Banks, Non-Banking Financial Companies and Insurance companies would need to embark on the journey of implementation of Ind AS from 1 April 2018 with the date of transition being 1 April 2017. From this edition of Accounting and Auditing Update (AAU), we are starting with a series of articles that will provide insights into key Ind AS implementation issues from accounting and financial reporting perspective for entities in the financial services sector. In this issue, we describe the computation of effective interest rate for loans advanced by banks with the help of case studies.

Companies incur expenditure on enabling assets either when a new project needs to be initiated or while scaling up their operations. The Expert Advisory committee of the Institute of Chartered Accountants of India (ICAI) has dealt with the issues of recognition of cost of enabling assets under Accounting Standards. With Ind AS being the new financial reporting framework, the Ind AS Transition Facilitation Group (ITFG) has provided its opinion on recognition of such assets. Our article in the AAU captures the accounting treatment of such assets both under Accounting Standards and Ind AS.

Under the Companies Act, 2013 (2013 Act) section of AAU, we highlight the role and responsibilities of Independent Directors both under the 2013 Act and Securities and Exchange Board of India’s (SEBI) regulations.

Under Ind AS financial reporting standards while assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form. In our article, on sale and leaseback arrangements, we aim to highlight the concept of substance over form under the sale and leaseback arrangements with the help of an example.

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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Accounting treatment of enabling assets

This article aims to:

- Explain the accounting treatment of enabling assets under Ind AS and Accounting Standards

The existing accounting framework in India relating to treatment of expenditure incurred by a company towards certain assets whose ownership is not vested with the company is partially driven by principles and partially by the nature of such expenditure and the related factors stemming from the specific arrangements entered into by the company on a case-to-case basis. Whenever there is a new project being initiated by a company, for example, setting up of a new refinery, it may have to incur expenditure on the construction/development of certain assets like electricity transmission lines, railway siding, roads, culverts, bridges, etc. in order to facilitate construction of the project and subsequently facilitate its operations. The ownership of such assets (hereinafter referred to as ‘enabling assets’) as well as the land on which these assets are situated may not vest with the company.

The need to incur expenditure on such enabling assets ranges across industries and in particular with companies entering into arrangements with government-owned entities towards construction/development of certain assets owned by such government entities. For example, a power sector company could be engaged in projects involving augmentation of sub-stations and construction of transmission lines. The ownership of sub-station after the modifications and the augmented transmission lines shall vest with state electricity boards. Can the power company argue that such expenditure ought to be capitalised in its books since the same is directly related to the construction of the power project and that the benefit will accrue to the company for more than a year?

Likewise, a company engaged in mining operations transports coal through road transport in the absence of rail connectivity. Owing to some restriction on the movement of commercial vehicles, the company enters into a Memorandum of Understanding (MoU) with the state government to widen the existing two-lane roadway to four lanes. It was also a business necessity and compulsion to widen the road to transport the coal stock and to maintain continuity of production, ultimately facilitating unrestricted movement of vehicles and also benefitting villagers living nearby. The land on which the road is situated and the road will be the property of the state government. In this situation, can the company record the road-widening expenditure as an intangible asset reasoning that the benefit of this expenditure will accrue to the entity for periods beyond one year?
Accounting dilemma under the existing Indian GAAP

Under Indian Generally Accepted Accounting Principles (GAAP), while there is no direct reference to the treatment to be given for expenditure incurred on such ‘enabling assets’, the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) has dealt with the same in some of its opinions issued in the past.

Paragraph 49(a) of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, defines an asset as ‘a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise’. Further, Paragraph 88 of the aforesaid framework requires that ‘An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably’. From the above, it is evident that an expenditure incurred by an enterprise can be recognised as an asset only if it is a ‘resource controlled by the enterprise’.

Whether an ‘enabling asset’ meets the recognition criterion of a tangible or intangible asset

Expenditure incurred towards enabling assets can result into a tangible asset, only when, the company is able to control such assets. i.e., the company can exchange it for other assets, employ it to produce goods or services, charge a price for others to use it, use it to settle liabilities, hold it, or distribute it to owners. Further, an indicator of control of an item of a fixed asset would be that the entity can restrict the access of others to the benefits derived from that asset. However, in many situations, the ‘enabling assets’ are of such nature that the ownership does not vest with the company and these assets are typically available for general public use even though the company is entitled to use the assets for the purpose of completing its own projects, and subsequently for operational purposes. Consequently, the company does not control such assets, and therefore, the expenditure incurred towards such ‘enabling assets’ cannot be capitalised as a separate tangible asset in such cases.

As regard whether such expenditure incurred towards enabling asset meets the definition of an ‘intangible asset’, the view is that even though the economic benefits are expected to flow to the enterprise from such facilities, the company does not have control over such facilities, thereby, not meeting the criteria laid down in AS 26, Intangible Asset. In the example of road-widening expenditure covered above, neither the land to be acquired for widening the road nor the road will be the property of the company. Further, the company does not enjoy control in terms of restriction of access of others to the benefits arising from the widened road faculty. Thus, the prescribed treatment under the existing Indian GAAP in relation to expenditure incurred on such ‘enabling assets’ as covered above is to charge it to the statement of profit and loss of the period in which the same is incurred.

Meeting the criterion of capitalisation

One of the key considerations, as discussed above, is the exclusivity of usage of such assets by the company, coupled with its ability to restrict the access of others to these benefits. For example, let us say a power company incurs expenditure on transmission lines used by it to transmit electricity and there exists a legally tenable agreement with the state electricity board, which provides for the exclusive use by the company of transmission lines up to a limited defined capacity, thereby, restricting access of others to the benefits emanating from such assets. In such a scenario, the conclusion may tend to move towards capitalisation on the grounds on existence of control over such assets. If capitalised, whether such expenditure is to be recorded as a tangible or intangible fixed asset would depend on various factors which include legal ownership of such an asset, terms of joint arrangement, right to release excess capacity, etc.

Does Ind AS allow capitalisation of enabling assets due to its wider definition and recognition criteria?

As per Ind AS 16, Property, Plant and Equipment, the cost of an item of Property, Plant and Equipment (PPE) shall be recognised as an asset, if and only if, it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably.

Further to the above, the standard also covers situations wherein a company is required to acquire an item of PPE for safety or environmental reasons. In such cases, the standard provides that the acquisition of such PPE, although not directly increasing the future economic benefits of any particular existing item of PPE, may be necessary for an entity to obtain future economic benefits from its other assets. Such items qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

1. ICAI publication: The Chartered Accountant August 2016 EAC opinion on ‘treatment of expenditure incurred by the company on roads for transportation of coal’
2. ICAI EAC opinion finalised on 18 March 2010 on Treatment of capital expenditure on assets not owned by the company.
For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals. Related plant enhancements are recognised as an asset because without them the entity is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with Ind AS 36, Impairment of Assets. Thus, unlike Indian GAAP, the recognition criterion laid down under Ind AS 16, as covered above, provides flexibility for entities to capitalise items of PPE which would have otherwise been charged off to the statement of profit and loss.

Given this context under Ind AS from an asset recognition standpoint, would ‘enabling assets’ fall within the purview of capitalisation given its nature and circumstances under which expenditure on such assets are incurred by the entities.

The Ind AS Transition Facilitation Group (ITFG) in its second bulletin considered that capitalisation of expenditure incurred on the construction of assets on land not owned by a company would depend on facts and circumstances of each case, particularly, considering paragraph 16(b) of Ind AS 16, Property, Plant and Equipment, which states that such an expenditure should be necessary for making the item of PPE capable of operating in the manner intended by management.

Under Ind AS 16, the cost of an item of PPE includes costs directly attributable to bringing the asset to the location and conditions necessary for it to be capable of operating in the manner intended by management. For example, an entity may buy land with the intention of constructing a new building on the site. The cost of demolishing any existing building on the site should be capitalised as part of the cost of property because demolition is a direct result of the decision to construct a new building. Likewise, when an entity agrees to relocate a community (or part thereof) in order to construct an asset – e.g. a golf course, such relocation costs shall be eligible for capitalisation because they are directly attributable to the construction of the asset.

