SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter paragraphs in the Independent Auditor’s Report* establishes mechanisms for auditors of financial statements of all entities to include additional communication in the auditor’s report through the use of EOM and other matter paragraphs when the auditor considers it necessary to do so.
- These paragraphs are presented separately from the KAM section in the auditor’s report.
- SA 701 and the implementation guide provided following guidance with respect to EOM, other matter and KAM section:
  - **In case a matter has been determined to be a KAM:** The auditor is required to include the matter in the auditor’s report in accordance with SA 701. The auditor should not use an EOM paragraph or other matter paragraph to highlight the matter instead of the requirements of SA 701.
  - **In case a matter is not determined to be a KAM as per SA 701 (i.e. it did not require significant auditor attention):** If the matter is fundamental to the users’ understanding of the financial statements, then the matter should be reported in an EOM paragraph in the auditor’s report in accordance with SA 706. For instance, in the following circumstances, an auditor would consider it necessary to include an EOM section:
    - An uncertainty relating to the future outcome of exceptional litigation or regulatory action
    - A significant subsequent event that occurs between the date of the financial statements and the date of the auditor’s report
    - A major catastrophe that has had, or continues to have, a significant effect on the entity’s financial position.
Presentation of KAM

- KAM should be presented as a separate section after the basis for opinion section of an auditor’s report.

- In case KAMs identified relates to a modification, a statement to this effect is to be included under the KAM heading.

- In case, ‘material uncertainty relating to going concern’ section is required as per revised SA 570, then KAM section is placed after that section.

- Based on the auditor’s judgement as to the relative significance of the information included in the EOM paragraph, an EOM paragraph may be presented either directly before or after the KAMs section.

Types of KAMs not to be reported

- Under the following circumstances, a matter determined to be a KAM is not required to be communicated in the auditor’s report:
  
a. Law or regulation precludes public disclosure about the matter.

b. The auditor determines that the matter should not be communicated in the auditor’s report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This will not be applicable if the entity has publicly disclosed information about the matter.

- In such a case, a written representation from management, and when appropriate, those charged with governance, could be obtained as to why public disclosure about the matter is not appropriate, including management’s view about the significance of the adverse consequences that may arise as a result of such communication.

- Apart from the above, there could be very limited situations (such as listed entity with very limited operations) where there are no KAMs to be communicated. However, in such a case also, KAM section will be given in the auditor’s report.
Derecognition and consolidation requirements in a securitisation transactions

This article aims to:
- Explain the derecognition and consolidation requirements in a securitisation transactions.

Summary

Banks and Non-Banking Financial Companies (NBFCs) often enter into securitisation transactions to generate liquidity, facilitate capital relief and redistribute credit risks to a certain extent. Currently, these entities derecognise securitised loans from their balance sheet if legal ‘true sale’ criteria as specified by the Reserve Bank of India (RBI) are met. Further, trusts or other Special Purpose Vehicles (SPV) set up for the securitisation are generally not consolidated based on the guidance in Accounting Standard (AS) 21, Consolidated Financial Statements.

On transition to Ind AS, banks would have to apply the guidance in Ind AS 110, Consolidated Financial Statements to determine whether such SPVs should be consolidated. Further, the derecognition of securitised loans from the banks’ separate as well as consolidated financial statements would be determined by guidance in Ind AS 109, Financial Instruments. Most securitisations require the originating banks to provide support in the form of credit enhancement and grant banks the right to any excess returns. These features generally fail the derecognition tests in Ind AS 109 and result in continued recognition of the securitised assets by the originating bank. This may also affect the bank’s ability to obtain capital relief by entering into these structured transactions.

While banks are exempt from applying the derecognition guidance to past securitisations (completed prior to the Ind AS transition date), no such exemption is available for consolidation. Consequently, banks would not have to recognise loans securitised prior to transition on their separate balance sheet, but may have to consolidate the securitisation SPV. This would result in such loans being brought back on the consolidated balance sheet.
This article highlights the interaction between derecognition and consolidation guidance, as relevant for securitisation transactions, with the help of the following example.

**Example: Securitisation of home loans**

Figure 1 illustrates the structure for a securitisation transaction involving assignment of a portfolio of home loans by Bank S to an SPV – ‘Trust A’ on 1 April 2016:

Since the assignment was in the nature of a ‘true sale’ on 1 April 2016, the bank derecognised the home loan portfolio from its financial statements (except to the extent, it continued to hold 10 per cent of the loan portfolio in accordance with the RBI guidelines) under previous GAAP. The difference between the income earned on the home loan portfolio and the interest paid to investors, being ‘excess returns’, would be passed on to Bank S on a subordinated basis. The excess returns serve as a ‘first loss’ credit enhancement for the external investors. Bank S also provided Trust A with credit enhancement facilities in the form of an off-balance financial guarantee.

