KPMG

Voices on Reporting

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Speaker for the webinar

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Agenda

- **Accounting for software development cost under the waterfall method and agile method**
  - Background
  - Waterfall s Agile method
  - Challenges under agile method
  - Accounting under waterfall and agile methods
  - Other considerations
- Key implementation issues of CARO 2020
- Clarifications on Schedule III of the Companies Act, 2013

Background

Accounting framework

The accounting framework for internally generated intangibles is governed by IAS 38/Ind AS 38, *Intangible Assets* which require separation of the research phase from the development phase. While expense incurred on research are expensed, expenses incurred on development are capitalised only if the criteria mentioned in IAS 38/Ind AS 38 are met.

The development of software is generally performed under either of the two approaches:

Waterfall or Traditional method

Traditionally, companies developed software applications under 'Waterfall model' i.e. in phases (sequence) whereby software was developed after an idea was analysed, deemed feasible and approved.

Agile method

'Agile method' is based on iterative/repetition of feature requirements and solutions based on customer expectations/business needs which is carried out through 'sprints'. Research, development, testing, upgrade, minor/major enhancements, etc. are all carried out simultaneously during software development.

Many of the leading technology companies and startups today practice the agile methodology for software development.

Waterfall vs agile method

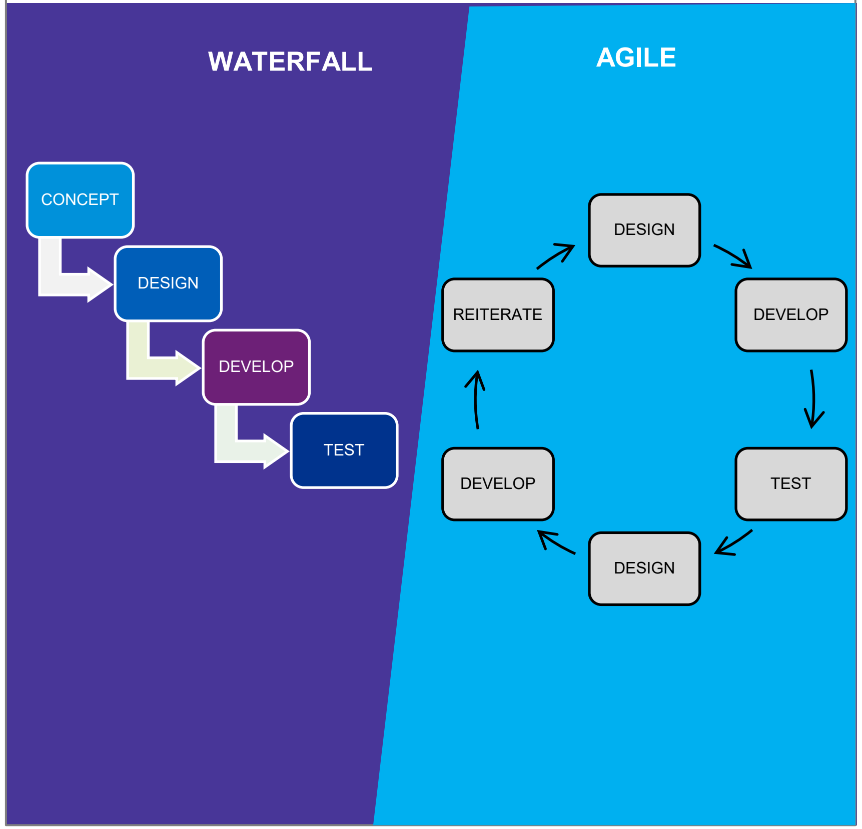
Waterfall method:

- Involves planning entire project in advance
- Lot of documentation performed upfront before any coding starts
- Preparation of detailed business case - business needs, overall strategy, etc.
- Preparation of technical requirement document by technologists
- Commencement of coding, integration, and final testing before ready
- New activity starts only once the earlier is completed.

