Accounting and Auditing Update

In This Edition

Consumer markets and Ind AS  p01
Conversation with V. Srinivasan  p05
Foreign Direct Investment in the retail sector  p09
Consumer market – Embroiled by the Advertisement, Marketing and Promotion issue  p13
Liquor industry in India  p17
Fraud in the consumer markets sector  p23
Internal financial controls  p27
Regulatory updates  p31
In continuation with our current series of the Accounting and Auditing Update, this month’s edition focusses on the consumer markets sector.

The Indian Accounting Standards (Ind AS) largely converged with the International Financial Reporting Standards (IFRS) are bringing about a paradigm shift in financial reporting in India. This sector faces a significant impact in two main areas – revenue recognition and the consideration of embedded leases, which this publication seeks to highlight.

Our Accounting and Auditing Update also carries an interview with Mr. V. Srinivasan, Chief Financial Officer and Company Secretary, Godrej Consumer Products Limited and explores some key accounting, reporting and other topical matters relevant to the industry.

Foreign Direct Investment (FDI) serves to be one of the sources of capital inflow for this sector. FDI in India is regulated by the policies laid down by the Government of India. This publication highlights the key updates in the FDI policy relating to the consumer markets sector and discusses important impact areas of the same. We also lay emphasis on how transfer pricing affects the sector, via complex issues relating to advertisement, marketing and promotion expenditure and an overview of the recent judgements of Indian courts in this area.

Another area that impacts the consumer markets sector is fraud risk, which could have serious consequences on the reputation and profitability of companies. We also examine some of the key considerations and challenges that companies in this sector could face while implementing Internal Financial Controls as required under the Companies Act, 2013 and also outline a potential approach to manage these challenges.

We also highlight some of the distinct features and challenges associated with accounting and reporting for the liquor industry, a key sub-sector within consumer markets. Finally, we have also included a regular round-up of the regulatory updates.

As always, we would be delighted to receive any kind of feedback/suggestions on the topics that we have covered.
Overview
Consumer markets in India

The Indian consumer segment comprises an enormous middle class, substantially a large upper middle class with small population in lower income bracket. With consumer spending expected to increase twofold by 2025\(^1\), the growth is principally benefitted from increasing disposable income and favourable demographics.

Key emerging trends in the sector

Urban consumption growing strong
An increasing share of incremental merchandise retail is expected to come from urban and semi-urban centres, primarily driven by the outcome of the rapid urbanisation in India. The urban consumption is expected to account for 56 per cent of the total consumption in 2021, compared to 48 per cent in 2012.\(^2\)

e-commerce playing pivotal role
Factors like convenience, wide assortment options, swift acceptance of online platforms and advanced internet networks are likely to drive the Indian e-commerce market, which is estimated to reach USD220 billion in terms of gross merchandise value (GMV) with 530 million shoppers by 2025\(^3\).

FDI garnering attention
Enabling 51 per cent FDI in multi-brand retail and 100 per cent in single-brand retail indicates the government’s focus to bring investment into the country. This was followed by allowing 100 per cent FDI in the processed food retailing and marketplace model of e-commerce.\(^4\)

What’s expected in 2016–17?

A simpler tax regime on its way: The implementation of GST is likely to make the trade simple and bring operational effectiveness in businesses by reducing costs. The companies in the consumer sector are likely to get benefitted from lesser logistics costs, saving about 1.5 per cent of sales in storage expenses\(^5\).

Revival of rural demand:
Awaited restoration of sturdy demand in the consumer goods sector did not happen in 2015 since the feeble monsoon that led to a slowdown in rural consumption. With a normal monsoon expected in 2016, recovery is awaited as 35 per cent of the sales of packaged consumer goods companies depend on the rural market.\(^6\)

Fall in fuel prices helping cost management:
With crude oil prices dropped below USD50 per barrel, the packaged consumer goods companies can certainly expect a significant reduction in their manufacturing and logistics costs.\(^7\)

Pressure from watchdogs:
Regulatory and compliance costs, particularly for food-based companies, are likely to increase in 2016 as the Food Safety and Standards Authority of India is expected to stress companies to act in accordance with safety standards and maintain product quality.\(^8\)

Rajat Wahi
Partner and Head
Consumer Markets
KPMG in India

---

01. Indian Consumer Market, IBEF, April 2016
02. Emerging Trends in Retail & Consumer Products, ET Retail.com, 9 January 2014
03. Budget2016: Retailers like Walmart Tesco to gain as Govt allows 100% FDI in multi-brand processed food retailing, The Economic Times, 1 March 2016
05. Oil prices fall back below $50 as economic concerns rise, Livemint Website, 13 June 2016
06. Food regulator cracks the whip on Aquafina, Bisleri, Kinley, others, The Hindustan Times, 28 June 2016

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
Consumer markets and Ind AS
This article aims to:

Highlight the impact of Ind AS on consumer markets sector

With Ind AS becoming applicable for the first phase of companies from 1 April 2016, some sector specific impacts are critical to understand, to appreciate the future of financial reporting.

