ACCOUNTING AND AUDITING UPDATE

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In this issue

KPMG
cutting through complexity

Editorial

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The pharmaceutical sector in India is fascinating. On one hand, this is a sector that is witnessing significant investments (both local and inbound international flows) and yet on the other hand, there are numerous challenges, whether it is price control or mandatory licensing, that confront this industry. We take a close look at this sector through a series of articles in this month's issue of the AAU.

We examine the accounting landscape for the capitalisation of R&D costs, and whilst highlighting some of the diversity that exists in practice, we try and provide a perspective on what is the intent of the standard setters and international practice in this area. We also highlight the history and evolution of price control in India for pharmaceuticals, and also provide some insight into the accounting and reporting challenges arising out of the Supreme Court decision on how price control guidelines should operate.

Dealing with product recalls is one of the events that companies would like to avoid, but have to deal with at some juncture or the other. We have tried to enumerate some of the reporting challenges and considerations associated with product recalls this month. We also highlight a key tax and compliance issue that the industry has been grappling with relating to the provision of freebies to medical practitioners. This is a particularly tricky matter that has many dimensions ranging from accounting, tax deductibility and professional ethics.

This month we also provide you with some insight into how IFRS 10, the new consolidation standard, could affect the real estate sector by highlighting some key areas and arrangements that could be impacted. While this standard is not yet effective in India, but with the renewed push towards IFRS/IND-AS by the regulatory authorities; this should be of interest and engage the attention of many stakeholders.

We also cover the key aspects of EU audit reforms this month. This change is one of the single largest policy shifts that have taken place internationally with regard to audits and auditors in some time, and the direct and indirect impact on even Indian companies could be significant. In some ways, it does not seem to matter if you are an auditor or a preparer of financial statements these days; there is just a lot of change and movement to deal with.

As I sign off for this month, I would like to remind you that in case you have any suggestions or inputs on topics we cover, we would be delighted to hear from you. Happy reading!

Pharmaceutical Industry

In-House research and development (R&D) cost

Expenditure on R&D by Indian pharmaceutical entities has gone up significantly during recent years as companies strive to tap the opportunities arising from the loss of patent exclusivity.

In this article, we examine some of the key accounting aspects relating to capitalisation of in-house R&D cost as intangible asset primarily under Indian GAAP and IFRS.

This article aims to

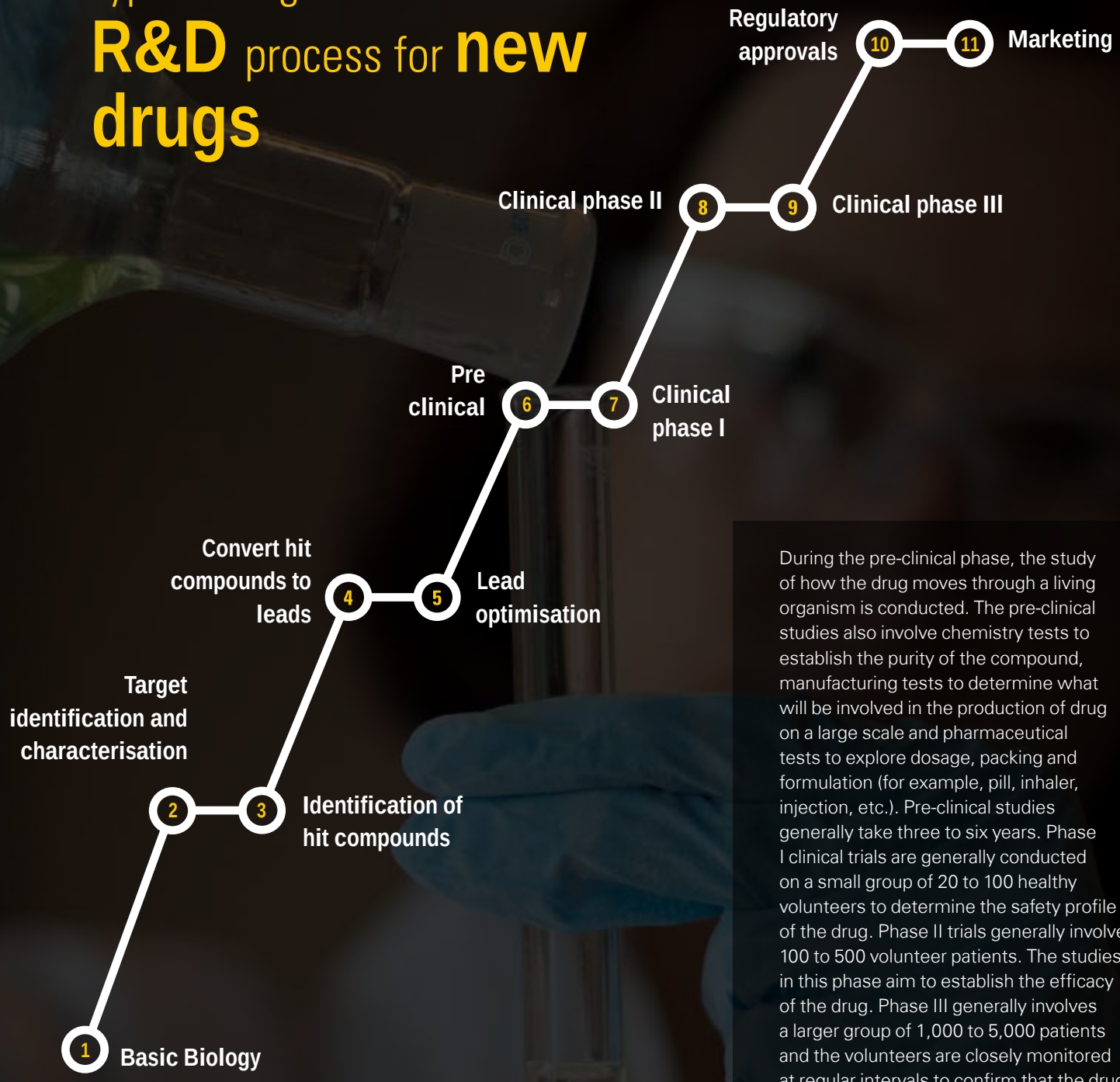
- Explain the accounting for capitalisation of in-house R&D as intangible assets under Indian GAAP and IFRS
- Highlight various considerations and accounting challenges in this area
- Discuss the diversity in practice in relation to criteria used by pharmaceutical companies for capitalisation of in-house R&D costs as intangible assets.

R&D process for developing new drugs

Before we examine the accounting aspects relating to capitalisation of in-house R&D cost as intangible asset, it would be helpful to highlight in brief the R&D process for developing new drugs that is typically followed in the pharmaceutical industry.

In stages 1 and 2, biological studies are conducted to understand how a disease works and this leads to identification of the specific targets, inhibition of which plays a crucial role in treating the particular disease. In stages 3 to 5, teams of chemists, pharmacologists and biologists are engaged in screening thousands of compounds, chemically or genetically engineering new ones to generate potential compounds. Those molecules that have desirable properties are further modified to enhance the activity or minimise side effects (this process is known as lead optimisation). Pre-clinical testing (on animals: stage 6) and clinical trials (on humans: stages 7, 8 and 9) are conducted to determine the efficacy and safety of the molecule.

Typical stages involved in the **R&D** process for **new drugs**



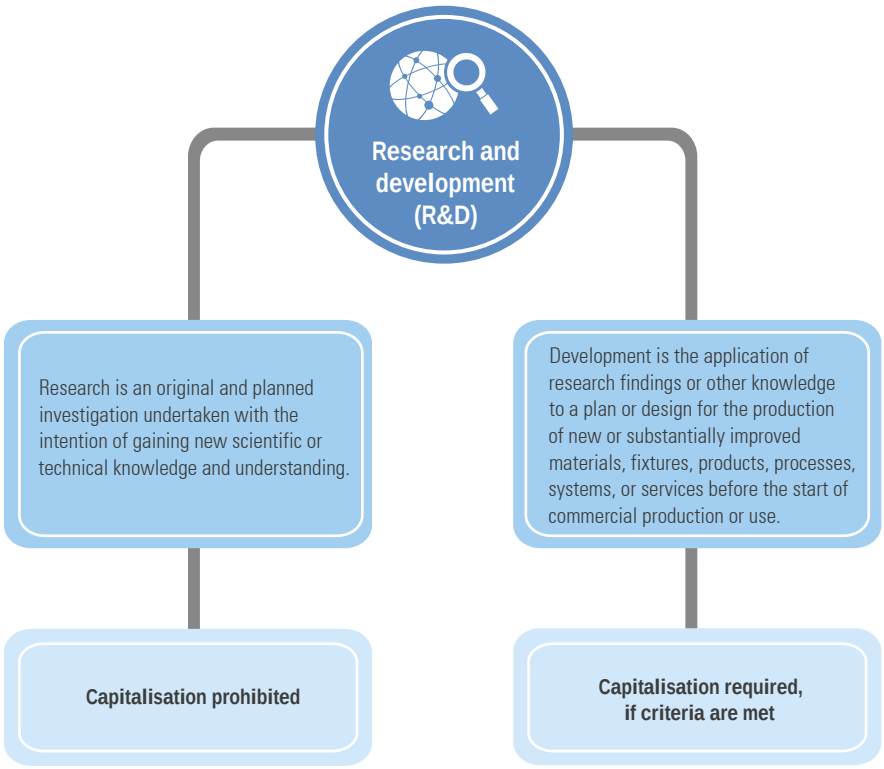
During the pre-clinical phase, the study of how the drug moves through a living organism is conducted. The pre-clinical studies also involve chemistry tests to establish the purity of the compound, manufacturing tests to determine what will be involved in the production of drug on a large scale and pharmaceutical tests to explore dosage, packing and formulation (for example, pill, inhaler, injection, etc.). Pre-clinical studies generally take three to six years. Phase I clinical trials are generally conducted on a small group of 20 to 100 healthy volunteers to determine the safety profile of the drug. Phase II trials generally involve 100 to 500 volunteer patients. The studies in this phase aim to establish the efficacy of the drug. Phase III generally involves a larger group of 1,000 to 5,000 patients and the volunteers are closely monitored at regular intervals to confirm that the drug is effective and to identify side effects. During the phase III studies, toxicity tests and long-term safety evaluations are also carried out. Clinical trials take about 2 to 6 years. Once all the three phases of clinical trials are completed, the entity applies for regulatory approvals. The clinical phase is the most expensive stage in new drug development process.