Agile method

- Preparation of charter (i.e. business case) by identifying feasibility, high-level features, source of revenue and business need
- Requirements keep evolving over the period
- Development of product in iterations or sprints (ranging from one-three weeks) on approval of charter
- Each sprint forms an increment of the application, getting feedback from stakeholders, modify the next set of requirements for the next sprint.

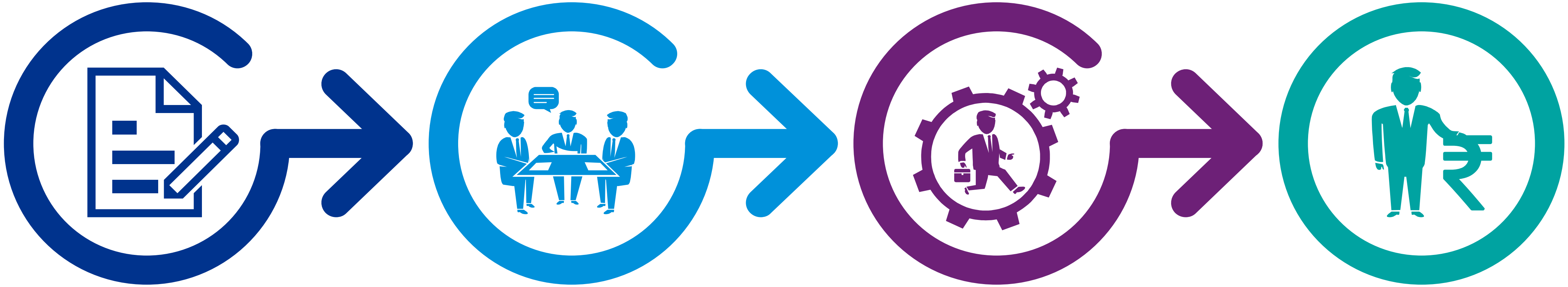
Figure: Difference between waterfall and agile method of software development



Challenges under agile method

Challenges

- Research, development and post-implementation phases are not distinct, unlike waterfall method, resulting in significant judgement and robust processes to identify and classify costs to be capitalised
- Agile development activities tend to move almost simultaneously through all the phases, resulting in difficulties to identify costs specific to development phase
- In the absence of sufficient and diligent records/processes regarding the timing and nature of activities being performed, capitalisation of costs become a challenge. Inappropriate records could lead to incorrect accounting.
- Understanding and computing the percentage of time spent by the developer towards software development activities could involve significant judgement
- Uncertainty of capex budgets at the beginning of the year, given the iterative and incremental development methods employed in case of agile.



Accounting under waterfall and agile methods (1/3)

Accounting under Waterfall method

- The current accounting guidance aligns with the waterfall software delivery methods
- The accounting guidance and policy specifies that activities relating to design, build, and implement new software could be capitalised as capital expenditure
- Other costs, such as planning or support of the software, would need to be expensed as an operating expenditure.

Plan	Design	Build	Implement	Monitor/Support
Plan the end-to-end technology implementation	Design the end-state solution	Build the end-state solution	Implement, test and deploy the end-state solution	Monitor the solution after Implementation
OpEx	CapEx			OpEx

OpEx

- Conceptual formulation of alternatives
- Evaluation of alternatives
- Determination of existence of needed technology
- Final selection of alternatives
- Requirement gathering
- Planning and estimating for the project

CapEx

- Design of chosen path, including software configuration and software interfaces
- Coding of the software
- Installation to the hardware
- Testing including User Acceptance Testing
- Deployment efforts to production
- Administrative tasks within Design, Build and Implement phases should be expensed; for example OpEx

OpEx

- Training
- Application maintenance and operation

Source: KPMG Publication May 2018 "Accounting Agile"

Accounting under waterfall and agile methods (2/3)

Accounting under agile method

There are generally three parts for agile development:

- **Theme** - Represents a team's high-level strategy for its product (*e.g. - fill empty seats in theaters*)
- **Epic** - breaking theme into smaller strategic plans (*e.g. use a mobile app to drive last-minute ticket sales*)
- **Stories** - breaking epic into **user stories**, which represents small **unit of development** to complete the goal *(e.g. create and assign promotional codes for last-minute purchases)*

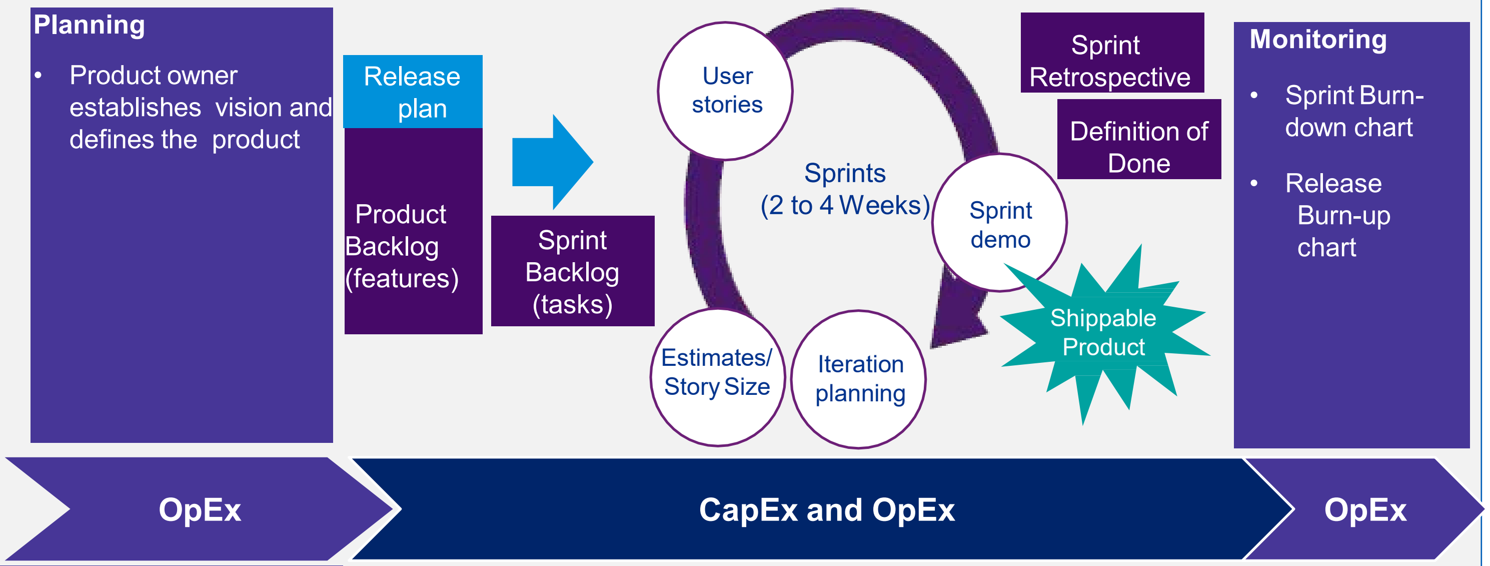
Theme → Epic → Story

- Agile work is performed through tasks called "**user stories**"
- The level of effort spent on a user story needs to be measured under agile, which can replace the traditional timecard records under waterfall method
- User stories are classified by the type of work being performed (i.e. development, upgrade, enhancements, maintenance, etc.) which forms the basis for accounting under agile method.

Accounting under waterfall and agile methods (3/3)

Cost eligible for capitalisation under agile

- The current accounting guidance does not specifically address accounting under agile method
- **Stories** that add new functionality of the feature; the effort for those stories may be subject to CapEx treatment
- Other **stories** such as prototype, exploration, defects, proof of concept, experiments, re-works etc. may not be eligible for capitalisation.