**Accounting guidance and analysis**

**Separate financial statements**

The bank has provided credit enhancement in terms of a ‘first loss’ facility as well as a guarantee to the trust. On the basis that these facilities result in continued exposure to the credit risk, interest rate risk, liquidity risk and some prepayment risk associated with the home loans, the bank would be unable to derecognise the loans from its financial statements. However, as per Ind AS 101, the derecognition requirements are applied prospectively to transactions occurring on or after the transition date, i.e. 1 April 2017. Therefore, Bank S would not be permitted to recognise the home loans in its separate financial statements since these loans had already been derecognised (prior to transition date) under previous GAAP based on legal ‘true sale’ criterion.
Consolidated financial statements

When determining whether the securitised assets should be derecognised in the consolidated financial statements of Bank S, the first step for the bank is to evaluate whether it should consolidate Trust A on transition to Ind AS. Subsequently, the bank should assess whether the securitised loans meet the derecognition criteria in Ind AS 109 at the consolidated level. Under IGAAP, Bank S was not required to consolidate the financial statements of Trust A since it did not exercise ‘control’ in accordance with AS 21. However, under Ind AS 110, the evaluation of control is based on a four step model.

Ind AS 101 does not provide for any exemption from the consolidation requirements of Ind AS 110. Therefore, the bank should determine whether it ‘controls’ Trust A based on the guidance in Figure 2 below.

The analysis above indicates that Bank S controls the trust since:

- It has established the trust and the securitisation structure to meet its funding and liquidity requirements as well as to obtain capital relief;
- The activities of the trust are largely pre-determined by the bank and are fairly narrow in scope, requiring no significant operating decisions to be made; and
- It continues to be exposed to substantially all the credit risk as well as interest rate risk. Although some prepayment risk is transferred to the investors, the bank is also exposed to prepayment risk on its right to excess returns.

Figure 2: Control analysis for Bank S

<table>
<thead>
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<th>Step</th>
<th>Description</th>
<th>Analysis</th>
</tr>
</thead>
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<tr>
<td>01</td>
<td>Understand the investee</td>
<td>Determine purpose and design - Set up as financing vehicle to provide liquidity to Bank S; Identify relevant activities - Pass through of cash flows and manage loans in default; Decisions on relevant activities - Activities and processes are predefined by Bank S. No significant ongoing operating decisions to be made;</td>
</tr>
<tr>
<td>02</td>
<td>Power over the relevant activities</td>
<td>Voting rights - Power is not exercised through voting rights due to its predetermined structure; Evidence of practical ability to direct - Trust has been set up by Bank S, which has also pre-defined the framework within which it can operate; Special relationship - Trust set up specifically for the securitisation of the bank’s assets; Large exposure to variability of returns - Yes, the bank is exposed to variable returns since it provides first loss protection and is entitled to excess cash flows;</td>
</tr>
<tr>
<td>03</td>
<td>Variability of returns</td>
<td>Continued exposure to risks/risk transfer - External investors entitled to a fixed coupon payable in priority as per a defined payment waterfall. Bank S remains exposed to credit risk since it provides credit enhancement in the form of first loss protection; Investor’s exposure to risks - Investor is exposed to some prepayment risk, although credit risk is substantially retained by the bank; Rights to variable returns of investor - Bank S has retained interest in the loan portfolio through its right to excess returns;</td>
</tr>
<tr>
<td>04</td>
<td>Linkage</td>
<td>Principal or agent - Bank S has pre-defined the activities of Trust A to manage its liquidity needs and earn variable returns, hence it is acting as a principal;</td>
</tr>
</tbody>
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Evaluation for derecognition in consolidated financial statements

The derecognition requirements need to be applied to the consolidated financial statements of Bank S, which include the trust. The loans were not derecognised at a consolidated level under previous GAAP since, previously, there was no requirement to consolidate the trust under AS 21. The Ind AS 101 exemption related to past derecognition of financial assets would therefore not apply. The bank would therefore have to evaluate the transaction under Ind AS 109 to determine if it qualifies from derecognition at a consolidated level at the time of transition to Ind AS.