Source: Research and Information System for Developing Countries - Discussion paper #176, The R&D Scenario in Indian Pharmaceutical Industry by Reji K Joseph

Distinction between research and development and the accounting consequences

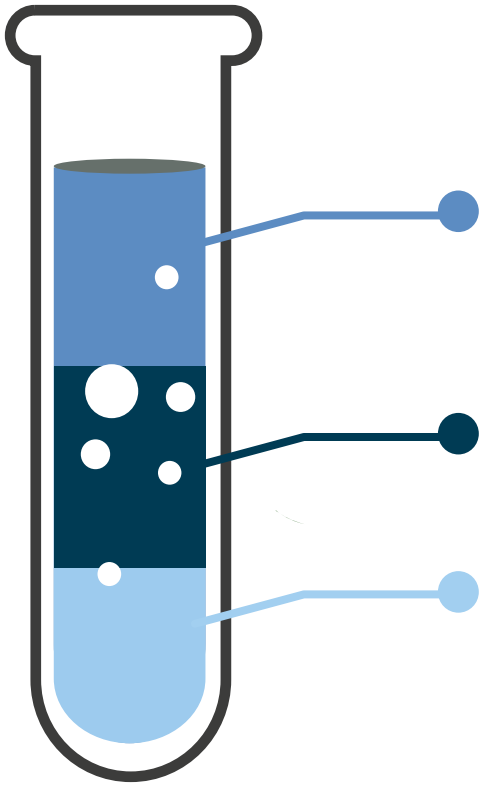
Development activities differ from basic research in that they are focussed on creating new molecules. Entities recognise their own research costs (basic research) as an expense. In contrast, internal development costs must be capitalised if certain criteria, described below, are met. If these criteria are not met, internal development costs must also be recognised as an expense.

Accounting consequences for research and development



Source: Accounting Standard (AS) 26, *Intangible Assets*; International Accounting Standard (IAS) 38, *Intangible Assets*; KPMG in India analysis

Decision-making process for capitalising development costs



Step 1

Do the activities qualify as development activities?

Step 2

Have the general criteria for an intangible asset been met?

Step 3a, b

Have the recognition criteria for an intangible asset been met?

Have the recognition criteria been substantiated by specific indications of an internally generated intangible asset?

Source: AS 26, *Intangible Assets*; IAS 38, *Intangible Assets*; KPMG in India analysis

General criteria for recognising the costs of in-house development activities as intangible asset

The costs of in-house development activities are recognised as an internally generated intangible asset from the date on which all the criteria for the asset's recognition are met. The capitalisation of the costs of in-house development activities is a three-step process that can be broken down as depicted in the diagram.

Step 1

The issue of whether the activities qualify as development activities is a definitional issue. The first step is, therefore, to establish whether the entity's activities are, by nature, research or development activities. Development activities are when products, fixtures, materials, processes, systems, or services are newly developed or substantially improved. Accounting standards provide examples of development activities, such as:

a. the design, construction and testing of pre-production or pre-use prototypes and models

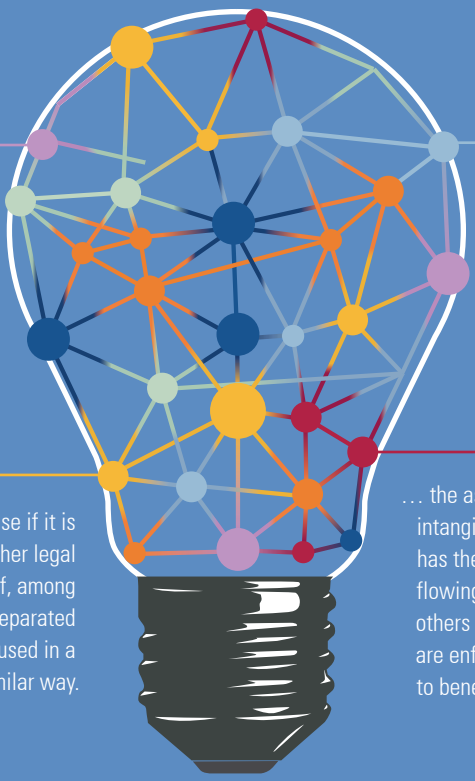
b. the design of tools, jigs, moulds and dies involving new technology

c. the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production

d. the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Step 2

An intangible asset generally exists if general criteria as depicted in the diagram below are fulfilled.



… the asset is a non-monetary asset without physical substance.

… future economic benefits can be attributed to the asset. These benefits may result from revenue, cost savings, or other benefits for the entity from its use of the asset. For example, technological expertise may reduce production costs

… the asset is identifiable. This is the case if it is separable or based on contractual or other legal rights. An asset is always separable if, among other things, it is capable of being separated from the entity and sold, licensed, or used in a similar way.

… the asset is controlled by the reporting entity. An intangible asset is controlled if the beneficial owner has the power to obtain the future economic benefits flowing from the underlying resource and to deny others access to those benefits (e.g., legal rights that are enforceable in a court of law). However, access to benefits can be denied in other ways.

Source: AS 26, *Intangible Assets*; IAS 38, *Intangible Assets*; KPMG in India analysis

Step 3a

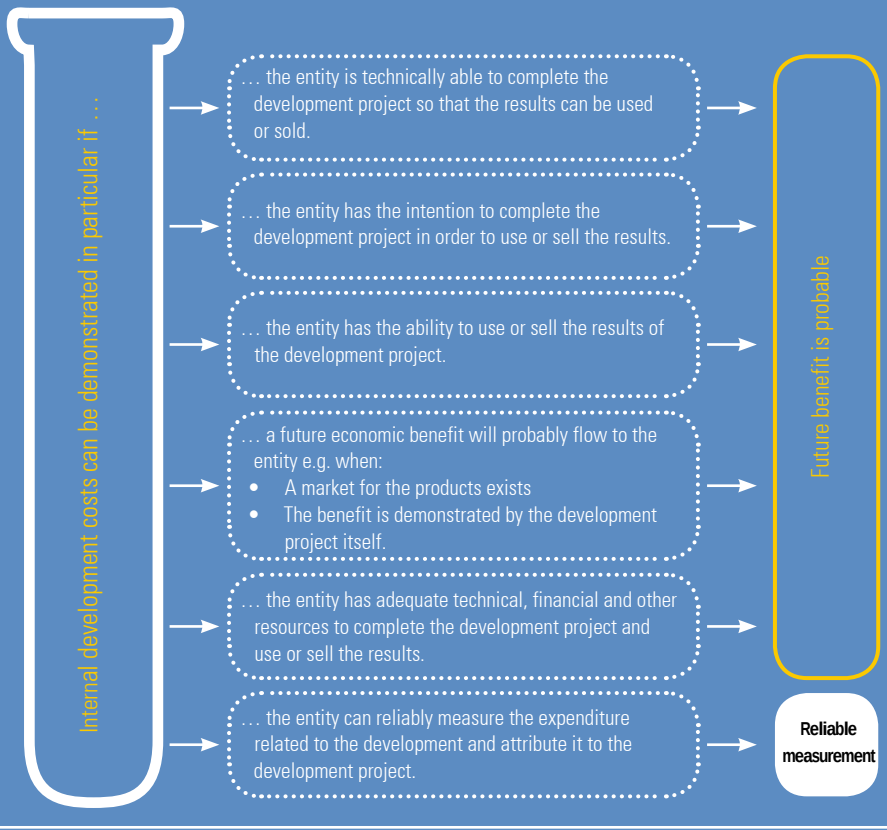
An intangible asset shall be recognised if it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably.

The requirement to recognise an intangible asset also applies to internally generated intangible assets, such as internal development costs. The recognition criteria for development costs are substantiated by specific indications that are addressed in the following six indications.

Step 3b

The accounting standards under Indian GAAP and IFRS specify six indications that are designed to substantiate the probability of the expected future economic benefits and the reliable measurement (measurability). The specific indications can be attributed to the economic benefits and the reliable measurement of costs as depicted in the diagram:

Specific indications for economic benefits and measurement



Source: AS 26, *Intangible Assets*; IAS 38, *Intangible Assets*; KPMG in India analysis

Development costs must be capitalised if all the specific indications are met (capitalisation requirement). This does not, however, mean that the implementation of the specific indications in accounting standards place higher thresholds for the capitalisation of the internal development costs (internally generated intangible asset) in comparison to other assets. Nor do the specific indications establish any additional recognition criteria. Rather, the specific indications represent definitional criteria that are designed to reduce the requirement for interpretation with regard to future economic benefits and reliable measurement.

Diversity of practice in relation to criteria used by pharmaceutical entities for capitalisation of in-house R&D cost as intangible asset

Accounting requirements for capitalisation of in-house R&D cost as intangible asset are similar under Indian GAAP and IFRS. However, it appears from the financial statements of pharmaceutical entities that there exists diversity in practice in relation to criteria used for capitalisation of in-house R&D cost as intangible asset.

Certain leading pharmaceutical entities consider final regulatory approval as substantial evidence at which point all the criteria for capitalisation of in-house R&D costs as intangible assets have been met, although obtaining approval in one country might not provide a sufficient basis for capitalising the development costs incurred to obtain new drug approvals in other countries.

However, certain pharmaceutical entities indicate that the probable future economic benefits criterion is met even before the regulatory approval is received.

The diversity in practice can be broadly categorised as below:

a. Capitalisation of development costs after the development of the product has been completed and all the necessary public registration and marketing approvals have been obtained.