OpEx
- Product Planning (Product Backlog)
- Epic and Agile Release Train Planning (Epic/Feature Backlog)
- Program Increment (PI) or Release Planning & estimating

CapEx and OpEx

All efforts during the Sprints development should be considered CapEx except:
- Defects fix – considered maintenance work
- Development of Enabler stories for infrastructure, exploration, refactors
- Knowledge acquisition work: such as prototype, proof-of-concept, experiments, and design spikes.

Work necessary for understanding the problem or technical feasibility should be expensed.

OpEx
- Training
- Release or PI Retrospective
- Application maintenance and operation

Source: KPMG in the US Publication May 2018 "Accounting Agile"

Other considerations (1/2)

Impairment

- Identification of the unit of account for purposes of capitalisation is a critical judgment (i.e. unit of account could be a single sprint or multiple sprints together)
- Impairment charges could exist if a particular capitalised sprint(s) is replaced by a new sprint (e.g. due to better technology) .

Internal Controls Matters

Control aspects to be considered while adopting agile method:

- Risk Control Matrix (RCM) to be updated
- Appropriate controls for identifying and classifying the nature of activities eligible for capitalisation
- Appropriate controls for identifying the timing of commencement and cessation of capitalisation of expenses
- Updation to the IT system of the entity to keep track of the nature and timing of the development expense.

Other considerations (2/2)

Material weakness in ICOFR*

Illustrative **'Material weakness'** qualification for capitalisation of software development cost for an US SEC client:

'The Company did not obtain or generate sufficient relevant quality information to support the design and functioning of control activities over the accounting for capitalized software development costs. Specifically, the Company's process level control over internal use software development costs did not effectively track and categorize software development costs incurred during the application development stage to quantify amounts that should be capitalised as a long-lived asset, rather than expensed as research and development expenses. Additionally, the review control of the capitalised software development costs was not operating at a sufficient level of precision to identify potential material misstatements'

*ICOFR- Internal Controls Over Financial Reporting

Key considerations

1. Accounting under agile method is a new emerging area that will involve exercise of significant judgement while evaluating its accounting and presentation

2. Accounting and presentation will depend on the facts and circumstances of each case

3. Currently, no direct guidance is available in this area

4. Companies should develop robust systems, processes and controls to help with the accounting and presentation of these intangibles.

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- **Key implementation issues of CARO 2020**
- Clarifications on Schedule III of the Companies Act, 2013

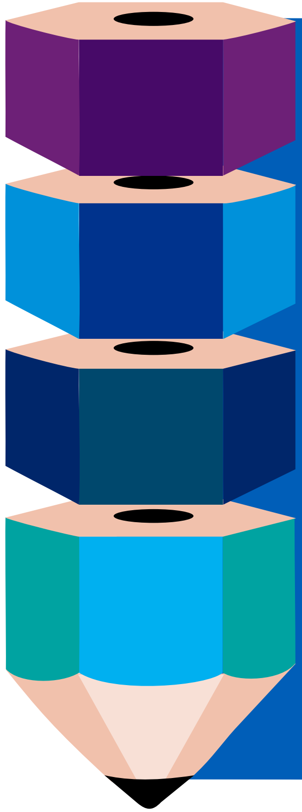
Companies (Auditor's Report) Order, 2020

- The Ministry of Corporate Affairs (MCA) issued the Companies (Auditor's Report) Order, 2020 (CARO 2020) on 25 February 2020. The Order was initially applicable for audits of financial statements for periods beginning on or after 1 April 2020. The MCA, vide notification dated 24 March 2020 revised the applicability of CARO 2020 to financial statements for periods beginning on or after 1 April 2021.
- There is no change in the applicability requirement of CARO 2020 as compared to CARO 2016.
- It includes several new clauses and has revised certain existing clauses of CARO 2016. It has significantly increased the reporting requirements of auditors.
- It has enhanced reporting requirements that aim to address the key concerns relating to the performance and operations of a company and also introduced reporting requirements aimed to assess and depict the liquidity position of a company.
- The Institute of Chartered Accountants of India has issued a Guidance Note on CARO 2020 to enable auditors to comply with the reporting requirements.
- Although there are several changes in reporting requirements, we have selected certain key topics of interest for companies in the technology sector.