For the consumer markets sector, one of the largest and fastest growing sectors in the country, a couple of Ind AS impact the heart of business performance i.e. sales and third party manufacturing arrangements.

Scheming the sales

The first impact area emanates out of Ind AS 18, Revenue and the treatment of discounts and promotion scheme to customers.

Under the prevailing Indian GAAP and accounting practices, revenue recognition, cash discounts and customer incentives are dealt with separately. More often than not, cash discounts and other forms of sales schemes and incentives are reported as a separate expenditure in the statements of profit and loss. Also the timing of recognising these discounts and incentives are such that they are booked only when various conditions and benchmarks have been met by the customer. This is prevalent in consumer market companies operating through a large distributor network, who in turn execute secondary sales.

However, under Ind AS 18, as per Para 9 “Revenue shall be measured at the fair value of the consideration received or receivable.”

As per Para 10, “The amount of revenue arising on a transaction is usually determined by an agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.”

Thus, Ind AS warrants that most discounts and rebates, including cash discounts and other schemes, offered to customers should be netted off against revenues as compared to being presented as expenses under the current Indian GAAP.

For example, if a customer purchases a certain value or quantity of goods, the refund of a specified percentage will be granted; or if the customer makes payment for the goods earlier than the credit period, a deduction based on a specified interest rate for early payment will be granted (cash discounts). If it is probable that the rebate or discount will be granted, and the amount can be measured reliably, then under Ind AS, the rebate or discount is recognised as a reduction of revenue as the sales are recognised. It must be noted that even if the scheme has not been concluded as on the balance sheet date, still an adjustment to revenues would be required on a best estimate basis.

Based on the above treatment, the revenues disclosed could be comparatively lower than the current practice. Further, it could also impact the disclosed gross margins as previously discounts were being accounted under other expenses.

Similarly, very common to the consumer market sector is the concept of customer loyalty programmes. Ind AS 18 specifically deals with such customer arrangements where Appendix B to the standard lays down specific accounting principles to deal with them.

The standard states that in case of customer loyalty programmes:

‘account for award credits as a separately identifiable component of the sale transaction(s) in which they are granted (the “initial sale”). The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the award credits and other components of the sale.’

The consideration allocated to award credits shall be measured by reference to their fair value, i.e. the amount for which the award credits could be sold separately;’

Thus, award credits are considered as a separately identifiable component to the sales transaction in which they are granted. Therefore, these are determined as being within the total sales made and are accordingly reduced from such sales value, to be deferred at the time of actual redemption of the loyalty credit.

The existing Indian GAAP mentions a similar accounting treatment under the Technical guide on accounting issues in retail sector. However, the guidance note allows two alternative accounting treatments. One of the most prevalent options currently being followed by a lot of companies under the Indian GAAP is that of estimating the cost of redemption of loyalty points and creating a provision for the same.

The above two changes are expected to bring about a notable change in the way financial statements of the companies in the sector would be studied and evaluated by analysts and experts. Performance evaluation indicators such as advertisement and sales promotion spend as a percentage of the total revenue would certainly undergo a change, with customer promotions shifting from the expense line to the revenue line. Further, for large organisations, managing the accounting of loyalty programmes and deferring the revenue component related to it, would also call for systematic IT level changes. This requires greater involvement of various elements within the organisation to be able to comply with the new accounting framework and yet be efficient in doing business. Additionally, companies would have to prepare reconciliations for sales disclosed in the sales tax returns when compared to the amounts reported in the financial statements.

01. KPMG report: ‘Indian retail – The next growth story’
Embedding the lease

It is extremely common for the consumer markets sector, especially the Fast Moving Consumer Goods (FMCG) industry, to enter into outsourcing arrangements for the manufacture of their products as part of their overall supply chain management strategy and attaining cost efficiencies.

It is in this area that the second impact for the consumer market sector triggers with the application of Ind AS 17, Leases and its Appendix C (the Appendix). The concept is known as embedded leases. Appendix C, Determining whether an arrangement contains a lease states in its background as under:

‘An entity may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset (e.g. an item of property, plant or equipment) in return for a payment or a series of payments.

Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include:

- Outsourcing arrangements (e.g. the outsourcing of the data processing functions of an entity)
- Arrangements in the telecommunications industry, in which the suppliers of network capacity enter into contracts to provide purchasers with the rights to capacity; and
- Take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take the delivery of the contracted products or services (e.g. a take-or-pay contract to acquire substantially all of the output of a supplier’s power generator).’