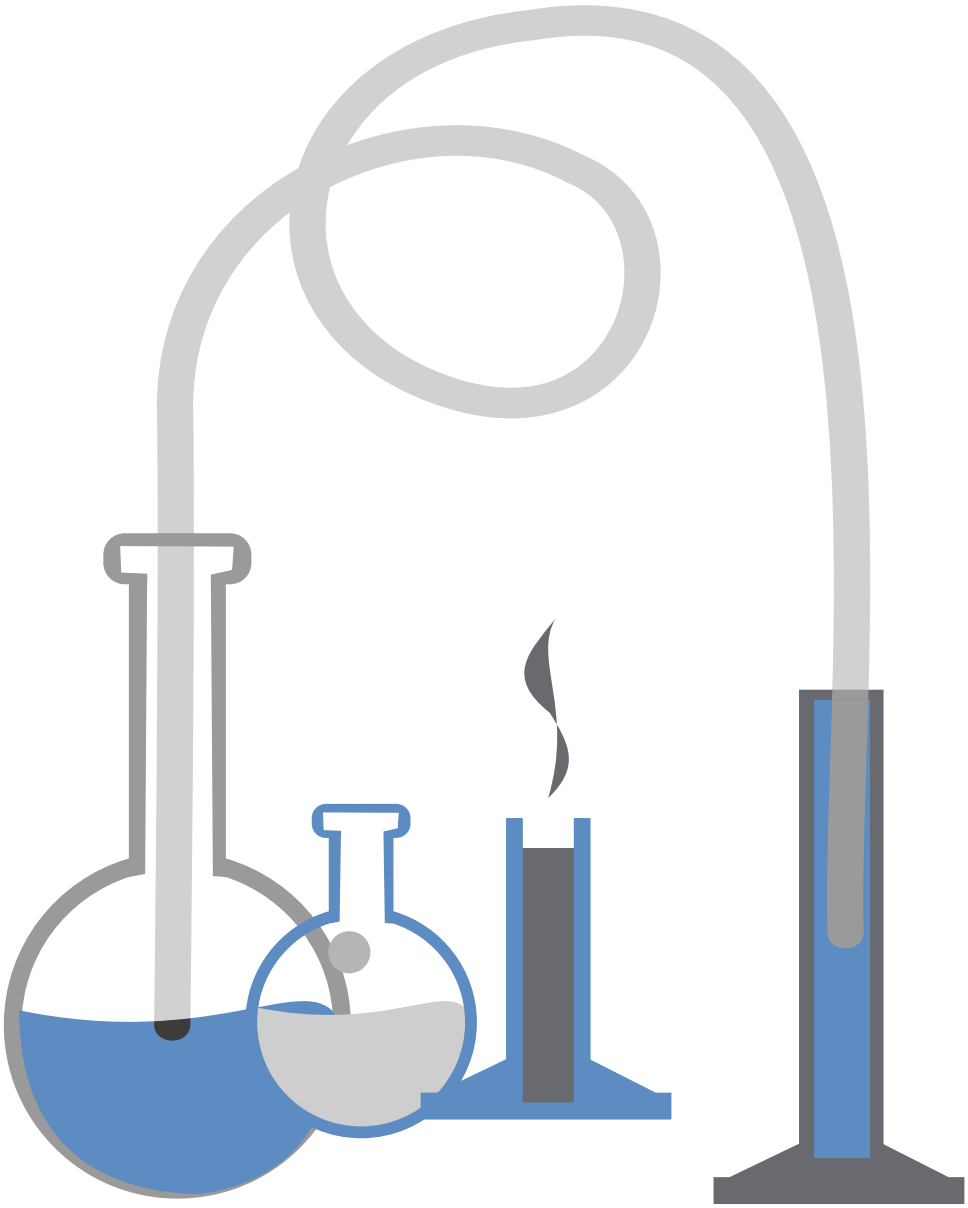
b. Capitalisation of development costs even before regulatory approval is received, namely when a filing for approval had been made in a major market, and approval was considered highly probable.

c. Capitalisation of development costs even before filing for regulatory approval has been made in a major market. However, approval is considered highly probable.

Conclusion

The accounting standard require capitalisation if certain criteria are met. Internationally, most companies do not capitalise such expenditure till regulatory approvals are received resulting in low levels of such assets being recognized.

In India, there is considerably more diversity in practice on capitalization of development costs which causes a lack of comparability in reported financial information. While it is true that the specifics of each drug development can be unique; the benefits of increased profits due to earlier capitalisation is often lost by listed entities because investors tend to ignore the value of capitalized R&D expenditure and instead focus on their perceptions of future cash flows and drug development pipelines to derive valuations.



Pharmaceutical industry

Price control implications

Evolution of the pricing policies and an overview of the regulatory framework in India

The Drug Price Control Order (DPCO) first took shape under Section 3 of the Essential Commodities Act in 1970, and was revised in 1979, 1987, 1995, and 2013. Prior to DPCO 1970, it was obligatory for the manufacturers to obtain prior approval of the government before increasing the prices of drug formulations. DPCO 1970 set out to achieve a direct control on the profitability of a pharmaceutical business, and an indirect control on the prices of pharmaceuticals. According to the regulation, so long as companies did not exceed the pre-tax profit limits set at 15 per cent, they were free to price the drugs sold.[1] Gradually ceiling prices for controlled categories of bulk drugs and their formulations, were introduced in India. DPCO 1979 first introduced the ceiling prices for controlled categories of bulk drugs and their formulations and 347 bulk drugs and formulations were put under price control. The retail prices of controlled formulations were decided by applying the concept of 'maximum allowable post manufacturing expenses' (MAPE) i.e., a mark-up on the cost of manufacture of the drugs.[1] The trend of de-regulation was set in motion post the DPCO 1979 by reducing the span of price control to 142 drugs as per DPCO 1987, and finally to 74 drugs as per DPCO 1995.

This article aims to

- Provide a brief overview of evolution of the pricing regulation in India
- Highlight some of the key challenges faced by the sector on account of the changing regulatory landscape
- Explain some of the related accounting issues and challenges.

1. Information sourced from the NPPA website www.nppaindia.nic.in

Salient features of DPCO 2013

DPCO 2013 brought about significant changes to the manner of controlling prices of drugs, and is based on three key principles:

- Prices of essential drugs should be controlled. Essentiality of drugs is determined by the inclusion of the drug in the National List of Essential Medicines (NLEM). This is different from the economic criteria/market share principle adopted in the Drug Policy of 1994.
- Only finished medicines are to be considered essential and not the bulk drugs. This is different from the earlier principle of regulating the prices of specified bulk drugs and their formulations adopted in the Drug Policy 1994.
- The regulation of the prices of drugs would be on the basis of regulating the prices of formulations through Market Based Pricing (MBP). This is different from the earlier principle of regulating the prices through Cost Based Pricing (CBP) principle under the Drug Policy 1994.

DPCO 2013 has increased the coverage of price control to 348 essential drugs as in the old era[2]. DPCO 2013 not only increased the number of drugs covered under the price control, it also changed the method of computing the price ceiling from a cost based method in the earlier DPCOs to a market price based method. The price ceiling under DPCO 2013 is fixed on the basis of simple average of the prices of all brands of drugs that have a market share of at least one per cent[3].

DPCO 2013 also increased the stipulated period within which the companies have to implement the new ceiling prices notified from time to time to 45 days from 15 days.[4] Market based price method appears to be a more transparent method of computing the ceiling price.

NPPA - Role and responsibilities in regulating the prices of drugs in the country

For the purpose of implementing the provisions of DPCO, the Government of India established the National Pharmaceutical Pricing Authority (NPPA) in 1997 through notification S.O. 637(E) dated 4 September 1997, and set it up as an attached office of the Department of Chemicals and Petrochemicals. It is responsible for implementing and enforcing the provisions of the DPCO in accordance with the powers delegated to it. NPPA is not only responsible to fix/revise the prices of controlled bulk drugs and formulations, but also to monitor the prices of decontrolled drugs in order to keep them at reasonable levels to help ensure availability of the medicines in the country. It controls and recovers from manufacturers any amounts overcharged by them with respect to the drugs sold in the country.

2. Information sourced from Central Drugs Standards Control Organisation's official website www.cdsco.nic.in and Information sourced from pharmabiz website www.pharmabiz.com
3. Information sourced from the NPPA website www.nppaindia.nic.in
4. Information sourced from the NPPA website www.nppaindia.nic.in

Disputes/litigations

The cost based method of price ceiling, as per the DPCOs prior to DPCO 2013, led to considerable litigation with respect to various aspects of pricing. The total amount of outstanding pricing litigation as per the NPPA website aggregates to INR26,000 million.[5] A lot of these litigations have been ongoing for more than a couple of decades.[5]

The subject matter of these disputes range from:

- classification of the drugs/APIs
- method of computation of cost
- Timely implementation of the revised prices, as notified by the NPPA from time to time.

These disputes are complex and the amounts under dispute are significant in many cases. When evaluating the possible effect on the financial statements, the following considerations are relevant:

- Probability assessment including legal opinions, as appropriate, based on facts of each dispute/litigation to determine appropriate provisions in relation to those disputes
- Assessment of interest liability
- Appropriate disclosures including potential financial consequences.

The prevailing industry practice seems to be to disclose such disputed amounts demanded as contingent liability based on legal advice obtained by them on these matters.

The recent Bombay High Court decision in the case of Indian Drug Manufacturers Association & Ors vs Union of India, followed by the Supreme Court judgement in GSK Vs Union of India dated 9 December 2013 along with the provisions of the DPCO 2013, has challenged the manner in which these disputes/liabilities were looked at previously with respect to disclosure and accounting point of view in the financial statements.

Prior to DPCO 2013, a manufacturer was mandated to ensure that the drugs covered under the price control are available in the market at the new price within 15 days of the price notification. Paragraph 14 (1) of DPCO, 1995 *'Every manufacturer or importer shall carry into effect the price of a bulk drug or formulation, as the case may be, as fixed by the Government from time to time, within fifteen days from the date of notification in the Official Gazette or receipt of the order of the Government in this behalf by such manufacturer or importer.'*

Department of Chemicals and Fertilizer's had clarified (vide circular dated 28 April 1979) under DPCO, 1970, as follows:

'… … … a question has been raised whether the reduction in prices is applicable to all the stocks of such formulations, whether lying with the manufacturers, distributors, dealers, etc. or only to such of the stocks as are cleared after the date of effectuation of reduction. This matter has been examined in consultation with the Ministry of Law, Justice and Company Affairs (Department of Legal Affairs), based on which it is clarified that all reductions in the prices of formulations effected from time to time by the Central Government would be applicable to the stocks cleared on and after the date of effectuation of reduction… … …'

It appears that the prevailing industry practice was to implement the new prices only with respect to the batches manufactured after the price notification. This may be due to impracticability to recall batches from the market that were sold before the price notification. However, NPPA did not agree with the approach of 'recall' practiced by the industry, and consequently became the subject matter of various demands on 'overcharging prices' issued by the NPPA.

Accounting challenges

Liability may need to be assessed

- from the commencement of the Order
- for all instances of overcharging, and not only where NPPA has sent a notice

Sales made at the old price from the date of notification could be a starting data point to determine the liability. In absence of accurate data, inventory in the market on the fifteenth day would be based on estimates.

There are conflicting High Court decisions on whether interest is payable from the date of overcharging or from the date of demand.

The DPCO 2013 states that the batches with the old price in the market will need to be withdrawn and the new prices are to be implemented within the 45 days limit.