The standard requires that the recognition of cost as part of the carrying amount of an item of PPE ceases when the item is in the location and the condition is necessary for it to be capable of operating in the manner intended by management. Therefore, costs of relocating or reorganising part or all post an item (that reaches the location and condition capable of operating in the manner intended by management) of an entity’s operations are not included in the carrying value of an item of PPE.

**Conclusion**

Though there exists a fair degree of theoretical appeal towards capitalisation of expenditure incurred towards enabling assets under Ind AS, practical implementation is judgemental and often fraught with intricacies on a case-to-case basis as also highlighted by the ITFG. With the rapid evolution of business models and increasing acceptance of public-private partnership arrangements across various industries, more challenges and complexities are bound to occur with the management of companies often exercising their judgement and discretion in the accounting treatment for ‘enabling assets’. Perhaps, it would augur well if the ICAI, albeit its clarification through the ITFG bulletin, comes up with a detailed guidance on the accounting position to be taken by companies on such enabling assets with a view to avoid divergent accounting practices.

**Amendment to the existing Indian GAAP**

On 30 March 2016, the Ministry of Corporate Affairs (MCA) issued the Companies (Accounting Standards) Amendment Rules, 2016 to amend the Accounting Standards as notified under the Companies (Accounting Standard) Rules, 2006, thereby, paving the way for changes to the existing Indian GAAP. The amendment rules have replaced AS 10, Accounting for Fixed Assets and AS 6, Depreciation Accounting, with a new AS 10, Property, Plant and Equipment. The ICAI and the MCA have clarified that the amended Accounting Standards should be used for preparation of financial statements under the Indian GAAP for accounting periods beginning on or after 1 April 2016.
Computation of EIR for loans advanced by banks

This article aims to:

- Describe the computation of Effective Interest Rate (EIR) for loans advanced by banks with the help of two case studies

Interest income is a key financial reporting parameter for banks and other financial services sector entities. Under the previous Generally Accepted Accounting Principles in India (previous Indian GAAP), these entities would have recognised interest income based on the coupon rate applicable on loans advanced. Other related items of income (e.g. loan processing fees) or expenses (e.g. commission, legal documentation costs, etc.) were not considered as a part of the interest income recognised on loans and would have been recognised upfront as income or expenses, respectively.

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

Financial assets and liabilities that are classified as ‘amortised cost’ are subsequently measured using the EIR method under Ind AS 109. In addition, financial assets (excluding equity instruments) that are classified into the Fair Value through Other Comprehensive Income (FVOCI) category may also require the application of the EIR method for recognition of interest income.

The EIR is calculated on initial recognition of the financial instrument and considers all contractual terms of the instrument and other fees and transaction costs that are an integral part of the EIR of a financial instrument. On the date of transition to Ind AS, banks are required to retrospectively determine the amortised cost of their financial assets/liabilities based on the EIR applicable on origination/initial recognition.

In the case studies given on the next page, we illustrate the methodology to determine the EIR of financial assets by using a certain degree of estimation when individual loan level historical information may not be available on transition.
Key characteristics of loans advanced

Case 1
Bank A (the bank) provides loans to both retail customers and corporates. On 1 April 2017, it had a portfolio of outstanding non-project term loans extended to corporates, amounting to INR500 million. The average tenure for similar term loans extended over the past 10 years is approximately four years.

On 1 April 2017, the bank does not have information on loan-wise origination dates and related costs incurred/fees received from borrowers for processing each loan. In accordance with its normal disbursement process, the bank generally disburses loans within two business days once the stamp duty is paid and processing fees are collected by it. The bank incurs an average of 2 per cent of the loan amount as stamp duty and other expenses and collects an average processing fee of one per cent on each loan from its customers. The bank has an internal legal department which prepares and reviews the loan agreements and provides other services to the loan processing and credit analysis department. The salary of the employees of the internal legal department is INR1.8 million p.a.

The bank has identified the month in which the loans outstanding at the date of transition were originated based on the months in which it paid the stamp duty and collected processing fees from borrowers, as given below:

<table>
<thead>
<tr>
<th>Amount of loans outstanding</th>
<th>Number of loans</th>
<th>Average coupon rate</th>
<th>Month of origination</th>
</tr>
</thead>
<tbody>
<tr>
<td>INR100 million</td>
<td>10 loans</td>
<td>12.40%</td>
<td>September 2013</td>
</tr>
<tr>
<td>INR150 million</td>
<td>20 loans</td>
<td>14.30%</td>
<td>March 2014</td>
</tr>
<tr>
<td>INR250 million</td>
<td>10 loans</td>
<td>15.40%</td>
<td>January 2015</td>
</tr>
</tbody>
</table>

As per the bank’s policy, all non-project term loans are held by it throughout the term of the loan i.e. it does not securitise, sell or syndicate these loans. Further, the principal repayment on these loans is due at the end of the loan term.

On 1 April 2017, the bank has to prepare an opening balance sheet under Ind AS and is required to compute the EIR and amortised costs for the outstanding loans.

Case 2
Bank A has provided home loans to various retail customers. A processing fee of 1 per cent of the amount disbursed is generally collected from customers at the time of processing the loan. If loans are extended to the borrowers through Direct Selling Agents (DSAs), a commission is paid to the DSAs by the bank. The commission is calculated as a percentage of the notional amount of the loan disbursed based on applicable slab rates. The bank also has a ‘new client acquisition’ team which markets loans to retail customers. A salary of INR2.4 million is paid to them on an annual basis.

During the quarter ended 30 June 2017, Bank A advanced home loans of INR40 million on the following terms:

<table>
<thead>
<tr>
<th>Loan amount in INR</th>
<th>Number of loans</th>
<th>Coupon rate</th>
<th>Tenure</th>
</tr>
</thead>
<tbody>
<tr>
<td>INR20 million</td>
<td>10 loans (through direct selling agents)</td>
<td>8.55%</td>
<td>8 years</td>
</tr>
<tr>
<td>INR12 million</td>
<td>3 loans (INR2 million through direct selling agent)</td>
<td>9.30%</td>
<td>15 years</td>
</tr>
<tr>
<td>INR8 million</td>
<td>1 loan</td>
<td>9.65%</td>
<td>20 years</td>
</tr>
</tbody>
</table>

The commission payable to DSAs is based on the number of loans sold during the year 2017-18 in accordance with the slab rates given below:

<table>
<thead>
<tr>
<th>Number of loans</th>
<th>Commission payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upto 50 loans</td>
<td>0.50 per cent of the total loan amount disbursed</td>
</tr>
<tr>
<td>51-100 loans</td>
<td>0.75 per cent of the total loan amount disbursed</td>
</tr>
<tr>
<td>101-150 loans</td>
<td>1 per cent of the total loan amount disbursed</td>
</tr>
</tbody>
</table>
In FY2017-18, the bank budgeted a sale of 150 home loans. Past trends and current economic forecasts indicate that the bank is likely to meet its sales targets. In the past, approximately 60 per cent of the total home loans disbursed were marketed by DSAs.

On 30 June 2017, a home loan with a carrying amount of INR2.82 million (original loan amount of INR4 million and outstanding loan amount of INR2.79 million) with an interest rate of 8.50 per cent p.a., having a tenure of eight years, with a balance repayment period of five years was foreclosed. A fee on the foreclosure of two per cent of the outstanding loan amount was recovered.

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

**Accounting issue**

While computing the gross carrying amount of financial assets or amortised cost of financial liabilities, Ind AS 109 requires banks to consider all contractual terms of the instrument and amortise fees and transaction costs that are an integral part of the EIR of the financial instrument over its expected life.

Bank A needs to compute the EIR and the gross carrying amount of loans outstanding on the date of transition to Ind AS (case 1) and compute the EIR for new loans advanced in the quarter ended 30 June 2017 (case 2).

**Accounting guidance**

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

![Figure 1: Accounting Guidance Diagram](source)

**Analysis**

**Case 1**

The non-project term loans extended to corporates are held by the bank within a business model with an objective to hold the loans for collection of principal and interest cash flows over their term. Further, the contractual cash flows arising from the loans are Solely Payments of Principal and Interest on the principal outstanding (SPPI). Therefore, the bank has classified and subsequently measures these loans at amortised cost.

To compute the gross carrying amount of the loan at the date of transition to Ind AS, the bank would have to determine the EIR of each individual loan. The stamp duty and other directly attributable costs incurred by the bank for processing the loan, and the processing fee collected from its customers are an integral part of the EIR of the loan. The salary of the employees of the legal department would not be considered while computing the EIR, since these are administrative costs incurred by the bank, which are not incremental in nature.