Working capital facilities

Clause 3(ii)(b)

Whether during any point of time of the year, the company has been sanctioned working capital limits in excess of INR5 crore, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details.



Key considerations

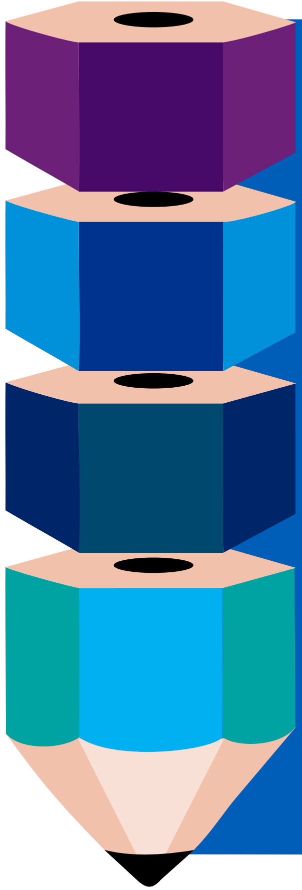
- Sanctions includes both fresh sanctions as well as renewals of existing limits. It also includes both fund based and non-fund-based credit facilities
- Ensure charges in respect of such facilities and the register of charges is updated in a timely manner
- Enhance the control environment with respect to review and approval of quarterly returns/statements and comparison thereof with the books of accounts. Maintain a repository of the requisite evidences
- Reporting obligations restricted to comparing the quarterly returns/statements with the books of accounts. For the purposes of reporting on this clause, the auditor is not required to audit the returns or the underlying books of accounts
- Examples of reportable differences include differences in the value of inventories, amount of debtors/creditors, ageing analysis of debtors, etc.

INR5 Crore

Whistleblower/Vigil Mechanism

Clause 3(xi)(c)

Whether the auditor has considered whistle-blower complaints, if any, received during the year by the company.



Key considerations

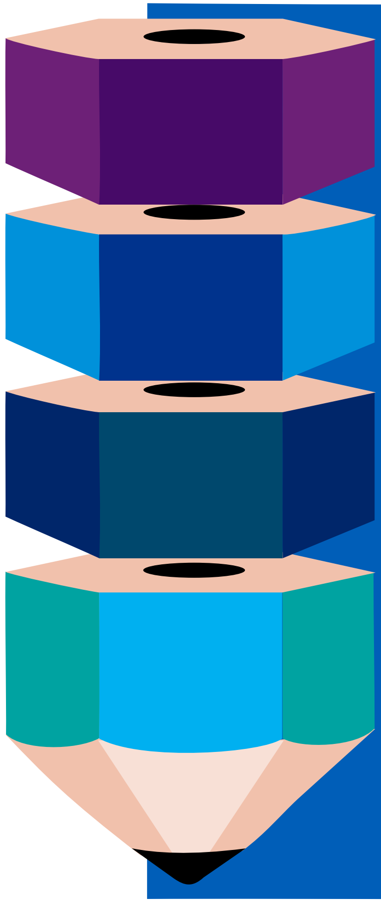
- Reporting obligations cover the entire year under audit and not a part of the year or as at the balance sheet date
- SEBI Listing Regulations and the Companies Act, 2013 (2013 Act) mandate certain classes of companies to establish a Whistle Blower (WB)/vigil mechanism. Other companies not covered by these regulations may voluntarily establish a WB/vigil mechanism
- For companies that have established a WB mechanism either pursuant to law or voluntarily, adequate procedures to handle anonymous complaints, accept confidential submission of concerns about questionable accounting, internal control, or auditing matters should be included
- The WB process should also be designed to ensure all complaints are investigated and resolved by the company in an appropriate and timely manner
- Companies should maintain a log of all WB complaints received, investigations carried out and resolutions/actions taken even where a WB process is not required to be established under any laws or regulations.