Para 13 of the DPCO 2013 reads as *'… … …that in case of scheduled formulations produced or available in the market before the date of notification of ceiling price, the manufacturers shall ensure within a period of forty-five days of the date of such notification that the maximum retail price of such scheduled formulation does not exceed the ceiling price… … … ….'*

In December 2013, the Supreme Court in its judgement in the GSK matter referred to the DPCO 2013 and ruled that under the erstwhile DPCO also the new prices should have been implemented in the market within 15 days of the price notification. The difference between the old price and the new price notified is the excess amount collected on any such drugs sold. Any excess amount collected after the 15 days limit would need to be deposited by the company with the NPPA. We understand that the NPPA has on 8 January 2014 written to the manufacturers' associations instructing the manufacturers to compute their liability with respect to excess amounts collected and suo-moto deposit these amounts with the NPPA. This was followed by a newspaper notice to all the manufacturers to this effect basis which companies are now required to determine and pay liability with respect to overcharging on account of not implementing price notifications within the stipulated time of 15 days.

(http://www.nppaindia.nic.in/order/letter8-1-2014.pdf)

5. Information sourced from the NPPA website www.nppaindia.nic.in

Some of the practical challenges faced by the industry in implementing this ruling and consequent notice by the NPPA are:

a. What should be the time frame with respect to which the liability on overcharging should be computed:
   - Manufacturer has been asked to do a self assessment under the pricing policy 1995 and pay up the overcharged amount with 15 per cent interest.
   - Given that the company may not have adequate data/records to go back up to 1995, whether one can take the stand to assess liability only for the past eight years since it is mandatory to maintain records only up to eight years.
   - Liability needs to be determined not only in cases where notices have been received but the management will need to assess all cases of overcharging even if a notice has not been received.
   - How does this impact any overcharging cases prior to 1995?

b. How should the liability on account of overcharged amounts be computed:
   - Should only the inventory on hand at the old prices be considered ?
   - Should all batches produced at the old price from the date of notification be considered?
   - Should all sales at the old price from the date of notification be considered?
   - How should management make an estimate of the inventory in the market from the effective date?

c. Another pertinent question is whether interest should be accrued on this liability from the date of overcharging i.e., the date of sale of the drugs or from the date of the demand/notice. This is also a subject matter of litigation.

There are following decisions by the High Courts on this matter:

- The Allahabad High Court's decision in the TC Healthcare case held that no interest could be charged prior to the date of the orders, calling upon the petitioner to deposit overcharged amounts
- The Delhi High Court's decision in the Best laboratories and Shimal Investment and Trading Co. held that the liability to pay simple interest arises when a default is committed in making payment of the demanded amount within the time stipulated therein
- There is also the contrary decision in the NR Jet case where the Bombay High Court ruled that 'they become liable to pay interest on the overcharged amount from the date on which they have overcharged the amount'.

The Supreme Court ruling in the GSK case would require companies to assess and provide for the liability arising from instances of overcharging; the approach followed by different companies to determine this liability may differ in practice and will need to be evaluated on a case to case basis. It is clear that this matter requires urgent attention and focus.

Product Recall

An accountant's perspective

This article aims to

- Discuss the accounting treatment of product recall on the financial statements.

Background

The general perception is that a company engaged in manufacturing of a product can never completely rule out the possibility of an inadvertent shipment of a defective product into the market, however, can definitely reduce the probability thereof.

Over the years, while the pharmaceutical industry has experienced product recalls, in the last year in particular, the number of instances have increased.

Product recalls are actions taken by a firm to remove a product from the market either voluntarily or at a regulator's request. There may be different type of product recalls as defined by the relevant regulatory authority of that market. For example – U.S. Food and Drug Administration (U.S. FDA) has classified various type of recalls as below:

- **Class I recall:** a situation in which there is a reasonable probability that the use of or exposure to a violative product will cause serious adverse health consequences or death.
- **Class II recall:** a situation in which use of or exposure to a violative product may cause temporary or medically reversible adverse health consequences or where the probability of serious adverse health consequences is remote.
- **Class III recall:** a situation in which use of or exposure to a violative product is not likely to cause adverse health consequences.
- **Market withdrawal:** occurs when a product has a minor violation that would not be subject to FDA legal action. The company removes the product from the market or corrects the violation. For example, a product removed from the market due to tampering, without evidence of manufacturing or distribution problems would be an example of a market withdrawal.
- **Medical device safety alert:** issued in situations where a medical device may present an unreasonable risk of substantial harm. In some case, these situations are also considered as recalls.

Product recalls if not handled appropriately can impact consumer confidence and thus, business. A recall usually attracts attention in the market place and therefore, certain aspects such as communication between the company/ regulator/the chain of customers, classification of the type of recall, recovery plans, etc. are vital for handling of product recalls appropriately. In this article, we present some of the accounting considerations related to situations of product recalls.

Allowance for sales return or reprocessing cost

Once a product recall is announced, customers start returning the product and the company will likely either refund the consideration collected from the customer or provide replacement/reprocessed product. The company is required to recognise an allowance for the related cost at the time of announcement of product recall and estimation thereof may warrant a detailed analysis of particular facts and circumstances. The estimation process may become more challenging due to the fact that precise data relating to channel inventory (inventory lying in supply chain beyond direct customers of the company) may not be readily available and therefore, a thorough analysis of facts and circumstances plays a critical role in developing such estimates.

Additionally, presentation of this cost in the statement of profit and loss account has generated debate across companies especially regarding whether:

- the selling price should be presented as reduction from revenue with corresponding inventorisation of the returned material at its net realisable value less reprocessing cost, if any, or
- the best estimate of the loss expected to be incurred in respect of sales returns, including any estimated incremental cost necessary to resell the products (expected to be returned), on the basis of available relevant factors, should be presented as a separate expense item in the statement of profit and loss[1].

While the practice followed by the pharmaceutical companies preparing financial statements in accordance with the International Financial Reporting Standards (IFRS) is to choose the first alternative discussed above, from an Indian GAAP perspective, diversity in practice exists for presentation of this cost. As per an Expert Advisory Committee (EAC) opinion issued in March 2012, the provision against expected sales returns is recorded only to the extent of the loss expected to be incurred (and not on full sale price) and thus, the cost of sale and inventories would not be adjusted.

Contractual claims

Customer contracts may contain a clause for reimbursement by the vendor of any loss incurred by the customer due to any supply disruption by the vendor or when the customer substitutes its vendor due to supply disruption (cost differential, if material, is procured from other vendor by the customer due to supply interruptions). This being a contractual claim, recognition of loss is required from accounting perspective when recall is announced and if it is expected that there would be a situation of supply disruption. The estimation of such claims is dependent upon what is the 'expected loss' of the customer due to supply interruption and may pose a challenge in estimating the loss in the financial statements.

Customer claims

Recall of a product where there is a reasonable probability that the use of or exposure to a violative product will cause adverse health consequences or death, may trigger end user claims in the form of class action suits or otherwise. Depending on the probability of the outcome of the legal matter, a provision may be required and thus, again posing a challenge to estimate a particular claim.

Consequential impacts

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

As evident, product recalls may cause significant challenges from accounting perspective in the form of significant estimations, impact beyond sales return and inventory, however, these can be addressed by performing a thorough impact assessment of the event. Further, depending on the type of recall and its impact on the company's business as well as financial statements, product recalls would require due considerations for appropriate disclosures.

1. ICAI Journal, The Chartered Accountant, March 2012

This article aims to

- Highlight an area of current controversy and provide a perspective relating to the tax deductibility of expenses incurred in providing freebies to medical practitioners by pharmaceutical companies

Tax deductibility of expenses incurred in providing freebies to medical practitioners by pharmaceutical and allied health sector industry

Background

There has been a debate on the tax deductibility of expenses incurred in providing freebies to medical practitioners by pharmaceutical and allied health sector industry. This debate has primarily arisen on account of a recent Central Board of Direct Taxes (CBDT) circular wherein it has been specified that such expenditure will not be allowed as a deduction under the provisions of Section 37(1) of the Income-tax Act, 1961 (ITA).

Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002

The CBDT circular relates to the guidelines issued by the Medical Council of India (MCI) which governs the professional code for doctors in India. The MCI issued 'Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002' (MCI Regulations) which stipulates guidelines relating to the professional conduct, etiquette and ethics for registered medical practitioners. The MCI Regulations were made more stringent on 10 December 2009, whereby medical practitioners were not allowed to receive, *inter alia*, any gift, travel facility, hospitality, cash or monetary grant from the pharmaceutical and allied health sector industries.

Expenses claim under the ITA

Section 37(1) of the ITA provides for deduction of any revenue expenditure in the computation of business income if such expense is laid out or expended wholly or exclusively for the purpose of business or profession.

However, as per *Explanation* to Section 37(1) of the ITA, claim of any such expense shall not be allowed, if the same has been incurred for a purpose, which is either an offence or prohibited by law.

Taxman issues a circular disallowing expenditure incurred on medical freebies

The CBDT issued a circular on 1 August 2012 stating that the claim of any expense for providing any gift, travel facility, hospitality, cash or monetary grant or similar freebies to medical practitioners in violation of the provisions of the MCI Regulations shall be inadmissible expenditure under Section 37(1) of the ITA, being an expense prohibited by law. This disallowance shall be made in the hands of the assessee which is engaged in pharmaceutical or allied health sector industry.

The CBDT also stated that the sum equivalent to the value of freebies enjoyed by the aforesaid medical practitioner or professional associations would be taxable in the hands of the medical practitioners as 'business income' or 'income from other sources', as the case may be depending on the facts of each case.

The Himachal Pradesh High Court upholds the validity of the CBDT circular

Pursuant to the CBDT circular, the Confederation of Indian Pharmaceutical Industry (an apex body of small-scale manufacturers of drugs and pharmaceuticals in the country) filed a writ petition in the Himachal Pradesh High Court challenging the validity of the CBDT circular.

The Himachal High Court held that the MCI Regulations are statutory regulations which are issued in the interest of patients and the public[1].

The Court observed that there has been an increase in the number of complaints that the medical practitioners do not prescribe generic medicines and prescribe branded medicines only in lieu of the gifts and other freebies granted to them by some pharmaceutical industries.

It accordingly upheld the validity of the CBDT circular and held that any act prohibited by the MCI regulations would amount to an act prohibited by law.

The Court also held that if the assessee satisfies the assessing authority that the expenditure is not in violation of the regulations framed by the Medical Council, then it may claim a deduction for such expenses.