Since the origination date and the transaction costs are not available for each individual loan that has been advanced prior to the date of transition, the bank may consider using a certain level of estimation in computing the EIR of the loans, specifically relating to average tenure, processing fees charged, etc. The estimates may be based on past trends observed by the bank, adjusted for expectations based on future economic conditions.

**Transaction costs and fees**

Based on a historical analysis of the stamp duty and other directly attributable expenses incurred and the processing fees collected, the bank considers that it incurs an average cost of 2 per cent and collects an average processing fee of 1 per cent on the loan amount disbursed. These average rates may be used to estimate the transaction costs/fees for each loan to determine the initial recognition amount.
**Origination date and tenure**

In the current case, past trends indicate that the term loans are generally disbursed in the same month in which the processing fees are collected. Hence, management considers that the month in which processing fees are collected indicates the month in which the loan was originated. Therefore, the bank has estimated that the outstanding loans were originated at the beginning of the month in which the processing fees were collected from the borrowers. Further, the bank has determined that the average tenure for this category of loans (based on its past experience) is approximately four years. This may be considered as the expected life of the outstanding loans for determining their EIR.

**Estimation of EIR for a group of loans**

On the basis of the above assumptions, the bank has determined that the outstanding loans were disbursed in the following months - September 2013, March 2014 and January 2015 (termed as loan tranche 1, loan tranche 2 and loan tranche 3). The average coupon rate for these tranches were 12.40 per cent p.a., 14.30 per cent p.a. and 15.40 per cent p.a. respectively. Since the bank is unable to determine the origination date for each individual loan, it estimates the EIR for each loan tranche (based on the month of origination). On the basis of this computation, the EIR is determined as 12.07 per cent p.a., 13.96 per cent p.a. and 15.05 per cent p.a. respectively.

The gross carrying amount of the loan tranches can therefore be computed as follows:

<table>
<thead>
<tr>
<th>Amount initially recognised</th>
<th>Loan tranche 1</th>
<th>Loan tranche 2</th>
<th>Loan tranche 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus Cash inflows</td>
<td>101</td>
<td>151.5</td>
<td>252.5</td>
</tr>
<tr>
<td></td>
<td>(37.2)</td>
<td>(64.35)</td>
<td>(77.00)</td>
</tr>
<tr>
<td>Plus or minus Cumulative amortisation, using the EIR of any difference between the initial amount and the maturity amount</td>
<td>43.56</td>
<td>65.06</td>
<td>85.39</td>
</tr>
<tr>
<td>Equals Gross carrying amount</td>
<td>107.36</td>
<td>152.21</td>
<td>260.89</td>
</tr>
<tr>
<td>Minus Loss allowance</td>
<td>- *</td>
<td>- *</td>
<td>- *</td>
</tr>
<tr>
<td>Equals Amortised cost</td>
<td>- *</td>
<td>- *</td>
<td>- *</td>
</tr>
</tbody>
</table>

* The estimate of loss allowance based on expected credit losses has been excluded from this illustration for simplicity

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

**Considerations on first time adoption of Ind AS**

On first time adoption of Ind AS 109, the bank is required to compute the amortised cost of the loans on the Ind AS transition date. The difference between the gross carrying amount as on that date as computed under Ind AS 109, and the book value of the loans under Indian GAAP would be adjusted in retained earnings. This is illustrated below:

<table>
<thead>
<tr>
<th>Loan tranche</th>
<th>Gross carry amount as per Ind AS 109</th>
<th>Book value</th>
<th>Accrued interest</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan tranche 1</td>
<td>107.36</td>
<td>100</td>
<td>7.23</td>
<td>0.13</td>
</tr>
<tr>
<td>Loan tranche 2</td>
<td>152.21</td>
<td>150</td>
<td>1.79</td>
<td>0.42</td>
</tr>
<tr>
<td>Loan tranche 3</td>
<td>260.89</td>
<td>250</td>
<td>9.63</td>
<td>1.26</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>1.81</td>
</tr>
</tbody>
</table>
Case 2
For retail home loans advanced during the quarter ended 30 June 2017, the bank has information on the various contractual terms that are required to determine the EIR. However, the transaction costs (i.e. commission payable to direct selling agents) which are an integral part of the EIR of the loan are not known at the time of origination of the loan. Since the amount of commission payable would be crystallised only at the end of the year based on the total number of loans sold by agents, the bank would be required to estimate the commission costs that are integral to determining the EIR of the loans advanced during the quarter.

In FY2017-18, the bank budgeted a sale of 150 home loans. Trends over the previous five years indicate that the bank has generally met or exceeded its budgets for sales of home loans. Further, current economic factors (such as the rising market trends in the residential real estate sector) indicate that the bank is expected to meet its budget for home loan sales during the current year. A historical analysis also indicates that approximately 60 per cent of the total home loans advanced by the bank A are sourced by direct selling agents. Based on past analysis, the bank estimates that in FY2017-18, approximately 60 per cent of total home loans advanced (i.e. 90 loans) will be sourced by direct selling agents. Accordingly, the bank estimates transaction costs (being commission payable) as 0.75 per cent on the notional amount of home loans originated through direct selling agents, based on the applicable slab rates.

While computing the gross carrying amount of the loans, the bank may combine loans with homogenous characteristics (i.e. maturity period, coupon rate and cost and fee pattern) for estimating the EIR. Therefore, of the loans advanced during the quarter ended 30 June 2017, those with a maturity period of eight years are grouped as loan tranche 1, those with a maturity period of 15 years as loan tranche 2 and those with a maturity period of 20 years as loan tranche 3.

In loan tranche 1, all the loans are sourced by the direct selling agents. However in loan tranche 2, only some of the loans (amounting to INR2 million) are sourced by direct selling agents. For computing the EIR, loan tranche 2 should be bifurcated between the loans sourced by agents and those sourced directly by the bank. The EIR of only those loans that are sourced by agents would be adjusted for the estimated commission payable. The fixed salary paid to the new client acquisition department of the bank is not directly attributable to an individual loan and is also not incremental in nature. Accordingly, it is not integral to determining the EIR of the home loans.

Based on the approach described above, the EIR for the loan tranches is estimated as follows:

<table>
<thead>
<tr>
<th>Loan tranche</th>
<th>Loan tranche 1</th>
<th>Loan tranche 2 (sourced by agents)</th>
<th>Loan tranche 2 (directly sourced by the bank)</th>
<th>Loan tranche 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>EIR</td>
<td>8.59%</td>
<td>9.33%</td>
<td>9.42%</td>
<td>9.76%</td>
</tr>
</tbody>
</table>

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

Foreclosure of loan
Ind AS 109 requires classification of a financial asset based on the business model within which it is held and the contractual characteristics of its cash flows. A financial asset that is held for collection and has contractual cash flows that meet the SPPI criterion is classified as and subsequently measured at amortised cost. Ind AS 109 also requires a consideration of any provisions that may change the contractual cash flows, for e.g., a prepayment feature. An entity should assess whether the contractual cash flows that could arise over the life of the financial asset (including after the change) meet the SPPI criterion. In this context, a prepayment feature where the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, including reasonably additional compensation for the early termination of the contract, would generally meet the SPPI criterion.

On foreclosure of the loan consequent to prepayment, the bank should credit the foreclosure fee of two per cent on the outstanding loan amount to the statement of profit and loss, and the difference between the amortised cost and the amount received on foreclosure is charged/credited to the statement of profit and loss. In the current illustration, an amount of INR0.03 million would be debited to the statement of profit and loss.
Consider this

- For loans that are classified as FVOCI (since they are held within a business model that has a dual objective), the accounting treatment for foreclosure fees and gain/loss on foreclosure would have been similar. The foreclosure fees and the difference between the amount received and the fair value of the loan on the date of the foreclosure would be credited/charged to the statement of profit and loss. Additionally, the changes in fair value that were recognised in Other Comprehensive Income (OCI) for the period over which the asset was held would be recycled to the statement of profit and loss on foreclosure.