The securitisation transaction does not appear to meet the ‘pass through’ requirements in Ind AS 109 since all collections are not passed on to the external investors (some of the amounts collected are retained by the bank as excess cash flows). Further, the bank appears to retain substantially all risks and rewards through its continued exposure to credit risk and marginal returns. This indicates that the bank would continue to recognise the securitised loans in its consolidated financial statements. The PTCs issued to external investors would be classified as borrowings.

Consider this

- Currently, RBI guidelines require ‘true sale’ criteria to be met to permit securitised assets to be removed from the balance sheet of the originating bank. These criteria differ from the requirements of Ind AS 109 and may result in different outcomes. The RBI’s Report of the Working Group on Ind AS released in September 2015, recommends alignment of the accounting framework for derecognition and securitisation with the principles of Ind AS 109, while retaining prudential tools/filters to manage the impact on regulatory capital requirements, dividend distribution, etc.
Accounting for income taxes: Few practical considerations

This article aims to:
- Highlight the complexity in determination of effective income tax rate for interim financial statements statements and accounting for deferred taxes in a common control business combination

Accounting for income taxes has always been complex not only due to various interpretation challenges of any income tax law but also various judgemental considerations. Examples of judgement areas are assessment of probability for recognising deferred tax assets on accumulated losses, taxes on undistributed earnings, scheduling origination/reversal of temporary difference and change in assessment of deferred tax of either of the combining entities in a business combination under common control at the date of combination. The complexity may further increase when accounting for income taxes for any interim period.

Therefore, in this article, we highlight certain practical considerations in relation to:

i. Accounting for income taxes in any interim period

ii. Accounting for deferred taxes in business acquisition involving entities under common control.
Accounting for income taxes in any interim period

The term ‘interim period’ is defined in Ind AS 34, *Interim Financial Reporting* as a financial reporting period which is shorter than a full financial year.

As per paragraph 30(c) of Ind AS 34, ‘income tax is recognised in each interim period based on the best estimate of weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.’

The best estimate of the weighted average annual income tax rate expected for the full financial year is calculated by estimating the ‘total’ tax charge for the year (comprising both current and deferred tax) and expressing this as a percentage of expected accounting profit or loss for the year. This ‘effective’ average annual tax rate is then used to compute the ‘total’ interim tax charge. Also, it is important to note that in certain situations actual tax computation for an interim period may be more relevant and acceptable when reliable estimate of full year pre-tax income cannot be made or when a small change in any item of tax computation results in a significant change in weighted average annual effective tax rate, etc.

Computation of effective tax rate is a matter of judgement and an estimate of the many critical aspects. Few important factors to be considered in determining annual effective tax rate are as follows:

- Tax rate and laws used are those which are applicable for full year that have been enacted or substantively enacted by the end of the interim reporting period
- Generally, separate estimated average annual effective income tax rate should be determined for each jurisdiction and for different categories of income (if different tax rate is applicable for those different categories)
- Expected annual pre-tax income and tax deductions which may be linked to events or income/expenditure expected to arise in future interim periods should be considered when estimating annual effective tax rate
- Accounting impact for one-off items
- Accounting for tax rate or law change, one-off deduction or significant income/expenditure item in any interim period, reassessment of any deferred tax item, etc.

While first three bullets are self-explanatory or to be accounted for in line with the broad principles of Ind AS 12, *Income Taxes*, it is important to understand how bullet 4 and 5 should be considered in determining tax expense/credit for any interim period.

Generally, a one-off event will be those items which are unusual or infrequent in nature and involves a relatively high degree of abnormality. It may not be possible to reliably estimate the effect of a one of event and therefore, accounting effect of such an event should be recognised in the interim period in which such one-off event arises instead of including this in estimation of weighted average annual income tax rate.

In respect of bullet 5 listed above, there could be an impact due to either re-measurement of existing deferred tax item or tax rate change for the current full year. Generally, there are two methods to estimating the weighted average annual income tax rate to apply to interim periods in relation to change in tax rate and reassessment of recognition of deferred taxes on carry forward losses. The method adopted to estimate the weighted average annual income tax rate to apply to the interim results for such items should be applied consistently as an accounting policy.

Under the first method, the weighted average income tax rate does not include the impact resulting from items listed in bullet 5 above and therefore, the impact of premeasuring these balances is recognised immediately in the interim period in which the change in rate is enacted or substantially enacted considering it as the one-off event.

Alternatively, the second method takes a contrary view where the impact effect of a change in the tax rate spread/allocated over the remainder of the annual reporting period via an adjustment to weighted average annual income tax rate.