An alternate view

As per an alternate view canvassed by the industry, it is believed that the expenditure incurred in providing medical freebies to medical practitioners are allowable as a deduction on account of the following line of reasoning:

- The MCI Regulations are applicable only to the doctors and their professional associations, and have no relevance or force of law to the pharmaceutical companies. In other words, the said Regulations are binding only on the medical practitioners and not on the pharmaceutical companies. Accordingly, the MCI Regulations should not be regarded as a 'law' as far as the pharmaceutical companies are concerned and hence, the expenses incurred by the pharmaceutical companies can not be disallowed under Section 37(1) of the ITA
- The CBDT circular is binding on the tax authorities only and not mandatory for the assesses, and accordingly it is possible for the assessee to make claims to the contrary.

It appears that this matter can only be settled by the Supreme Court of India or through an explicit amendment in the ITA. Till then, there remains a risk of increased investigation by the revenue officials during the course of an assessment proceeding and resultant litigation. Depending upon the facts, there is also a risk of reopening of the completed assessment (as per the provisions prescribed under the ITA), with attendant risk of consequent tax/interest demands and initiation of penalty proceedings.

In light of these developments, companies need to evaluate the stand taken for the purpose of advance tax, tax provisioning in books of accounts and disclosure in the tax audit report (i.e., Form 3CD) prescribed in the Income-tax Rules, 1962. They will also need to evaluate, depending upon the facts, whether withholding tax under Section 194J of the ITA is applicable while providing any medical freebies to doctors and consequential applicability of Section 40 (a)(ia) of the ITA.

It also appears that the above debate in the context of Section 37(1) of the ITA may not impact the calculation of 'book profit' under Section 115JB of the ITA in absence of explicit provisions in Section 115JB which seek to disallow expenses incurred for any purpose which is an offence or which is prohibited by law (unlike *Explanation* to Section 37(1) of the ITA).

1. Himachal Pradesh High Court decision (CWP No. 10793 of 2012-J.)

Accounting for ESOP Trust by a listed company

EAC opinion

This article aims to

- Explain the accounting treatment of employee stock option plan trusts in the stand-alone financial statements of a listed company based on a recent EAC opinion.

Generally, companies administer employee stock option plans (ESOP) to their employees through ESOP trusts created for this purpose. Currently, in India there are two sets of accounting guidance available for accounting for ESOPs. One is issued by the Institute of Chartered Accountants of India (ICAI) - 'Guidance Note on Accounting for Employee Share-based Payments' (guidance note) in 2005, and other issued by the Securities and Exchange Board of India (SEBI) - SEBI (Employee Stock Option Scheme (ESOS) and Employee Stock Purchase Scheme (ESPS)) Guidelines in 1999 (SEBI guidelines) to be followed by listed companies. The guidance note and the SEBI guidelines differ in certain aspects and one such area of accounting is ESOP schemes administered through a trust.

The guidance note recommends that for the purpose of preparing consolidated financial statements the trust created for the purpose of administering employee share-based compensation, should not be considered for consolidation. According to the guidance note, the nature of a trust established for administering ESOP scheme is similar to that of a gratuity trust or a provident fund trust as it does not provide any economic benefit to the enterprise in the form of, say, any return of investment. The SEBI guidelines, on the other hand, recommend that the financial statements of a company shall be prepared as if the company itself were administering the ESOS/ ESPS.

Recently, by way of an EAC opinion, the Expert Advisory Committee (EAC)[1] of the ICAI has clarified the accounting treatment in relation to 'consolidation of an ESOP trust in the stand-alone financial statements of a listed company'. Additionally, the EAC has clarified related guidance on:

1. Manner of presentation/disclosure of company's shares held by the trust in the stand-alone financial statements of the company
2. Consideration of investment in own shares for the purpose of calculating Earnings per share (EPS)
3. Accounting treatment to be followed in financial statements prepared as per section 44AB of the Income-tax Act, 1961.

1. EAC Opinion issued in the ICAI Journal, The Chartered Accountant, March 2014

Brief facts of the case

a. A listed company (Co.) in India issued an employee stock option (ESOP) scheme

b. The Co. established an ESOP trust

c. The trust obtains funds through a loan from the company to purchase Co.'s shares

d. Co. makes a fresh allotment of shares for the trust to purchase shares

e. The trust allocates shares to employees on exercise of their right, in exchange of cash, and repays loans to the company

f. The Co. prepares Indian GAAP stand-alone financial statements.

Consolidation of an ESOP trust in the stand-alone financial statements of a listed company

The EAC has clarified that:

a. In case of listed companies, if there are certain differences between the guidance provided by the ICAI guidance note and the related SEBI guidelines, then to the extent the requirements of the SEBI guidelines differ from the guidance note, the SEBI guidelines will prevail.

b. The stand-alone financial statements of the listed company should portray the picture as if the company itself is administering the ESOP Scheme, i.e.:

- The Co. should recognise the expense arising from the ESOP scheme
- The operations of the ESOP trust should be included in stand-alone financial statements of the Co. in so far as the ESOP is concerned
- Loans to the ESOP trust appearing in the books of the Co. should be eliminated against loan from the Co. as appearing in the books of the ESOP trust.

Manner of presentation/ disclosure of Co.'s shares held by the trust in the stand-alone financial statements of the Co.

The EAC has clarified that:

- The amount representing the grant date intrinsic value of the options yet to be exercised by the employees should be disclosed as 'shares held in trust for employees under ESOP scheme'
- Further, this amount should be presented as a deduction from share capital to the extent of face value of the shares and securities premium for excess amount exceeding the face value of shares
- The Co. should give a suitable note in the notes to accounts to explain the nature of this deduction.

Calculation of basic and diluted earnings per share (EPS)

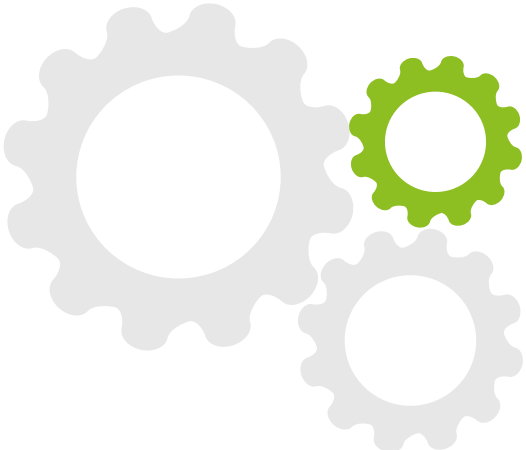
The EAC has clarified that:

- Basic EPS: For the purpose of calculating basic EPS in the stand-alone financial statements of the Co., shares allotted to the ESOP trust should be included in the shares outstanding, only when the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions
- Diluted EPS: For the purpose of calculating diluted EPS, the shares allotted to ESOP trust are treated as potential equity shares (even if the requisite vesting conditions are not fulfilled) provided their impact is dilutive.

Accounting treatment to be followed in financial statements prepared as per Section 44AB of the Income-tax Act, 1961

In the case discussed by the EAC, the Co. followed calendar year as its accounting year and hence, was required to prepare financial statements for the financial year for tax audit purposes. The query was raised whether the Co. should follow the ICAI guidance note or the SEBI guidelines for preparing financial statements prepared as per Section 44AB of the Income-tax Act, 1961.

The EAC opined that the Co. needs to follow the Companies (Accounting Standards) Rules, 2006 issued by the Ministry of Corporate Affairs on 7 December 2006. The Co. needs to also follow the SEBI guidelines while the ICAI guidance note should only be followed in respect of matters not addressed in the SEBI guidelines, provided it is not inconsistent with the SEBI guidelines. For preparing financial statements for audit under Section 44AB of the Income-tax Act, 1961, the EAC has guided that the Co. should follow the same accounting policies and accounting standards which the Co. has used for preparation of its annual accounts that were laid at the annual general meeting of the Co. under the Companies Act.



IFRS 10

impact on the real estate industry

This article aims to

- Explain the impact of IFRS 10 on the real estate industry.

The Institute of Chartered Accountants of India (ICAI) recently issued draft Ind-AS 110 corresponding to the new/revised IFRS 10, *Consolidated Financial Statements* issued by the International Accounting Standards Board (IASB). The Ind-AS is similar to IFRS 10 with the exception that the Ind-AS does not contain provision relating to exemption from preparation of consolidated financial statements. This has been left to be governed by the Companies Act, 2013 and the SEBI regulations.

The new standard on consolidation significantly increases the responsibility on the reporting entities to make and disclose the judgement for consolidation of entities. This article briefly discusses the new requirements brought about by IFRS 10 and its impact on the real estate industry (excluding real estate funds).

A brief take on IFRS 10

IFRS 10 was issued by the IASB in May 2011 together with amended IAS 27 *Separate Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*. These standards are effective for annual periods beginning on or after 1 January 2013 and must be applied retrospectively, subject to certain transition rules.

IFRS 10 introduces a new definition of control that will determine which entities are to be consolidated. Previously, IFRS had two consolidation models – one for special purpose entities (SIC 12) and another for all other investees (IAS 27). With the advent of IFRS 10, there will only be a single control model where the investor would consolidate an investee only when it has power, exposure to variability in returns and a linkage between the two.

This new definition of control may significantly impact the composition of financial statements. One of the highly impacted industries is most likely the real estate industry which has complex group structures, special purpose vehicles created for individual projects, significant related party transactions and complex contractual arrangements.

The application of IFRS 10 could mean that the real estate companies may have to re-evaluate all their investments which may result in consolidation which were hitherto not consolidated under the consolidation standards and deconsolidation of certain investments which do not fall under the new definition of control.

Determination of control

IFRS 10 uses a single control model and places an emphasis on the following three elements to determine if the investor controls the investee:

- Power over the Investee
- exposure, or rights, to variable returns
- the ability to use its power over the investee to affect the amount of the investor's returns

Criteria for Assessing Control

Power over the investee

IFRS 10 defines power as having existing rights that give the investor the current ability to direct the relevant activities, which significantly affects the investee's returns. An assessment if an investor has power over an investee can become complex and significant judgement may need to be exercised. The standard provides detailed application guidance on such assessments and clearly states that only substantive rights need to be considered to determine if the investor has power over the investee. Some of the examples of rights that may give an investor power over an investee, may include

- Voting rights or substantive potential voting rights of an investee
- Appointing, remunerating and terminating key management personnel who have the ability to direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities as an agent
- Rights to direct the investee to enter into a significant transaction for the benefit of the investor
- Rights arising from other contractual arrangements, including an agreement with other vote holders that give the investor the ability to direct the relevant activities.