- Banks would have to develop and implement robust information systems to collect and maintain accurate information relating to individual loans advanced. At a minimum, these systems should capture the origination date, the maturity period, the cost incurred, fees collected, syndication and other agreements entered into with respect to individual loans. Considering the extensive disclosure requirements in Ind AS, banks should exercise judgement and perform a cost-benefit analysis when implementing or modifying their information systems.

- Alternate approaches and methodologies may be devised for estimating the amortised cost of financial assets and liabilities at the transition date, in the absence of detailed information at an individual loan level. An entity should consider the most appropriate approach based on the facts and circumstances applicable to it and disclose any significant judgments used in the preparation of financial statements.

- As per para 2.8 of the Report of the Working Group on Implementation of Ind AS by Banks in India (the Working Group Report) issued by the Reserve Bank of India (RBI) in 2015, if it is impracticable (as defined in Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors) for an entity to apply retrospectively the EIR method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind ASs shall be the new gross carrying amount of that financial asset or the new amortised cost of the financial liability at the date of transition to Ind AS. Banks may consider adopting this approach if appropriate in the context of the information available with them on transition.
Independent Directors:
An insight into the role and responsibilities

This article aims to:
- Highlight the key role and responsibilities of the Independent Directors prescribed under the Companies Act, 2013 and the Listing Regulations.

Introduction
The Board of Directors (BoD) of a company are an integral part of a company and are entrusted with the most crucial responsibility relating to the functioning and overall governance of a company. The Companies Act, 2013 (2013 Act) and the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), 2015 (Listing Regulations) took note of this fact and accordingly prescribed stringent guidelines relating to the appointment, roles and responsibilities of the Directors.

In this article, we attempt to provide an overview of the class of directors a company can appoint with a focus on the role and responsibilities of an Independent Director under the 2013 Act and the Listing Regulations.

Minimum and maximum number of Directors
Depending upon the class of a company, following are the minimum number of Directors required under the 2013 Act:
- In case of a public company - Three Directors
- In case of a private company - Two Directors
- In case of one person company - One Director.

The maximum number of directors would be 15. However, such a number could be increased after passing a special resolution. Additionally, certain prescribed class of companies should appoint at least one woman Director on their Board (discussed under ‘classification of directors’).

The 2013 Act does not prescribe any minimum or maximum thresholds for the number of directors for the companies formed with the charitable objects, etc. (i.e. companies covered under Section 8 of the 2013 Act).
## Classification of Directors

A company should have following class of directors depending upon the prescribed requirements:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Particulars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resident Director</td>
<td>All companies should have at least one Director whose stay in India has not been less than 182 days in the previous calendar year.</td>
</tr>
<tr>
<td>Woman Director</td>
<td>A listed company and an unlisted public company is required to appoint at least one woman Director if it has either:</td>
</tr>
<tr>
<td></td>
<td>• Paid-up share capital of INR100 crore or more, or</td>
</tr>
<tr>
<td></td>
<td>• Turnover of INR300 crore or more.</td>
</tr>
<tr>
<td>Independent Director</td>
<td>Public companies are required to have at least two Independent Directors if they meet any of the following criterion:</td>
</tr>
<tr>
<td></td>
<td>• Paid-up share capital of INR10 crore or more</td>
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<tr>
<td></td>
<td>• Turnover of INR100 crore or more</td>
</tr>
<tr>
<td></td>
<td>• Outstanding loans/debentures/deposits exceeding INR50 crore. Listed public company should have at least one-third of the total number of directors as Independent Directors.</td>
</tr>
<tr>
<td>Director elected by small shareholders</td>
<td>Listed company should have one small shareholders’ Director subject to receipt of a notice by either:</td>
</tr>
<tr>
<td></td>
<td>• 1,000 small shareholders, or</td>
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<tr>
<td></td>
<td>• One-tenth of the total number of such shareholders.</td>
</tr>
<tr>
<td>Additional Director</td>
<td>Articles of a company may authorise appointment of an additional Director (other than a person who fails to get appointed as director in a general meeting) at any time.</td>
</tr>
<tr>
<td>Alternate Director</td>
<td>An alternate Director can be appointed (not being a person holding any alternate directorship for any other Director in the company) in place of a Director who is not present in India for a period of not less than three months subject to the following conditions:</td>
</tr>
<tr>
<td></td>
<td>• Company is authorised by its articles to make the appointment</td>
</tr>
<tr>
<td></td>
<td>• Appointment is made by passing an ordinary resolution.</td>
</tr>
<tr>
<td></td>
<td>A Director appointed in place of an Independent Director should possess requisite qualifications to be appointed as an Independent Director.</td>
</tr>
<tr>
<td>Nominee Director</td>
<td>Board authorised by its articles can appoint any person as a director nominated by any institution in accordance with the provisions of the prevalent law or any agreement or by the central or the state government by virtue of its shareholding in a government company.</td>
</tr>
<tr>
<td>Managing Director (MD)</td>
<td>A Director who by the virtue of the articles of a company or an agreement with the company or a resolution passed in its general meeting, or by its BoD, is entrusted with substantial powers of management of the affairs of the company and includes a Director occupying the position of Managing Director, by whatever name called.</td>
</tr>
<tr>
<td>Whole-Time Director (WTD)</td>
<td>Includes a Director who is in the whole-time employment of the company.</td>
</tr>
<tr>
<td>Manager</td>
<td>An individual who, subject to the superintendence, control and direction of the BoD, has the management of the whole, or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a Manager, by whatever name called, whether under a contract of service or not.</td>
</tr>
</tbody>
</table>

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

1. The paid-up share capital or turnover or outstanding loans/debentures/deposits existing on the last date of latest audited financial statements should be taken into account.

2. In case a company fails to meet any of the above given thresholds relating to appointment of an Independent Director for a consecutive period of three years, then such a company is not required to appoint Independent Directors till such time it meets either of the conditions.
The definition of an Independent Director under the Listing Regulations is the same as defined in the 2013 Act except that under the Listing Regulations, an Independent Director means a non-executive Director other than a nominee Director who, inter alia, does not have material pecuniary relationship with the listed entity, its holding, subsidiary or associate company, or their promoters, or directors during the two immediately preceding financial years or during the current financial year.

**Independent Director**

The definition of Independent Director in the 2013 Act is elaborate and has many aspects. Some of the important aspects are covered in this topic. An Independent Director is a Director other than a MD, a WTD or a nominee Director who, inter alia, in the opinion of the board, is a person of integrity and possesses relevant expertise and experience and does not have pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or Directors, during the two immediately preceding financial years or during the current financial year.

It is important to note that an Independent Director would not be considered to have a pecuniary relationship for transactions with a company, its holding, subsidiary or associate company, or their promoters, or Directors provided such transactions are in the ordinary course of business and are at an arm’s length.

**Requirements prescribed under the Listing Regulations**

- **Number of Directors:** The BoD of a listed entity should have an optimum combination of executive and non-executive Directors with at least one woman Director. However, at least 50 per cent of the BoD should comprise of non-executive Directors. Following conditions should also be taken care of:
  - **In case a chairperson of the BoD is a non-executive Director:** At least one-third of the BoD should comprise of Independent Directors.
  - **In case of a regular non-executive chairperson also a promoter or related to any promoter or related to any managerial personnel of the entity:** At least half of the BoD should comprise of Independent Directors.
  - **In case there is no regular non-executive chairperson:** At least half of the BoD should comprise of Independent Directors.
  - **In case of a material subsidiary:** At least one Independent Director on the Board of the listed entity should be a Director on the Board of an unlisted material subsidiary, incorporated in India.

3. Material subsidiary is a subsidiary, whose income or net worth exceeds 20 per cent of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year.

Key elements of appointment
Following are the key elements related to the appointment of an Independent Director under the 2013 Act:

- Tenure of service of Independent Directors: An Independent Director is required to hold office for a term up to five consecutive years on the Board of the company subject to a maximum of two consecutive terms. However, a retiring Independent Director would become eligible for appointment after the expiry of three years from completion of his/her term (cooling-off period). During the cooling-off period, such a Director cannot be appointed or be associated with the company in any other capacity, either directly or indirectly.

Appointment for a period less than five years
An Independent Director can be appointed for a term less than five years, however, appointment for any term (whether for five years or less) would be treated as one term under Section 149(10).