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Accounting for reassessment of deferred tax of a merging entity with another common control entity

Currently, we routinely come across mergers and acquisition involving entities within common control. Other than business synergies, there could be tax positions and realisability synergies driving some of these transactions. Therefore, it is not uncommon to see a reassessment in deferred tax position of merging entity as on the date of combination in such transaction.

Generally, in a business combination between two entities which are not under common control while impact of such reassessment on the date of business combination is considered as an adjustment to acquired assets and thus will impact goodwill or bargain purchase gain computation, any subsequent change post acquisition date is considered to be an adjustment to the statement of profit and loss, subject to rules relating to measurement period.

However, for business combination among entities under common control, the general guidance is to apply ‘as if pooling of interest method’ and therefore, all items of assets and liabilities are combined from the first day of earliest comparative period presented or whenever entities came under common control, whichever is later. Therefore, neither goodwill nor bargain purchase gain is accounted for.

Ind AS is silent on the accounting treatment of reassessment of deferred tax of combined entity i.e. whether it should be recognised in the statement of profit and loss or statement of changes in equity.

Under U.S. GAAP, the deferred tax consequences of changes in the tax bases of the combined entity’s remaining assets and liabilities caused by the common control merger would be included in equity.

Therefore, under Ind AS entities should carefully assess whether under a common control business combination the impact due to reassessment of deferred taxes would be accounted in the statement of changes in equity or statement of profit and loss on the basis of facts and circumstances of each case.

Conclusion

As is evident from an interim financial reporting perspective, it is important to appropriately classify and account for one-off event/items and making long-term driven accounting policy choice to reflect the impact of certain reassessments caused either due to internal estimation or due to change in tax laws or rates. From the perspective of transactions under common control, it is important that whether the tax effect of a particular item especially reassessment of deferred tax of merging entity on the date of combination will be accounted as an adjustment to equity or through the statement of profit and loss.
Regulatory updates
MCA amends provision relating to resignation of independent directors

Background

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

Recently, on 3 January 2018, the Companies (Amendment) Act, 2017 (Amendment Act, 2017) received the assent of the President of India. The Amendment Act, 2017 makes significant changes to the 2013 Act which are aimed at ease of doing business, better corporate governance and enforcement of stringent penal provisions for defaulting companies.

New development

With an aim to ease difficulty and to ensure better corporate governance, MCA through its notification dated 21 February 2018 issued Companies (Removal of Difficulties) Order, 2018 (difficulty order). The difficulty order issued an amendment to Section 169(1) of the 2013 Act to ensure better corporate governance in companies and balancing of powers of the board of the company.

The amended provision provides that an independent director who is appointed for the second term i.e. reappointed under Section 149(10) would be removed from the board of directors of the company only through a special resolution and after giving him/her a reasonable opportunity of being heard.

The amendments would be effective from the date of its publication in the Official Gazette i.e. 22 February 2018.

(Source: Companies (Removal of Difficulties) Order, 2018 issued by MCA dated 21 February 2018)

The MCA issues relaxations for government companies

The MCA on 5 June 2015 issued notifications which provided exceptions/modifications/adaptations to some of the provisions of the 2013 Act for government companies. The exemption provided to government companies included exemption from the provisions of AS 17, Segment Reporting for the companies engaged in defence production.

Recently, the MCA through its notification dated 23 February 2018, amended the erstwhile notification dated 5 June 2015 to provide that the companies engaged in defence production are exempt from the provision on segment reporting under the applicable Accounting Standard i.e. current IGAAP (AS) or Ind AS, whichever is applicable to the entity.

(Source: MCA notification 802(E) dated 23 February 2018)

MCA notifies section relating to constitution of NFRA

The MCA through its notification dated 21 March 2018 notified following provisions relating to constitution of the National Financial Reporting Authority (NFRA) with effect from 21 March 2018.

- Section 132(3) of the 2013 Act provides that NFRA should consist of a chairperson, who should be a person of eminence and having expertise in accountancy, auditing, finance or law to be appointed by the central government and such other members not exceeding 15 consisting of part-time and full-time members as may be prescribed. Further, the chairperson and members should make a declaration to the central government in the prescribed manner regarding no conflict of interest or lack of independence in respect of his or their appointment.

Additionally, the chairperson and members, who are in full-time employment with NFRA should not be associated with any audit firm (including related consultancy firms) during the course of their appointment and two years after ceasing to hold such appointment.