Exposure, or rights, to variable returns

IFRS 10 states that variable returns are returns that are not fixed and have the potential to vary as a result of the performance of the investee. The investor will need to assess whether returns from the investee are variable and how variable those returns are on the basis of the substance of the arrangement and regardless of its legal form.

The standard provides examples of returns which include:

- Dividends, other distributions of economic benefit and changes in the value of the investor's investment in that investee
- Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation, tax benefits, and access to future liquidity that an investor has from its involvement with an investee
- Returns that are not available to other interest holders.

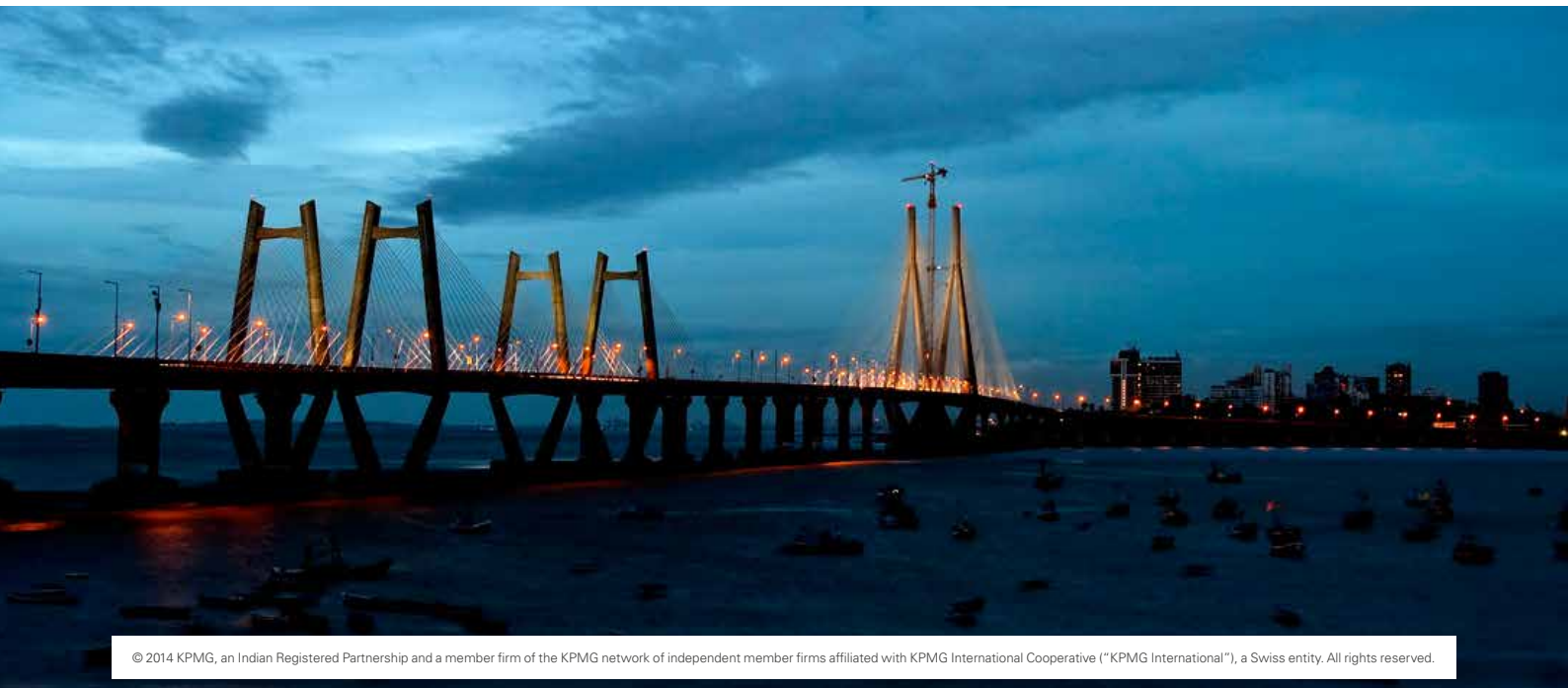
Link between power and returns

In order to determine if the investor has control over the investee, it will need to assess the link between the power and the returns. The determination would involve assessing if the investor has the ability to use its power to affect the investor's returns from its involvement with the investee. An important consideration in this assessment would be to determine if the investor has a principal or agent relationship with the investee. Some of the factors that need to be considered under this assessment are:

- the scope of its decision-making authority over the investee
- the rights held by other parties
- the remuneration to which it is entitled in accordance with the remuneration agreement.

Ind-AS 110 replicates the provisions of IFRS 10 with respect to the determination of control and the consolidation procedures.

Real estate groups will need to evaluate their investments in entities - regardless of whether it has majority voting rights or not and their involvement in special purpose vehicles. IFRS 10 envisages scenarios of consolidation even in cases where there is less than majority voting rights but there is exposure to variability of returns of the investee subject to the definition of control being fulfilled. The following section discusses certain scenarios relevant to the real estate industry where IFRS 10 application can be challenging.



Captive power generators

The real estate industry is under continuous innovation to improve profitability. Vertical integration is one of the strategies adopted by major players to cut costs and consolidate their position in the market. Say, a company has developed a property and wants to ensure continuous power supply to the property; the company could contract with an existing power generator for purchase of power. The local regulation may require the company to hold a certain percentage of equity in the generator to qualify the power generator as a captive power generator. It is also not uncommon that the company finances the expansion of the power generator to meet the power needs of the property being developed by the company.

Such arrangements call for a detailed review of the relationship the company has with the power generator to evaluate whether the company controls the power generator.

The factors to consider in the evaluation of whether the company has power over the power generator include the voting rights the company is entitled to, the contractual rights of the company over the relevant activities of the power generator as per the power purchase agreement/ shareholders' agreement with the power generator. The focus is to evaluate whether the company has the current ability to direct the relevant activity of the power generator.

The financial support, if any, extended by the company will need to be evaluated under the lens of exposure to variability of returns from the power generator. The greater the level of financial support and greater the exposure to variability of returns, the more likely it is that the company has more than protective rights over the power generator.

Investment properties as silos

An investor should evaluate whether independently leased out properties of an entity that may be collateralised with a debt can be considered as a silo. Say a company owns several properties that have been leased out to various companies. The company has financed the construction of the property with various loans with recourse only to the respective property developed with the borrowed funds. The lessee will need to evaluate whether the leased property can be considered as a silo within the company for further evaluation under IFRS 10 for consolidation. The situation becomes more complex when the lessee has provided a residual value guarantee or has a fixed purchase price option.

Should the lessee conclude that the silo needs to be consolidated based on the principles laid out in IFRS 10, other challenges related to consolidation will emerge. Ascertaining the relevant financial balances of the silo (carving out) will be the first practical issue the lessee will have to deal with among others.

Involvement of strategic operating partners

It is not uncommon for companies with different competencies to partner together for development and maintenance of properties (e.g., a partner for construction of the properties and another for the marketing and on-going maintenance of the property). In such arrangements, there may be more than one activity of the company that significantly affects the partners' returns. When there are multiple activities that affect significantly the returns of the partners, and these activities are directed by different partners, it is important to determine which of the activities most significantly affect the partners' return. It is likely that one activity may be directed by the voting rights which are held by a partner while the other activity may be directed through a contract by different partners.

Significant judgement is involved in ascertaining which among the multiple activities is the relevant activity. The partner that has power over that relevant activity would then consolidate the company. This situation and determination differs from a scenario of joint control, which is defined as the contractually agreed sharing of control and requires unanimous consent of the parties sharing control for decisions about the relevant activities.

Agency in structured entities

To comply with local state regulations on ceiling on land holdings, real estate companies may hold land in other entities (special purpose vehicles (SPV)), whose shareholder could be relatives of the sponsors/promoters or employees of the company. Such SPVs carry on real estate operations. The current consolidation framework in India does not cover such arrangements for consolidation as the real estate company has no share holding. Hence, such SPVs do not get consolidated.

Under IFRS 10, the real estate company will need to evaluate whether the shareholders of the SPV are acting as agents of the real estate company despite there being no direct ownership of equity. A similar challenging situation arises where two real estate companies controlled by different family members/ relatives have significant inter-company transactions.

Other situations meriting careful consideration

Following are certain other aspects that require careful consideration:

- The terms of a joint development arrangement with contractual rights given to the land owner and developer.
- Evaluation of long term arrangements with suppliers. Normally, a routine supplier arrangement would not mean that the supplier is a de facto agent of the customer, even if the supplier only sells its products/services only to one customer. This is because the customer would not have any control over the relevant activities of the supplier as it is controlled by the suppliers' shareholders. However, arrangements with any special rights attached which offers control or exposes the customer to variability of returns of the supplier will need to be closely looked at from the stand point of IFRS 10.
- In 2012, the IFRS 10 was amended to provide an exemption from consolidation for investment entities that are required to measure investments at fair value through profit or loss. The corporate structure of certain real estate groups may need to be closely evaluated. The ultimate holding company which often only holds investments in operating real estate companies, such corporate structures being created as a part of externalisation event for strategic sale or with an initial public offering in mind, may not qualify for exemption from preparing consolidated financial statements as an investment entity.

In conclusion

While the Ind-AS 110 is still in draft, the application of its principles could have far reaching impacts on the real estate industry. The increasing complexity in group structures and transactions result in management judgement playing a significant role in drawing conclusions under Ind-AS 110 or IFRS 10. This application of judgement for concluding whether an entity needs to be consolidated or not will also need to be disclosed in the financial statements regardless of what the final conclusion on consolidation is. Many entities may even consider modifying arrangements that currently exist if they lead to unintended or unwanted consolidation related conclusions.

EU audit reforms

This article aims to

- Summarise the requirements of the amended EU directive relating to statutory audits of public-interest entities in the EU.

On 3 April 2014, the European Parliament adopted in a plenary session, the amended Directive on Statutory Audit and the Regulation on specific requirements regarding the statutory audit of public-interest entities (PIEs)[1].

This audit package has been formally adopted by the Council of Ministers on 14 April 2014[2].

The legislation has been published in the Official Journal of the European Communities on 27 May 2014. The Regulation will enter into force 20 days after publication in the Official Journal i.e. from 16 June 2014. The 28 Member States of the EU will than have a two year transition period to adapt their national laws from 17 June 2016[3].