Internal Audit System

Clause 3(xiv)

(a) Whether the company has an internal audit system commensurate with the size and nature of its business.

(b) Whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.



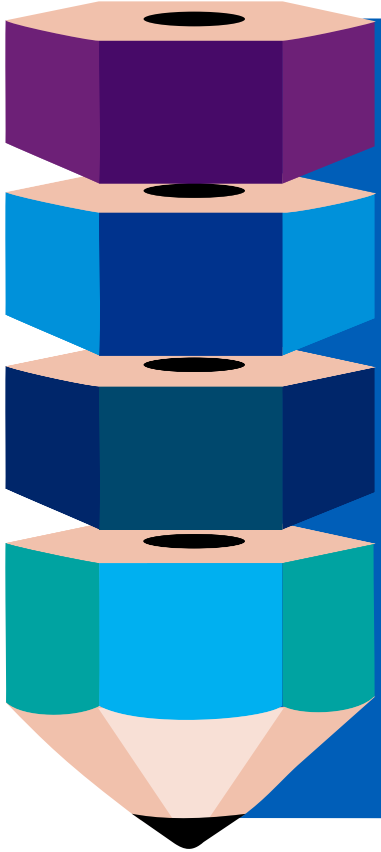
Key considerations

- Section 138 of the 2013 Act, prescribes the classes of companies that need to have an internal audit system
- Companies may have its own internal audit department or entrust the work of internal audit to an external agency, in either case with appropriate professional qualifications
- The internal audit system should be commensurate with the size of the company and the nature of its business. This assessment should take into account no. of operating locations, centralized/decentralised control environment, homogeneous/heterogeneous controls, extent of IT systems involved in financial reporting
- The Audit Committee (AC)/Board should, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audits. It is a good practice to also involve statutory auditors in determining the scope of work and periodicity of reporting
- The internal audit system should normally report directly into those charged with governance of the company i.e. AC/Board
- Ensure there is an adequate follow-up system to verify if the deficiencies pointed out are corrected and remedial action taken on the deficiencies reported upon by the internal audit system
- Auditors are required to consider the reports of the internal auditor before conclusion of audit and finalisation of their audit report, including implications on reporting on internal financial controls. This will include meetings with the internal auditors to discuss their findings and observations.
- Emerging areas of focus for internal audit – cyber security, data privacy and fake employment

Related party transactions

Clause 3(xiii)

Whether all transactions with the related parties are in compliance with sections 177 and 188 of the 2013 Act, where applicable and the details have been disclosed in the financial statements etc., as required by the applicable accounting standards.



Key considerations

- Section 188 of the 2013 Act, prescribes Related Party Transactions (RPTs) for which prior approval of board of directors and/or shareholders is required subject to certain exceptions. Section 177 requires audit committees to approve a company's transactions with related parties
- Under Section 188, approval of the Board/shareholders is not required for RPTs carried out in the ordinary course of business and on an arms' length basis
- Arm's length generally assessed based on transfer pricing requirements under Income Tax Act, 1961
- Evaluate and strengthen the control framework in relation to identification of related parties, related party transactions and assessment of arms' length.
- An auditors' reporting obligations under this clause include compliance with sections 177/188 of 2013 Act as well as the adequacy of disclosures given in the financial statements pursuant to the requirements of Ind AS 24/AS 18, *Related Party Disclosures*
- As per the latest amendment in the Listing Regulations by SEBI, effective 1 January 2022, all RPTs need to be approved by independent directors on the audit committee.

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Clause 3(xvii)

Whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses.