Further, such person would have to demit the office after two consecutive terms even if the total number of years of his/her appointment in such two consecutive terms is less than 10 years. In such a case, the person completing consecutive terms of less than 10 years would be eligible for appointment only after the expiry of the cooling-off period of three years.

- Declaration of independence: Every Independent Director is required to provide a declaration of meeting the specified criteria of independence (Section 149(6)) at the first Board meeting in which he/she participates as a Director and thereafter at the first Board meeting in every financial year or whenever there is a change in the circumstances which could affect his/her status as an Independent Director.

- Code for Independent Directors: Schedule IV to the 2013 Act includes a code for Independent Directors. It lays down the guidelines relating to the professional conduct, role and functions, duties of an Independent Director, their manner of appointment, reappointment, resignation or removal and an evaluation mechanism.

Additionally, it provides that the Independent Directors of a company should hold at least one meeting in a year, without the attendance of non-Independent Directors and members of management to:

- Review the performance of non-Independent Directors, the Board as a whole and Chairperson of the company and
- Assess the quality, quantity and timeliness of flow of information between the company management and the Board that is necessary for the board to effectively and reasonably perform their duties.

Requirements prescribed under the Listing Regulations

- The BoD of listed entities are required to formulate a code of conduct for all its members and senior management. Such a code should incorporate the duties of the Independent Directors as prescribed under the 2013 Act.

- Performance evaluation of Independent Directors should be done by the entire BoD, excluding the Director being evaluated.

- Listed entities are required to familiarise the Independent Directors about the listed entity, including nature of the industry in which it operates, its business model, roles, rights and responsibilities of Independent Directors.

- Additionally, the corporate governance section of the annual report of every listed entity should incorporate disclosure on performance evaluation criteria of Independent directors.

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Guidance Note on Board evaluation

Securities and Exchange Board of India (SEBI) recently issued a Guidance Note on Board Evaluation (GN) with the purpose to inform the listed entities and their BoD about various aspects involved in the Board evaluation process and to improve their overall performance as well as corporate governance standards to benefit all stakeholders.

The GN, *inter alia*, facilitates an Independent Director to perform their role effectively as a member of the Board and also as a member of a committee and considering criticism of such Directors constructively as one of the main functions of the board. Additionally, it prescribes specific criteria for evaluation of Independent Directors which, *inter alia*, relates to assessment of their qualification, experience, knowledge and competency, independence, commitment and Independent views and judgement.

- **Fees of Independent Directors:** Independent Directors are not entitled to any remuneration other than fees for attending Board or committee meetings, reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members. Stock options are specifically prohibited to be issued to them.

- **Liability of actions:** An Independent Director and a non-executive Director not being promoter or key managerial personnel would be liable only for such acts of omission or commission by a company which had occurred with his/her knowledge, attributable through Board processes, and with his/her consent or connivance or where he/she had not acted diligently.

- **Data bank of Independent Directors:** A company could select its Independent Directors from a data bank. However, the company needs to ensure exercise of due diligence before making such a selection.

**Number of Directorships**

No person is permitted to hold office as a Director including alternate Directorship, in more than 20 companies at the same time and of which the maximum number of public companies in which a person can be appointed as a Director could be up to 10.

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7. For reckoning the limit of public companies in which a person can be appointed as a director, directorship in private companies that are either holding or subsidiary company of a public company should be included.
Duties of Independent Directors

The 2013 Act specifies the duties of Directors in general and for Independent Directors as well. The duties of directors are specified in Section 166 and the duties specifically to be performed by Independent Directors in Schedule IV (Code for Independent Directors).

Duties of all Directors (including Independent Directors) are as follows (Section 166):

- Act in accordance with the articles of the company
- Act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment
- Exercise duties with due and reasonable care, skill and diligence and should exercise independent judgement
- Not to involve in a situation in which there may be a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company
- Not achieve or attempt to achieve any undue gain or advantage either to himself/herself or to his/her relatives, partners, or associates and if such director is found guilty of making any undue gain, he would be liable to pay an amount equal to that gain to the company
- Not to assign his/her office. Any such assignment made would be void.

Duties of Independent Directors specified in the code for Independent Directors (Schedule IV), inter alia, includes the following:

- Regular updation of the skills, knowledge and familiarity with the company
- Seeking appropriate clarification, professional advice and opinion of outside experts
- Attending all meetings of the board and the committees
- Ensuring attention and deliberation prior to approving related party transactions
- Non-disclosure of any confidential information.

Reporting on internal financial controls

The Directors’ responsibility statement requires Directors of the listed companies to state whether they had laid down Internal Financial Controls (IFC)8 to be followed by the company and that such IFC are adequate and were operating effectively. Additionally, the Board’s report is required to state the adequacy of the IFC with respect to financial statements.

Role of Independent Directors in constitution of committees

- **CSR committee (Section 135):** A Corporate Social Responsibility (CSR) committee must have at least one Independent Director out of three or more directors (required for a CSR committee).

  However, as per the Companies (Corporate Social Responsibility Policy) Rules (Rule 5(1)), an unlisted public company/private company which is not required to appoint an Independent Director, should have a CSR committee without an Independent Director.

  The CSR committee would be responsible for the formulation and recommendation to the Board of Directors, a CSR policy indicating the activities to be undertaken by the company, recommendation of the amount of expenditure to be incurred on the CSR activities and monitoring of CSR policy from time to time.

- **Audit committee (Section 177):**

  An audit committee of a listed company and public company9 should have at least three directors with majority being Independent Directors.

  The committee would, inter alia, be responsible for recommendation of appointment, remuneration, terms of appointment of auditors of the company, review and monitor the auditor’s independence and performance and evaluation of internal financial controls and risk management systems.

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8. Internal financial controls means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

9. A public company meeting any of the given criteria is required to constitute the committee:

   - Paid-up share capital of INR10 crore or more
   - Turnover of INR100 or more
   - Outstanding loans, borrowings, debentures or deposits exceeding INR50 crore.
• Nomination and remuneration committee (Section 178): A nomination and remuneration committee of a listed company and public company¹⁰ should comprise of three or more non-executive Directors out of which not less than one-half should be Independent Directors. The committee is required to formulate the criteria for determining qualifications, positive attributes and independence of a Director and recommend to the Board a policy, relating to the remuneration for the Directors, key managerial personnel and other employees.

Requirements prescribed under the Listing Regulations

- The Chairperson of the nomination and remuneration committee should be an Independent Director who should be present at the AGM to answer shareholders’ queries.
- The role of the nomination and remuneration committee would extend to assessment of whether the term of appointment of the Independent Directors should be extended on the basis of the report of the performance evaluation of Independent Directors.

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

The CLC and the Amendment Bill proposed the following in relation to appointment and qualification of Independent Directors:

- Test of materiality: Introduce a test of materiality, for the purpose of determining whether pecuniary relationships could impact the independence for becoming an Independent Director.

- Restriction on appointment:
  - Currently, an individual is restricted to be appointed as an Independent Director in case his relative is a Key Managerial Personnel (KMP) or an employee in the company, its holding, subsidiary or associate company during any of the preceding three years. The CLC recommended that the scope of the restriction should be modified. As per the CLC, for the preceding years, the restriction should be for relatives holding board or KMP/one level below a board position similar to that obtained in Section 141(3)(f). The scope of restriction after appointment is to be retained.

  The Amendment Bill by way of an explanation proposes that the scope of restriction should not apply to employment of a relative during the preceding three financial years.
  - 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 should be made more specific by clearly categorising the types of transactions as provided under Section 141(3)(d).

- Methodology for performance evaluation: Amendment to Schedule IV and Section 178(2) of the 2013 Act to enable the nomination and remuneration committee to prescribe ‘a methodology for the evaluation of performance of individual Directors, committee(s) of the Board and the Board as a whole’, and the Board to carry out the performance evaluation as per the methodology approved by the Board.

- Revision in threshold for unlisted companies: The CLC proposes to increase the threshold criteria for unlisted companies so that the compliance in context of the requirement for Independent Directors, audit committee and nomination and remuneration committee is not required for smaller unlisted companies.