1. European Commission Statement/14/104 dated 3 April 2014 and European Commission Memo/14/256 – Reform of the EU Statutory Audit Market – Frequently Asked Questions dated 3 April 2014
2. Press release by Council of The European Union 14 April 2014
3. Official Journal of the European Union, Volume 57, dated 27 May 2014

Background to the EU audit reforms[4]

The European Commission (EC) had issued a Green Paper on Audit Policy in October 2010 in response to the financial crisis, in which the EC questioned whether the role of auditors can be enhanced to mitigate any future financial risk and initiated a consultation process. The financial crisis highlighted that a number of banks had been given clean unqualified audit reports despite huge losses. The Green Paper identified a number of areas which the EC identified as a cause of concern. In particular, it identified 'relevance of audit' and 'expectation gap' between users' expectations from statutory auditors and what statutory auditors are bound to deliver.

In response to this, in December 2011, the EC submitted two proposals for consideration by the European Parliament and the Council of Member States on:

1. A revision of the existing Audit Directive
2. A regulation on specific requirements regarding statutory audit of PIEs.

The two texts were negotiated under the ordinary legislative procedure. The European Parliament and the Member States reached a preliminary agreement on compromised texts on 17 December 2013.

Key elements of the legislation

Through the EU audit reforms, the EC expects to improve audit quality and restore investor confidence in financial information. The main objectives of the reform include:

- Further clarify the role of the statutory auditor
- Reinforce the independence and the professional skepticism of the statutory auditor
- Facilitate the cross-border provision of statutory audit services in the EU
- Contribute to a more dynamic audit market in the EU
- Improve the supervision of statutory auditors and the coordination of audit supervision by competent authorities in the EU.

The main features of the legislation include:

Scope of the legislation

The legislation affects the statutory audits of PIEs. PIEs definition capture all EU entities, irrespective of size that (i) have securities listed on a regulated market, are (ii) credit institutions, or (iii) insurance undertakings.

Member States may also expand the PIE definition to include other entities depending on the nature of their business, their size or the number of their employees.

The reforms are expected to impact thousands of entities throughout Europe and have an extraterritorial dimension for multinational groups. Subsidiaries that meet the definition of a PIE would be affected by the regulation irrespective of whether they have an EU or non-EU parent.

Mandatory rotation of statutory auditors of PIEs

PIEs would be required to change their statutory auditors or their audit firms every ten years as a maximum. Member States may establish shorter rotation periods (e.g., Italy and the Netherlands will be able to retain their existing rotation requirements of nine years and eight years respectively).

Member states also have the option to allow PIEs to extend the rotation period (i) by an additional ten years upon tender (maximum period 20 years), or (ii) by additional 14 years in the case of joint audit (maximum period 24 years).

Non-EU groups that have an EU based PIE in their group structure will be required to rotate the auditors of those subsidiaries.

Non-audit services (NAS)

The legislation introduces a list of non-audit services that statutory auditors and audit firms (including members of the statutory auditor's network) will not be able to provide to the PIE (audited entity), to its EU parent undertaking and to its controlled undertakings within the EU.

Examples of non-audit services that have been prohibited include, inter alia, tax compliance, tax advice, corporate finance and valuation services. An option is provided to Member States to allow certain tax and valuation services on conditions that they do not have a direct effect on the financial statements or, if they do, that the effect is immaterial. Member States also have the possibility of prohibiting more non-audit services than those covered in the legislation.

The prohibition also extend to the financial year immediately preceding the appointment of the statutory auditor ('clean period') with regard to designing and implementing internal control or risk procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems.

The legislation establishes that when a statutory auditor or an audit firm has been providing non-audit services to the audited PIE for a period of three or more consecutive financial years, the total fees for such services shall be limited to a maximum of 70 per cent of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertaking, of its controlled undertaking and of the consolidated financial statements of that group of undertakings.

All calculations for the cap need to be done at group level i.e., they need to take into account not only the audited entity but also, where applicable, its parent undertaking, its controlled undertakings and the consolidated financial statements of that group of undertakings.

Member States have the option to apply a cap that is lower than 70 per cent.

The prohibitions of the legislation are far more extensive than the rules currently in place in many EU member states and go well beyond the international independence requirements in the International Ethics Standards Boards for Accountants' code or indeed the Securities and Exchange Commission's independence rules in the U.S.

4. European Commission's Green paper - Audit Policy: Lessons from the Crisis dated 13 October 2010; European Commission's Proposal for a Regulation of the European Parliament and of the council on specific requirements regarding statutory audit of public-interest entities dated 30 November 2011; European Commission's Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts dated 30 November 2011

Audit committees

The audit committee would play a direct role in the appointment of the statutory auditor or the audit firm. It will also monitor the statutory audit, as well as the performance and independence of the statutory auditor. Audit committee would approve all permissible non-audit services after having assessed the threats and safeguards to the auditor independence.

The legislation also requires that the auditor submits an additional report to the audit committee explaining the results of the statutory audit, including for instance on the methodology used, on possible significant deficiencies identified in the internal control system, on the valuation methods applied, etc.

Member States have the option to set additional requirements in relation to the content of the additional report to the audit committee.

Auditor reporting to shareholders

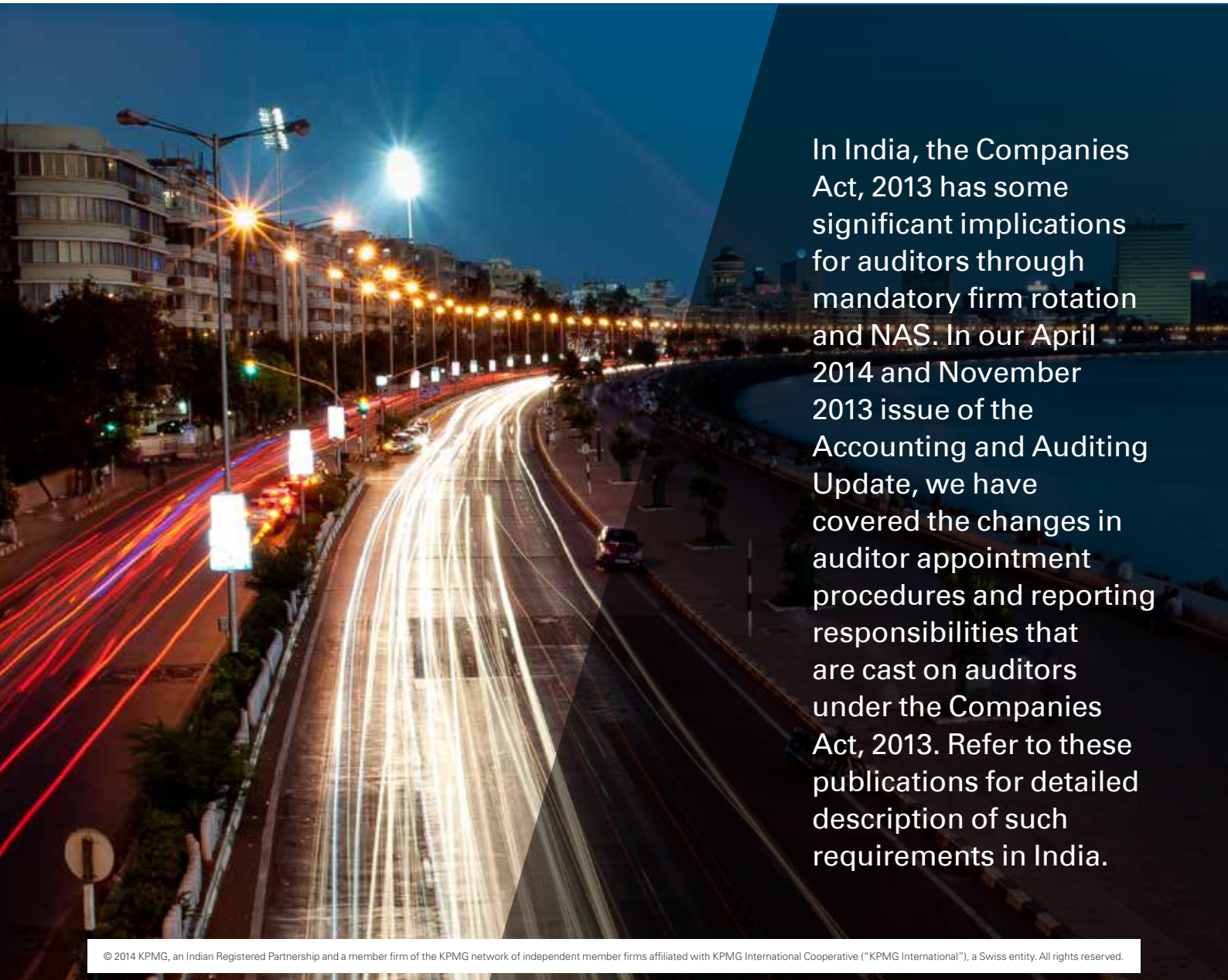
The legislation expands auditor reporting requirements in order to enhance shareholders' understanding of the audit process including critical judgements made during audit.

International Standards of Auditing (ISA)

Both the amended Directive and the Regulation empower EC to adopt the ISAs via delegated acts. While ISAs are already in force in some Member States, their adoption at EU level will help foster a level playing field and avoid any possible fragmentation.

Transition arrangements

There are specific transitional provisions for the mandatory audit firm rotation requirements which come into effect progressively starting with long tenure audit engagement of 20 years or more: these have a six year transition period from the date of the legislation coming into force. PIEs will therefore be required to change their auditors no later than 17 June 2020 on such engagements. Where the audit engagement tenure is less than 20 years but greater than 11 years, from 17 June 2023 the auditor could not be reappointed (nine-year transition). However, if audit engagement tenure is less than 11 years, then there seems to be some uncertainty regarding the interpretation of the rules with regards to this tranche.



In India, the Companies Act, 2013 has some significant implications for auditors through mandatory firm rotation and NAS. In our April 2014 and November 2013 issue of the Accounting and Auditing Update, we have covered the changes in auditor appointment procedures and reporting responsibilities that are cast on auditors under the Companies Act, 2013. Refer to these publications for detailed description of such requirements in India.

Stock **compensation**

When performance target could be achieved after the requisite service period

This article aims to

- Discuss the accounting treatment of employees share-based payments in which the terms of the award provide that the performance target could be achieved after the requisite service period under US GAAP

Companies compensate, retain and attract employees by issuing various employee stock option plans (share-based payment awards) to them.