The MCA has issued the Companies (Accounts) Amendment Rules, 2018

The MCA through its notification dated 27 February 2018 issued Companies (Accounts) Amendment Rules, 2018 which has amended the existing Rule 10 of the Companies (Accounts) Rules, 2014. The rules provide a format in which entities are required to input details of their financial statements. Currently the rules provide form AOC-3 which includes the format for filing financial statements under current Indian GAAP i.e. Accounting Standards (AS).

The amended rules provide a new form i.e. Form AOC-3A for entities which are required to comply with the Companies (Indian Accounting Standards) Rules, 2015 to file their financial statements in the format of abridged financial statements and cash flow statement.

The amended rules are applicable from date of its publication in the Official Gazette i.e. 28 February 2018.

(Source: MCA notification GSR 191(E) dated 27 February 2018)
• Section 132(11) provides that the central government may appoint a secretary and such other employees as it may consider necessary for the efficient performance of functions by NFRA under the 2013 Act and the terms and conditions of service of the secretary and employees should be such as may be prescribed.

Additionally, MCA issued the NFRA (Manner of appointment and other terms and conditions of service of chairperson and members) Rules, 2018. The Rules, interalia, provides guidance with respect to the following:

• Composition of NFRA
• Manner of appointment of the chairperson and members of NFRA
• Norms for removal of chairperson or member
• Procedure for enquiry of misbehaviour or incapacity of the chairperson or a member.

The rules came into force from the date of their publication in the Official Gazette i.e. 22 March 2018.
(Source: MCA notification dated 21 March 2018 and NFRA (Manner of appointment and other terms and conditions of service of chairperson and members) Rules, 2018)

SEBI recommended additional methods for MPS requirements

Background

Rule 19A of the Securities Contracts (Regulations) Rules, 1957 (SCRR) provides that every listed company is required to maintain a public shareholding of at least 25 per cent. Additionally, Regulation 38 of Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) provides that the listed entity shall comply with Minimum Public Shareholding (MPS) requirements in the manner as specified by SEBI.

The SEBI through its circular CIR/CFD/CMD/14/2015 dated 30 November 2015 provided for following methods that may be used by a listed entity to achieve compliance with MPS requirements mandated under Rules 19(2)(b) and 19A of SCRR and Regulation 38 of Listing Regulations.

a. Issuance of shares to public through prospectus
b. Offer for sale to public through prospectus
c. Sale of shares held by promoters through secondary market in terms of SEBI circular CIR/CFD/CMD/14/2015 dated 1 February 2012
d. Institutional placement programme
e. Rights issue to public shareholders
f. Bonus shares to public shareholders
g. Any other method as may be approved by SEBI on a case to case basis.

In this regard, listed public sector companies have been provided additional time till 21 August 2018 to comply with the requirements. Accordingly, listed entities that have a public shareholding of less than 25 per cent are required to adopt any of the certain methods to comply with the MPS requirements.

New development

The SEBI through its circular (SEBI/HO/CFD/CMD/CIR/P/43/2018) dated 22 February 2018 introduced two additional methods for listed entities to comply with the MPS requirement i.e.

• Open market sale: Sale of shares up to 2 per cent of the total paid up equity share capital held by promoters/promoter group in open market subject to certain conditions as mentioned in the circular.
• Qualified Institutions Placement (QIP): Allotment of eligible securities through QIP in terms of Chapter VIII of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Further, SEBI requires a listed entity to give an undertaking to the recognised stock exchange(s) obtained from the persons belonging to the promoter and promoter group that they would not buy any shares in the open market on the dates on which the shares are being sold by promoter(s)/promoter group as stated above.
(Source: SEBI circular number SEBI/HO/CFD/CMD/CIR/P/43/2018 dated 22 February 2018)
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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.

SEBI relaxes norms governing schemes of arrangements by listed entities
18 January 2018

The listed entities that desire to undertake a scheme of arrangement or are involved in a scheme of arrangement need to follow the regulations laid down by the Securities and Exchange Board of India (SEBI). On 10 March 2017, SEBI issued a circular which laid down a revised regulatory framework for schemes of arrangements by listed entities and relaxation under Rule 19(7) of the Securities Contract (Regulation) Rules, 1957.

On 3 January 2018, SEBI issued a circular to make certain amendments to the circular dated 10 March 2017. The recent circular is applicable from the date of its issue i.e. 3 January 2018. Some of the key relaxations provided in the circular relate to the following topics:

• Submission of documents to stock exchanges
• Relaxations with respect to locked-in promoter’s shares
• Extended time period for listing of specified securities.

In this issue of First Notes, we have provided an overview of the key amendments/relaxations given in the circular.

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