Key considerations

- Reporting under the clause to cover the period under audit and the immediately preceding financial year
- Cash losses for the purposes of this clause would mean net profit/loss after tax (excluding Other Comprehensive Income (OCI)), adjusted for non-cash items such as depreciation, amortisation of intangible assets/right of use assets, Employee Stock Option Plan (ESOP) expenses, impairment losses, etc. The cash losses should also be adjusted for the effect of qualifications in the audit reports to the extent the qualifications are quantified
- Cash profits/cash losses realised and recognised in OCI before their reclassification to the PL* should be considered in determination of cash losses but its subsequent reclassifications into the PL, being a non-cash adjustment, should not be considered.

*PL - statement of profit and loss

Clause 3(xxi)

Whether there have been any qualifications or adverse remarks by the respective auditors in the CARO reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

Key considerations

- Reporting under this clause is only required for those entities included in the consolidated financial statements to whom CARO 2020 is applicable
- In cases where the subsidiary auditor has not issued the CARO report, principal auditor to report the name of the subsidiary and the fact that CARO report not been issued till the date of the principal auditors' report
- Qualifications/adverse remarks given by the component auditors are presumed to be material. When reporting under this clause, the principal auditor is not required to reevaluate materiality from a consolidation perspective.

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- **Clarifications on Schedule III of the Companies Act, 2013**

Amendments to Schedule III of the 2013 Act

- Schedule III to the 2013 Act governs the format and content of financial statements
- With the objective of facilitating enhanced disclosures and transparency in the operations of companies, the MCA made several amendments to the 2013 Act.
- The amendments can be divided into the following 3 categories:
  - Reclassification of certain items in the financial statements
  - Disclosures on various regulatory matters primarily those arising from revised reporting obligations under the CARO 2020 and
  - Others - funding transactions with intermediaries, ageing of certain financial statement captions, etc.
- Although there are several changes in Schedule III, we have selected certain key topics of interest for companies in the technology sector.

Reclassification of items*

Particulars	New classification	Old classification
Lease liability under (Indian Accounting Standards) Ind AS 116, *Leases*	Current and non-current portion of lease liabilities to be disclosed under the head *'current and non-current financial liabilities'* on the face of the balance sheet.	Earlier disclosed under the head *'borrowings'* for non-current portion and *'other financial liabilities'* for current portion.
Security deposits	To be presented under '*current/non-current other financial assets'.*	Earlier presented under '*loans'.*
Current maturities of long-term borrowings	To be disclosed separately under *borrowings in current financial liabilities* (Ind AS)*/current liabilities* (Accounting Standards(AS)).	Earlier disclosed under other *financial liabilities(Ind AS)/other current liabilities (AS)*
Reserves and surplus	Option to present remeasurement of defined benefit plans and fair value changes relating to own credit risk of financial liabilities designated at Fair Value Through Profit & Loss (FVTPL) as a separate column under reserves and surplus.	Earlier companies did not have this option and were being recorded directly in reserves and surplus.

*Comparative figures to be reclassified accordingly.

Other disclosures

- **Detailed disclosures required where a company has advanced/loaned/invested funds** (borrowed funds/share premium/any other sources or kind of funds) to intermediaries* with the understanding (in writing/otherwise) that the intermediary would:
  - Directly/indirectly lend or invest in ultimate beneficiaries** or
  - Provide any guarantee, security or the like to or on behalf of the ultimate beneficiaries**

  (Similar disclosures on receipt of funds from funding party*).

  ***(Key consideration**: Purpose/usage of investments made, loans given to be monitored on a regular basis)*

- **Ageing of trade receivables/payable** (with specific sub-classification as disputed/ undisputed) and unbilled dues
- **Ageing of capital work-in-progress** (CWIP) and intangible assets under development

  ***(Key considerations**: Evaluate if the IT systems are upgraded to capture the relevant information. For example, does the vendor/customer master sheet capture credit terms for trade payables/receivables. Ageing of unbilled revenue and accrued expenses should particularly be an area of focus.)*

- **Effects of scheme of arrangement** accounted as per the approved scheme and accounting standards and any deviations to be explained