¹⁰ A public company meeting any of the given criteria is required to constitute the committee:
- Paid-up share capital of INR10 crore or more
- Turnover of INR100 crore or more
- Outstanding loans, borrowings, debentures or deposits exceeding INR50 crore.
Key challenging areas
The recommendation of the CLC and the Amendment Bill relating to introduction of the test of materiality for determining pecuniary relationships could help with incentivising individuals to be Directors and Independent Directors. However, there are certain other areas relating to the appointment and the responsibilities of an Independent Director which could impose challenges for the company and the board. These are as follows:

- **Mandatory appointment of a resident director:** All the companies are required to have at least one resident Director i.e. who has spent 182 days in India. This would pose challenge for the companies having limited operations in India as they are mandatorily required to comply with the requirements of the 2013 Act.

- **Onerous role in functioning of committees:** The role of Independent Directors in the committees formed under the 2013 Act (CSR committee, audit committee and the nomination and remuneration committee) are quite onerous as they expect an Independent Director to actively be involved in the formulation of the related policies and then continuously monitor its implementation. The more effective the policy, the more effective will be the corporate governance.

Consider this
- An Independent Director is required to hold office for a term up to five consecutive years on the Board of the company subject to a maximum of two consecutive terms.
- A person is not allowed to serve as an Independent Director in more than seven listed entities as per the Listing Regulations.
- An Independent Director would be liable only for such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.
Application of substance over form under Ind AS - sale and leaseback arrangements

This article aims to:

- Highlight the accounting of sale and leaseback transactions under Ind AS.

The framework for the preparation and presentation of financial statements in accordance with Indian Accounting Standards (Ind AS) suggests that one of the key qualitative characteristics of financial statements prepared in accordance with Ind AS is ‘substance over form’. It means that in order for the financial statements to faithfully represent the transactions that it purports to represent, the transactions should be accounted for and presented for in accordance with the substance of the transaction and not merely its legal form.

In this article, we aim to highlight the application of the concept of substance over form under the sale and leaseback arrangements with the help of an example.

Sale and leaseback
A sale and leaseback transaction has two components:
- The sale of the asset from the seller to the lessor, and
- The leaseback of the asset from the buyer/lessor to the seller/lessee.

The substance of these transactions is to generally provide finance to the lessee. Accordingly, the two components are accounted for separately rather than the seller/lessee accounting for the net effect of the combined transaction.

Generally, the sale consideration and lease rentals are interdependent as they are negotiated as a single package. The accounting treatment of the gain or loss on the transaction will depend upon whether the leaseback is classified as an operating lease or a finance lease.

A careful consideration of all facts and circumstances is required to determine the accounting treatment of sale and leaseback transaction. For example, a leaseback would be classified as a finance lease if substantially all the risks and rewards of ownership remain with the lessee, while a leaseback could be an operating lease on the basis of evaluation of risks and rewards that remain with the buyer/lessor.

Sale and finance leaseback
A sale and leaseback transaction may result in a leaseback that is classified as a finance lease. Under Ind AS, sale and finance leaseback transactions would be accounted for as a sale and a lease even though the net effect of the two transactions is that the seller retains, substantially, all the risks and rewards of the asset.

Accordingly, any gain on the sale is deferred and recognised as income over the lease term. No loss is recognised unless the asset is impaired.
Sale and operating leaseback

If the leaseback is classified as an operating lease, then any gain is recognised immediately if the sale and leaseback terms are clearly at fair value. Otherwise, the sale and leaseback are accounted for as follows:

- If the selling price is at or below fair value, then the gain or loss is recognised immediately. However, if a loss is compensated for by future rentals at below-market price, then the loss is deferred and amortised over the period in which the asset is expected to be used. The loss that is deferred cannot exceed the present value of the difference - i.e. rental savings - between the below-market rents and the fair-market rents over the period in which such differences exist, as determined at inception of the lease.

- If the selling price exceeds fair value, then that excess is deferred and amortised over the period for which the asset is expected to be used.

- If the fair value of the asset is less than the carrying amount of the asset at the date of the transaction, then that difference is recognised immediately as a loss on the sale.

Illustration

Company A enters into an arrangement with company B for manufacturing five ships as per the specifications provided by company A for INR200 crore. For this purpose, company A will give an initial deposit of INR50 crore to company B and the contract price will be discharged on a progressive basis as per the agreed milestones.

Company A simultaneously enters into an arrangement with company C, as per which, company C will be liable to discharge the amount of consideration to company B and will gain legal ownership of the ships. On delivery of the ships to company C, company A will lease the ships back from company C for a period of 20 years (which is the economic life of the ship) with an option to purchase the ships at the end of the lease term at a price which is lower than the fair value of the asset.

The aforementioned arrangement is a sale and leaseback arrangement because company A intends to purchase ships for its own purpose but enters into an arrangement with company C, whereby it sells its right to acquire the ships to company C, and subsequently takes the ships on lease from company C. The purpose of the entire transaction is to ensure that company A is able to finance the purchase of transaction, with ships as security.

The lease term is for a period of 20 years, which is almost equivalent to the economic life of the asset, and company A has an option to purchase the ships at the end of 20 years at a price which is significantly lower than the fair value of the asset. Therefore, it appears that the above arrangement is a sale and finance leaseback transaction.

Disclosure requirements

Disclosure requirements for lessees and lessors given in Ind AS 17, Leases apply equally to sale and leaseback transactions. The required description of material leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

Sale and leaseback transactions may also trigger separate disclosure criteria in Ind AS 1, Presentation of Financial Statements.

Consider this

- Immediate gain recognition from the sale and leaseback of an asset depends on whether the leaseback is classified as a finance or an operating lease and, if the leaseback is an operating lease, whether the sale takes place at fair value.

- A careful consideration of all facts and circumstances is required to determine the accounting treatment of sale and lease back transactions.
ICAI updates
Exposure drafts issued by the ICAI
The ICAI recently issued the following two exposure drafts:
- Amendments to Ind AS 101, First-time Adoption of Indian Accounting Standards
- Clarifications to Ind AS 115, Revenue from Contracts with Customers.

Amendments to Ind AS 101, First-time Adoption of Indian Accounting Standards

Introduction
As per Ind AS 101, if an entity on transition to Ind AS, assesses that there is no change in its functional currency, it may elect to continue with the carrying value for all of its Property, Plant and Equipment (PPE), measured as per the previous Generally Accepted Accounting Principles (GAAP) and use that as the ‘deemed cost’. Necessary adjustments, however, would be required to be made in this deemed cost for the changes in the decommissioning, restoration or similar liabilities pertaining to the PPE.

It is specifically mentioned in Ind AS 101 that where an entity opts for the carrying value of PPE approach, it cannot make any further adjustments to the deemed cost of the PPE for transition adjustments that might arise from the application of other Ind AS (apart from the adjustment mentioned above).

New development
The ICAI on 27 April 2017 issued an Exposure Draft for limited amendment to Ind AS 101 with regard to the carrying value of the deemed cost approach. The exposure draft proposes the following amendment in Para D7AA of Ind AS 101:

‘Where there is no change in its functional currency on the date of transition to Ind ASs, a first-time adopter to Ind ASs may elect to continue with the carrying value for a class of its property, plant and equipment as recognised in the financial statements as at the date of transition to Ind ASs, measured as per the previous GAAP and use that as its deemed cost as at the date of transition after making necessary adjustments in accordance with paragraph D21 and D21A, of this Ind AS. For this purpose, if the financial statements are consolidated financial statements, the previous GAAP amount of the subsidiary shall be that amount used in preparing and presenting consolidated financial statements. Where a subsidiary was not consolidated under previous GAAP, the amount required to be reported by the subsidiary as per previous GAAP in its individual financial statements shall be the previous GAAP amount.'
If an entity avails the option under this paragraph, no further adjustments to the deemed cost of the property, plant and equipment so determined in the opening balance sheet shall be made for transition adjustments that might arise from the application of other Ind ASs. This option can also be availed for intangible assets covered by Ind AS 38, Intangible Assets and investment property covered by Ind AS 40, Investment Property.

The proposed amendment could result in the following:

- **Cherry picking by class:** Allow entities to apply the carrying value as deemed cost for a class of PPE instead of all its PPE. For example, an entity may choose to apply carrying value as deemed cost approach to plant and machinery and apply fair value as deemed cost approach for land and building.

- **Related adjustments:** Earlier, if an entity availed the carrying value as the deemed cost for PPE, it was not allowed to make any other transition related adjustment to the PPE carrying value. Now, the amendment has reversed this stand and allows an entity to make adjustments to the deemed cost, which may arise due to the application of other Ind ASs.