ASC 718, *Compensation-Stock Compensation* (Topic 718) sets accounting requirements for share-based payment awards to employees, including employee share purchase plans (ESPPs). Topic 718 requires companies to recognise compensation cost of share-based payments based on the fair value of the award to employees. The classification of an award as equity or liability is an important factor which needs to be considered in the accounting for share-based payment arrangements because the type of classification (equity or liability) affects the measurement of the compensation cost recognised in the books. Awards which are classified as a liability are re-measured to fair value at each balance sheet date until the award is settled, whereas awards which are classified as equity are measured at grant-date fair value and are not subsequently re-measured.

A company may issue share-based payment awards that require a specific performance target to be met/achieved in order for the employees to benefit from the awards. The performance target may include attaining a specified profitability metric by the company or selling shares in an initial public offering (IPO). Generally, an award which is linked to a performance target also requires the employee to be in service until the performance target is achieved. However, in some cases, the terms of the award may provide that the performance target could be achieved after the employee completes the specified service period. For example, an award can include a performance target which depends on the company completing an IPO whereby even the former employees of the company are entitled to the award if the IPO takes place. In other words, the employee would still be entitled to the award, notwithstanding the fact that he is not in service on the date of achievement of the performance target.

Currently U.S. GAAP does not provide guidance on how to account for such share-based payment awards i.e., whether to treat the performance target mentioned above as a performance condition that affects vesting or not. Topic 718 states that a condition meets the definition of a performance condition only if the employee provides service to the employer for a specified period of time. However, Topic 718 does not specify that the employee must be rendering service when the performance target is achieved.

FASB's Emerging Issues Task Force (Task Force) discussed this matter (issue 13-D) at its 13 September 2013 meeting, where they contemplated alternative approaches and their merits from the point of view of measurement and timing of compensation expense. Our February 2014 issue of the Accounting and Auditing update covered the discussion of the Task Force at its 13 September 2013 meeting. At that meeting, the Task Force had agreed to issue a consensus-for exposure based on the performance condition approach, and the matter was to be taken up for further discussion at its 13 March 2014 meeting.

At the meeting held on 13 March 2014 the Task Force reached a final consensus that a performance target that could be achieved after the requisite service period should be treated as a performance condition that affects vesting, rather than a condition that affects the grant-date fair value. Hence, under this consensus, a company would not record compensation expense (measured as of the grant date without consideration of the effect of the performance target) related to an award for which transfer to the employee is contingent on the company's satisfaction of a performance target, until it becomes probable that the performance target will be met.

At its meeting on 26 March 2014, the FASB ratified the Task Force consensus on Issue No.13-D, 'Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period' and will release it soon as an Accounting Standards Update (ASU).

Disclosures and effective date:

The Task Force confirmed that no new disclosures will be required under this guidance, however, transition disclosures related to a change in accounting principles need to be considered. The total amount of compensation cost recognised during and after the requisite service period would reflect the number of awards that are expected to vest and would be adjusted to reflect those awards that ultimately vest.

This guidance will be effective for all entities for reporting periods (including interim periods) beginning after 15 December 2015. Early adoption is permitted. Entities will have the option of applying the guidance either prospectively (i.e., only to awards granted or modified on or after the effective date of the guidance) or retrospectively.

However, retrospective application would only apply to awards with performance targets outstanding at or after the beginning of the earliest presented comparative period by recording cumulative-effect adjustment in that period. A modified retrospective approach instead of a full retrospective approach has been recommended, hindsight accounting would be permitted so as to operationalise the approach.

Regulatory **updates**

Manner of reporting by the auditors with respect to deferred tax liability on special reserve created under Section 36(1)(viii) of the Income Tax Act, 1961

In December 2013, the Reserve Bank of India (RBI) had clarified that it is mandatory for the banks to create a deferred tax liability (DTL) as per AS 22, *Accounting for taxes on Income* on the special reserve created by them as per Section 36(1) (viii) of the Income Tax Act, 1961 even if these banks do not intend to withdraw from such reserve in future.

In this regard, the RBI had also prescribed the accounting treatment to be followed by the banks and had stated that if the expenditure due to the creation of DTL on special reserve as at 31 March 2013 has not been fully charged to the Statement of Profit and Loss, the banks may adjust such amount directly from reserves along with appropriate disclosures in the notes to the accounts to the financial statements for the financial year 2013-14. Further, for financial years ending on or after 31 March 2014, the amount of DTL on special reserve should be charged to the Statement of Profit and Loss of the respective year.

The Institute of Chartered Accountants of India (ICAI) reviewed the matter and re-iterated that in case any accounting treatment prescribed by a regulator is different from the respective treatment under the accounting standards, then the accounting treatment prescribed by the regulator should be followed.

In the present case, the ICAI noted that the adjustment of the entire amount of DTL as at 31 March 2013 from reserves, which was not provided for in prior years, is not in accordance with the accounting standards. However, since such treatment is in accordance with the prescribed accounting treatment by the regulator, then the auditor need not modify their audit opinion in respect of such prescribed accounting treatment. However, the fact may be brought about in the auditor's report by way of an 'emphasis of matter (EOM)' paragraph in accordance with the Standard on Auditing, 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, provided such prescribed accounting treatment along with quantification of the amount is disclosed in the notes to the accounts. The ICAI has also issued an illustrative EOM paragraph and illustrative notes to accounts in this regard.

[Source: ICAI Announcement dated 30 April 2014]

Approach paper on draft SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2014

On 5 May 2014, the Securities and Exchange Board of India (SEBI) has released the draft listing regulations (draft regulations). Through these draft regulations, the SEBI aims to maintain a single document encompassing all the substantive requirements and enabling provisions of the present listing agreement. The draft guidelines incorporate the provisions of the Companies Act, 2013 which have been notified and the requirements of the amended clause 49 as well. It has been clarified that the proposed amendments to clause 41 will be incorporated in these guidelines once those are finalised.

Procedural requirements have been specified separately through schedules and certain provisions have been re-arranged depending on timing and frequency of disclosures to be made. Further, the formats for the disclosure requirements will be prescribed separately.

In this regard, the SEBI has also released a summary of the major new provisions and other substantial changes incorporated in the draft guidelines.

[Source: SEBI's announcement dated 5 May 2014]

Premium recognition for variable insurance products

The Insurance Regulatory and Development Authority (IRDA) vide regulations issued in February 2013 had permitted life insurance companies to come up with variable insurance products, which could be issued in both, linked as well as non linked formats.

In order to bring uniformity in the accounting principles relating to the timing for recognition of income for variable insurance products and to align the treatment with the method used for the purpose of actuarial valuation for such products, the Insurance Regulatory and Development Authority (IRDA) has clarified that:

- In respect of unit linked variable insurance products, the premium should be recognised on the date of creation of units
- In respect of non-linked variable insurance products, the premium should be recognised on the date of the receipt.

IRDA has advised all insurance companies to comply with these clarifications.

[Source: IRDA/F&A/Cir/ACTS/118/04/2014 dated 28 April 2014]

Revision in the rules on creation of Debenture Redemption Reserve (DRR)

The Companies (Share Capital and Debentures) Rules, 2014 (Rules) issued by the Ministry of Corporate Affairs (MCA) on 27 March 2014, required companies to create DRR equivalent to at least 50 per cent of the amount raised through the debenture issue. However, the rules published in the Official Gazette which are effective from 1 April 2014 have exempted certain class of companies from creation of the DRR and in case of other companies, reduced the percentage for creation of DRR from 50 per cent to 25 per cent of the value of debentures.

Read KPMG's First Notes dated 19 May 2014 which provides a detailed overview of this change.

[Source: Companies (Share Capital and Debentures) Rules, 2014 as published in the Official Gazette]

Providing for unhedged foreign currency exposures – RBI's clarification

On 15 January 2014, the RBI had issued guidelines on 'Capital and provisioning requirements for exposures to entities with unhedged foreign currency exposure'. These guidelines were applicable from 1 April 2014. The guidelines included the methodology to be followed for calculating incremental provisioning and capital requirements for bank exposures to entities with unhedged foreign currency exposures.

Considering the hardship faced by the banks, the RBI has provided clarifications on these guidelines. The clarifications, inter-alia, include:

- Quarterly data from corporates may be used on a self-certification basis, subject to an annual certification by the statutory auditors
- USD-INR annualised volatility to be provided by Foreign Exchange Dealers' Association of India (FEDAI) to ensure consistency
- In case of unavailability of the audited results of the last quarter to determine Earnings before interest and depreciation (EBID) which is required to be compared with the likely loss on account of exchange rate movements, latest available audited quarterly or yearly results should be considered. This is relevant for private/unlisted companies
- Exclusion of inter-bank exposures from the scope of the guidelines
- Action to be taken in case corporates do not provide the required data in a timely manner

Also read KPMG's First Notes dated 5 June 2014 which provides details of the clarifications issued by the RBI.

[Source: RBI/2013-14/620 dated 3 June 2014]

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Introducing Voices on Reporting

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

In our call this month, we provided practical insights on steps that companies are taking in implementing the requirements under the Companies Act, 2013 that are now effective. We also discussed the key changes that were made in the gazetted version of the rules.

Additionally, we discussed the recent opinion issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on accounting for 'principal only currency swaps' as well as cover a clarification issued by the ICAI with respect to creation of deferred tax liability on 'special reserves' created by banks. Further, we briefly touched upon the proposed new roadmap for adoption of Ind-AS.

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

The lead article of our May 2014 Accounting and Auditing Update focusses on the Transport and Logistics sector and highlights some of the key revenue recognition issues faced by the sector. This month we also examine practical issues relating to dry docking expenditure. We also focus on some of the accounting and reporting implications of typical structures and investments by venture capital/private equity type investors under Indian GAAP and IFRS.

We also cover important developments relating to permissibility of following pushdown accounting in private companies and the accounting for income taxes in certain situations under U.S.GAAP. Finally, in addition to our round up on key regulatory developments during the recent past, we highlight how factoring arrangements are accounted for under Indian GAAP and IFRS.

The RBI clarifies certain provisions of unhedged foreign currency exposure guidelines

The Reserve Bank of India (RBI) on 15 January 2014 issued 'Capital and provisioning requirements for exposures to entities with unhedged foreign currency exposure' ('guidelines'). These guidelines, effective from 1 April 2014, prescribed the methodology to be followed for calculating incremental provisioning and capital requirements for bank exposures to entities with unhedged foreign currency exposures.

RBI vide notification dated 3 June 2014 has provided certain clarifications on these guidelines.

Our First Notes provides an overview of the clarifications provided by the RBI.

Back issues are available to download from: www.kpmg.com/in

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