  ***(Key considerations:** Evaluate if the scheme is in compliance with the relevant accounting standards. If not, disclosure requirements to be complied with)*

*any other person(s) or entity(ies), including foreign entities

**other persons or entities identified in any manner whatsoever by or on behalf of the company

Key amendments in notes to accounts (aligned with CARO)

The amendments to Schedule III are largely driven by the requirements relating to CARO 2020 to be applicable from financial year beginning 1 April 2021 as given below:

Title deeds of immovable properties:

Disclosure of details of title deeds of immovable properties not held in the name of the company (excluding leased assets)

CARO
Clause 3(i)(c)

Ratios:

Disclosure of certain ratios e.g. current ratio, debt service coverage, return on capital employed, net profit, etc.

(Explain items included in numerator and denominator of these ratios and any change in the ratio exceeding 25 per cent as compared to the preceding year)

(**Key considerations**: *Define the numerator/denominator and evaluate if this is in line with disclosures in Management Discussion and Analysis (MD&A)/other information and industry practice)*

CARO
Clause 3(xix)

Corporate Social Responsibility* (CSR):

Details of CSR including amount required to be spent, shortfall, previous years' shortfall, reasons for shortfall, nature of CSR, etc.

*disclosures currently are required to be made pursuant to ICAI's technical guide on accounting for CSR expenditure

CARO
Clause 3(xx)

Borrowings against security of current assets:

In case of borrowings from banks or financial institutions on the basis of security of current assets, disclose details relating to quarterly returns and summary of reconciliations.

CARO
Wider than Clause 3(ii)(b)

Loans and advances:

Disclosure of loans and advances granted in the nature of loans to promoters, directors, Key Managerial Personnel (KMPs) and the related parties, repayable on demand or granted without specifying terms (in the prescribed format).

(Key considerations: *(Whether an advance is in the nature of a loan would depend upon the circumstances of each case.)*

CARO
Clause 3(iii)(f)

Links to previous recordings of VOR

Month	Topics	Link
November 2020 (Special session)	• Accounting issues for technology sector in relation to taxation matters	Click here
January 2021	• Disclosure norms on forensic audit by listed entities • Revised framework for schemes of arrangements by listed entities • The Companies (Amendment) Act,2020 notified by MCA • Key considerations for interim and year-end reporting amid COVID-19 based on enforcement priorities for 2020 issued by European Securities and Markets Authority (ESMA) • Other regulatory updates	Click here
April 2021	• Amendments to Corporate Social Responsibility (CSR) provisions under the 2013 Act • The Companies (Amendment) Act, 2020 and consequent amendments to Rules and Schedules to the 2013 Act • Additional reporting in an auditor's report and additional disclosures in board's report • Maintenance of books of account in electronic mode • Other regulatory updates	Click here
July 2021	• MCA overhauls financial reporting requirements • Additional disclosures in corporate governance report • Key amendments to Listing Regulations • SEBI's decision on independent directors' regulations • Amendments to Business Responsibility and Sustainability Reporting (BRSR) framework • Other regulatory updates	Click here

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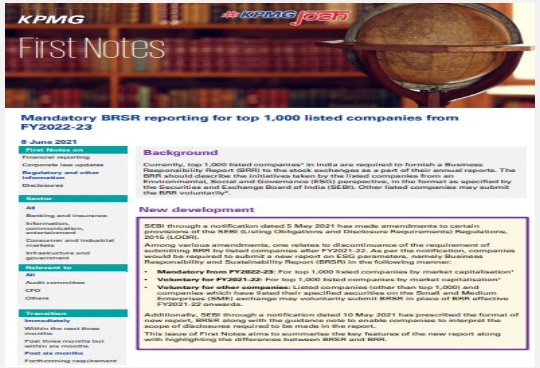
Accounting and Auditing Update

First Notes



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New issue of:

- Accounting and Auditing Update
- First Notes
- Voices on Reporting - publication

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