**Effective date**
An entity would apply the amendments relating to paragraph D7AA for annual periods beginning on or after 1 April 2017.

The period to provide comments on the exposure draft closed on 16 May 2017.

Please refer to KPMG in India IFRS Notes dated 9 May 2017 for detailed analysis of the exposure draft.

(Source: ICAI notification dated 27 April 2017 and KPMG in India’s IFRS Notes dated 9 May 2017)

### Clarifications to Ind AS 115, *Revenue from Contracts with Customers*

#### Background
The Ministry of Corporate Affairs (MCA), through its notification dated 16 February 2015, issued 39 Ind ASs, which are converged with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). On 22 July 2015, the IASB deferred the applicability of IFRS 15, *Revenue from Contracts with Customers* by one year to 2018. Consequently, the regulators in India such as MCA and ICAI deferred Ind AS 115, which is based on IFRS 15 and notified two standards - Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue* - that were applicable to entities transitioning to Ind AS from 1 April 2016 onwards.

#### New development
As a result of the discussions of the Transition Resource Group (TRG), which was jointly set up by IASB and the U.S. Financial Accounting Standards Board (FASB), on 12 April 2016, the IASB issued amendments to IFRS 15. These amendments did not change the underlying principles of IFRS 15, but clarified some requirements and provided additional transitional relief to companies that were implementing IFRS 15.

To keep Ind AS updated with revisions made to IFRS, and in order to maintain convergence, similar amendments were required in the Indian context. Accordingly, on 26 April 2017, the ICAI issued an Exposure Draft on Clarifications to Ind AS 115 (Exposure Draft). This Exposure Draft also proposes that Ind AS 115 would be applicable for accounting periods beginning on or after 1 April 2018.

The period to provide comments on the exposure draft closed on 16 May 2017.

Please refer to KPMG in India IFRS Notes dated 9 May 2017 for detailed analysis of the clarification issued by ICAI

(Source: ICAI notification dated 26 April 2017 and KPMG in India IFRS Notes dated 9 May 2017)

### Ind AS Transition Facilitation Group (ITFG) issues clarifications bulletin (Bulletin 8 and 9)

#### Background
With Ind AS being applicable to large corporates from 1 April 2016, the ICAI on 11 January 2016 announced the formation of the ITFG in order to provide clarifications on issues arising due to applicability and/or implementation of Ind AS. Over the past year, ITFG issued seven bulletins.

#### New development
Recently, ITFG released its two bulletins - Bulletin 8 and Bulletin 9 to provide clarifications on issues in relation to application of Ind AS.

Bulletin 8 provides clarification on eight issues related to the following:

- Provision for unspent CSR expenditure under Ind AS
- Disclosure of impact of Ind AS 115 in Ind AS financial statements
- Date of presentation for presentation of balance sheet
- Issue related to accounting of PPE
  - Capitalisation of an item of PPE not falling under the definition of an asset
  - Reversal of impairment
  - Revalued amount of PPE considered as deemed cost.
- Accounting for accumulated losses of subsidiaries
• Recognition of deferred taxes on capitalised exchange differences
• Recognition of dividend income on an investment in a debt instrument.

Bulletin 9 provides clarification on three issues which relate to the following:
• Treatment of dividend and dividend distribution tax in consolidated financial statements
• Accounting for business combinations of entities under common control
• Treatment of government grant in the case of a government company.

Please refer KPMG in India IFRS Notes dated 16 May 2017 and 29 May 2017 which provides an overview of the issues discussed in the ITFG bulletin.

(Source: Bulletin 8 and 9 issued by ITFG of ICAI)

Withdrawal of FAQs on the Revised Schedule VI to the Companies Act, 1956

The Institute of Chartered Accountants of India (ICAI) through its notification dated 25 April 2017 withdrew the Frequently Asked Questions (FAQs) on the Revised Schedule VI to the Companies Act, 1956 (1956 Act) as issued by the Corporate Laws and Corporate Governance Committee in May 2012. The decision was taken in issuance of Schedule III to the Companies Act, 2013 (2013 Act) which was to be followed by the companies from 1 April 2014, the applicability of Revised Schedule VI to the 1956 Act is for the preparation of financial statements prior to that period.

(Source: ICAI notification dated 25 April 2017)

SEBI updates

SEBI Board meeting

The Securities and Exchange Board of India (SEBI) in its meeting held on 26 April 2017 inter alia, took the following important decisions:

Inclusion of RBI registered systemically important NBFCs in the category of QIBs

Current provisions

Under the existing provisions, SEBI categories institutions such as banks and insurance companies as Qualified Institutional Buyers (QIBs). The QIBs are eligible for participation in Initial Public Offers (IPOs) with specifically earmarked allocations.

In the Union Budget presentation for FY2017-18, it was proposed to allow systematically important Non-Banking Financial Companies (NBFCs) regulated by the Reserve Bank of India (RBI), and above a certain net worth, to be categorised as QIBs since it would strengthen the IPO market and channelise more investments.

Amendment

Accordingly, the Board considered and approved the proposal for inclusion of systematically important NBFCs registered with the RBI having a net worth of more than INR500 crore in the category of QIBs.

As NBFCs are well regulated entities, classifying such NBFCs under the definition of QIBs would give issuers access to a larger pool of funds.

Exemption under ICDR, relating to preferential allotments, to be extended to scheduled banks and financial institutions

Current provisions

Currently, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR Regulations) prohibit the issuer from making preferential issue to any person who has sold any equity shares of the issuer during the six months preceding the relevant date.

It also provides that the entire pre-preferential allotment shareholding of the allottees, if any, should be locked-in from the relevant date up to a period of six months from the date of trading approval. Mutual funds and insurance companies are, however, exempted from both the said requirements.

Amendment

The SEBI has observed instances where the banking sector is exposed to the risks of significantly high Non-Performing Assets (NPA), and the banks have been advised by the RBI to reduce the NPA and to initiate stringent actions to recover the dues from the borrowers.

As a result, many banks are expected to aggressively recover their dues and in order to achieve this objective, they may opt for Corporate Debt Restructuring (CDR)/Strategic Debt Restructuring (SDR), or bilateral restructuring.

In order to carry out actions for recovery from a borrower, which may be a listed company, banks or financial institutions have sold equity shares of the issuer during the preceding six months of the relevant date. Such banks/financial institutions may also be one of the allottees of the specified securities of the company pursuant to the CDR approved scheme under the preferential issue route.

The Board considered and approved the proposal to extend such relaxations to the scheduled banks and public financial institutions.

(Source: SEBI press release PR No.: 25/2017 dated 26 April 2017)

MCA updates

Clarification regarding applicability of Section 16(1)(a) of the 2013 Act with respect to cases under corresponding provisions of the 1956 Act

Background

Section 16 of the 2013 Act provides that if a company has been registered with a name which is identical to or very nearly resembles the name by which a company in existence had been previously registered, then the central government may direct the company to change its name or adopt a new name, as the case may be, within a period of three months.

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The Board considered and approved the proposal to extend such relaxations to the scheduled banks and public financial institutions.

(Source: SEBI press release PR No.: 25/2017 dated 26 April 2017)
from the issue of such direction, after adopting an ordinary resolution for the purpose.

In relation to this, a representation was received by the MCA seeking clarification whether regional Directors can entertain fresh applications under Section 16 of the 2013 Act in respect of applications which were rejected by them under the 1956 Act on account of being time-barred as the 2013 Act does not specify any time limit.

Clarification
In view of the above, the MCA, through its circular dated 17 May 2017, issued a clarification which provides that the applications that were rejected on account of the aforesaid matters cannot apply afresh under Section 16(1)(a) of the 2013 Act as the extinguished limitation cannot be considered to be revived even if no limitation period has been prescribed in the section.

(Source: MCA circular 04/2017 dated 17 May 2017)

Companies (Acceptance of Deposits) Amendment Rules, 2017
The MCA, through its notification dated 11 May 2017, has amended the Companies (Acceptance of Deposits) Rules, 2014 which inter alia has increased the timeline for acceptance of deposits without deposit insurance contracts till 31 March 2018, or till the availability of a deposit insurance product, whichever is earlier.

The Rules are applicable from the date of their publication in the Official Gazette i.e. 11 May 2017.


IASB updates

IASB issues exposure draft of amendment to IFRS 9
Introduction
In July 2014, IASB issued the completed version of IFRS 9, Financial Instruments. The IFRS 9 sets out the principles to recognise and measure financial instruments in order to provide relevant and useful information to users of financial statements. The IFRS 9 is effective for annual periods beginning on or after 1 January 2018 with early application permitted.

The IFRS 9 specifies that while determining the classification and measurement of financial assets, entities should consider the business model in which they are held and the contractual cash flow characteristics of the asset. Based on these two factors, entities may classify their financial assets as measured at amortised cost, Fair Value through Other Comprehensive Income (FVOCI) or Fair Value through Profit or Loss (FVTPL).

For a financial asset to be eligible for classification and measurement at amortised cost or FVOCI, IFRS 9 requires its contractual cash flows to be ‘Solely Payments of Principal and Interest’ (SPPI).

Paragraph B4.1.10 when read with paragraph B4.1.11(b) of IFRS 9 states that a prepayment option in a financial asset meets the SPPI criterion, if the prepayment amount substantially represents unpaid amount of principal and interest, which may include reasonable additional compensation for early termination of the contract.

Reasonable additional compensation implies that the party choosing to exercise its option to terminate the contract compensates the other party.

New development
In 2016, IASB set up a limited scope project on IFRS 9 for symmetric ‘make whole’ prepayment options. This project covered the classification and measurement requirements for a financial asset, which included a prepayment option that allowed the borrower to prepay the financial asset at an amount that reflected the remaining contractual cash flows of the asset discounted at a market interest rate.

This prepayment option could result in the other party being forced to accept a negative compensation – for example the creditor may receive an amount lower than the unpaid amount of principal and interest if the debtor chose to prepay, when the market interest rate was higher than the effective interest rate of the asset.

Such an asset would not have cash flows that meet the SPPI criterion. Applying current IFRS 9 could result in the asset being classified and measured at FVTPL. The IASB believes this result may not be appropriate if amortised cost provides useful information.

Thus, the Interpretations Committee (IC) recommended and IASB proposed a narrow exception to the requirement in IFRS 9 for the classification and measurement of financial assets. Accordingly, on 21 April 2017, the IASB issued an exposure draft on Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9) (Exposure Draft).

The period to provide comments on the exposure draft closed on 24 May 2017.

Please refer KPMG in India’s IFRS Notes dated 8 May 2017 which provides an overview of the proposed amendments in the Exposure Draft.

(Source: Exposure draft issued by IASB on 21 April 2017)

IASB issues IFRS 17, Insurance Contracts
The IASB on 18 May 2017 issued IFRS 17, Insurance Contracts. This is the first IFRS for insurance contracts which aims to help investors and others better understand insurers’ risk exposure, profitability and financial position.

The IFRS 17 replaces IFRS 4, Insurance Contracts which was brought in as an interim standard in 2004. IFRS 4 has given companies dispensation to carry on accounting for insurance contracts using national
accounting standards, resulting in a multitude of different approaches. As a consequence, it has become difficult for investors to compare and contrast the financial performance of otherwise similar companies. Therefore, the Financial Stability Board in September 2015 noted the importance of completing the project to replace IFRS 4 with a new standard. IFRS 17 solves the comparison problems created by IFRS 4 by requiring all insurance contracts to be accounted for in a consistent manner, benefiting both investors and insurance companies. Insurance obligations will be accounted for using current values—instead of historical cost. The information will be updated regularly and provide more useful information to users of financial statements.

IFRS 17 has an effective date of 1 January 2021, but companies can apply it earlier.

(Source: IASB press release dated 18 May 2017)

Other updates

Issuance of draft regulations for fast-track insolvency of corporate persons covered under the Insolvency and Bankruptcy Code

Background

A unified insolvency code was the need of the hour and a key policy priority for the government, given that India's bankruptcy regime was considered outdated and ineffective towards the recovery of debt compared to global standards. The key policy charter of the Insolvency and Bankruptcy Code (the Code) is to facilitate time-bound and early assessment of the viability and liquidity of an enterprise, which has been found unviable.

Chapter II of Part II of the Code, inter alia, provides that in case any corporate debtor commits a default, then a financial creditor, an operational creditor or the corporate debtor itself could initiate the corporate insolvency resolution process in respect of such corporate debtor in a specified manner. The corporate insolvency resolution process should be completed within a period of 180 days from the date of admission of the application to initiate such a process.

Chapter IV of Part II of the Code contains the manner in which a fast-track corporate insolvency resolution process could be carried out which, inter alia, prescribes that the fast-track corporate insolvency resolution process should be completed within a period of 90 days from the commencement date of the insolvency.

New developments

On 18 April 2017, the Insolvency and Bankruptcy Board of India issued the following rules for public comments:

- Draft Insolvency and Bankruptcy Board of India (Fast Track Insolvency Resolution Process for Corporate Persons) Regulations, 2017 (draft Insolvency Regulations, 2017)
- Draft notification for eligible corporate debtors under Section 55(2) of the Code.

Please refer KPMG in India First Notes dated 28 April 2017 for the detailed analysis of the regulations.

(Source: IASB press release dated 18 May 2017)

CBDT issues draft ICDS on real estate transactions

Background

On 31 March 2015, the Ministry of Finance (MoF) issued 10 Income Computation and Disclosure Standards (ICDS) operationalising a new framework for computation of taxable income by all assessees other than an individual or a Hindu Undivided Family (HUF) who is not required to get his/her accounts of the previous year audited in accordance with the provisions of Section 44AB of the Income-tax Act, 1961 (IT Act). Such assessees need to follow the mercantile system of accounting, for the purposes of computation of income chargeable to income tax under the head 'Profits and Gains of Business or Profession' or 'Income from other sources'. The ICDS are applicable to specified assessees from Assessment Year (AY) 2017-18.

The Finance Minister constituted a Committee (the Committee) comprising of experts from accounting, departmental officers and representatives from the ICAI to recommend the areas in respect of which further ICDS may be notified under the IT Act.

New development

The Committee vide a press release dated 11 May 2017 issued the draft ICDS on real estate transactions (draft ICDS). The draft ICDS is based on the Guidance Note issued on real estate transactions (ICAI GN) issued by ICAI in 2012. For the purposes of providing uniformity, certainty and to harmonise the same with provisions of the IT Act, the Committee suggested certain changes to the draft ICDS in comparison to the ICAI GN.

The period to provide comments to draft ICDS closed on 26 May 2017.

Please refer KPMG in India’s First Notes dated 15 May 2017, which provides an overview of the draft ICDS issued by the MoF.

(Source: MoF notification press release dated 11 May 2017)
KPMG in India’s IFRS institute
Visit KPMG in India’s IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

Ifrs Notes
Ind As Transition Facilitation Group (ITFG) issues Clarification Bulletin 9
29 May 2017

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

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

New development
On 16 May 2017, ITFG issued Bulletin 9 to provide clarifications on three issues in relation to the application of Ind AS.

This issue of IFRS Notes provides an overview of the clarifications issued by the ITFG through its Bulletin 9.

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

CBDT issues draft ICDS on real estate transactions
15 May 2017

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The Committee vide a press release dated 11 May 2017 has issued the draft ICDS on real estate transactions (draft ICDS). The draft ICDS is based on the Guidance Note issued on Real Estate Transactions (ICAI GN) issued by ICAI in 2012. For the purposes of providing uniformity, certainty and harmonising the same with provisions of the IT Act, the Committee suggested certain changes in draft ICDS in comparison to the ICAI GN.

The draft ICDS is open for comments from stakeholders till 26 May 2017.

This issue of First Notes provides an overview of the draft ICDS issued by the MoF.

Voices on Reporting Newsletter - Annual update
As you are aware, KPMG in India conducts Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

We have summarised in a brief publication key updates relating to the year ended 31 March 2017 from the Ministry of Corporate Affairs, the Securities and Exchange Board of India, the Reserve Bank of India, the Institute of Chartered Accountants of India, the Insurance Regulatory and Development Authority of India and the Central Board of Direct Taxes for your reference.

We will continue to provide a summary of relevant updates in future also. We hope you find this summary to be of use and relevance.

Introducing
Ask a question
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