As can be noted above, it is probably for the first time that such transactions would be looked at from the lens of a leasing arrangement. At present, Indian GAAP does not provide for the accounting of such transactions as lease arrangements.

These are transactions which otherwise look like simple arrangements for the processing or supply of goods; however, these also contain a right to use the assets of the other party (many times exclusively) for a specific period of time. In exchange for this arrangement, the purchaser would make a fixed payment or a series of payments.

The Appendix states in Para 6, ‘Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

(a) Fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and
(b) The arrangement conveys a right to use the asset.’

Thus, a job-work arrangement which is captive in nature and requires the purchaser to make payments irrespective of whether the purchaser takes delivery of the contracted products or not, would typically be covered under the Appendix.

If on the basis of the principles laid down in the Appendix, it leads to an arrangement being classified as an embedded lease, the standards warrant that the payments being made by the purchaser must be separated for lease from other payments. Further, such a lease would then have to be evaluated as a finance lease or an operating lease under Para 10 and 11 of the standard. Further, the companies will also need to consider the withholding tax implications, as the disclosure of part of the outflow would be as either an operating lease or a finance lease.

For example: A enters into a purchase contract with B to purchase 1,000 units of product C every month at INR25 per unit. Product C can only be manufactured on a specific machine D owned by B. In case of any shortfall in procurement, A will compensate B at the rate of INR25 per unit of shortfall. The entire output from machine D is availed by A.

Under the current principles, the above transaction is generally accounted for as a normal purchase transaction at INR25 per unit. In case there is a shortfall, the payment amount is recognised as a penalty.

Under Ind AS, as B can manufacture the output only by using machine D, the entire output is supplied to A; and the pricing is on a take-or-pay basis, with the application of Ind AS resulting in the treatment of this arrangement as an embedded lease. Under this approach, the transaction is broken down into its two components - lease of machine D and charges for the purchase of product C. Further, depending on the period of the agreement, the consequences at the time termination, etc., the embedded lease may qualify as an operating lease or a finance lease. Under the operating lease approach, the total payments made by A to B would be segregated between the payment for lease of machine D (lease payments) and the payment for purchase of product C. Under the finance lease approach, machine D would need to be recorded as an asset of A, with a corresponding finance lease obligation. Payments made would be segregated between the repayment of the lease obligation, interest payment and payment for the purchase of product C.

The above example is a paradigm shift in the way we’ve looked at such arrangements in the past. Ensuring compliance to the new accounting standards, would warrant better appreciation of the requirements of Appendix C by not only the finance teams of organisations but also their commercial and legal teams. It is important to look at such arrangements every time they are renewed as well as the new terms and conditions that have been agreed upon.

To conclude, it is clear that the impact of Ind AS and its implementation is far reaching and beyond just the way financial statements will be prepared and reported. It shall certainly involve a few systematic and practical changes to the way business arrangements have been done and perceived until now.
According to the Ind AS adoption road map, several companies will be adopting Ind AS from 1 April 2016, with the date of transition being 1 April 2015. How are you addressing the challenges arising in the following areas:

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

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

Fast Moving Consumer Goods (FMCG) companies have not been impacted significantly on account of Ind AS and the magnitude of technical challenges have been limited. There have been only a couple of areas that have had an impact on business which include:

- Provision for sales returns
- Classification of promotional spends, such as discounts, etc.

In respect of Joint Ventures (JVs), one of the key impact areas for us included control assessment of JV agreements and the consequent implications of accounting/revaluation of call and put options.

We have prepared comprehensive documentation (by way of processes and flowcharts) to ensure that applicable changes are fully captured and are understood by the relevant stakeholders. Articulation of the policies and disclosures is also very critical in ensuring that the financial statements are correctly understood.

We started early and took all the stakeholders including the board members through the impact analysis of Ind AS on the business and financials. We will also suitably communicate the impact of transition to our investors.

Capacity and infrastructure challenges

The finance teams of the Godrej Consumer Products Limited (‘GCPL’) group (local and international) were briefed and trained on the changes and requirements of Ind AS. We decided not to make Ind AS related adjustments in some of the basic tracking Management Information System (MIS) to minimise business impact, e.g. the internal sales measurement and tracking.

Given the group’s vast geographical spread, the auditors and finance teams of all geographies have been aligned to the new requirements. Timely impact assessment of Ind AS has also helped the group to overcome any implementation challenges (e.g. data collation, recomputations, etc.). We did not have to do any major changes to IT systems/processes.

The key takeaways for the group are:

- Accounting has become an integral part of business for tracking and comparison – hence, we need to look at all major transactions, e.g. Merger and Acquisition (M&A) transactions, long-term agreements, etc., through the lens of Ind AS, and where necessary, structure the transactions suitably.
- Acknowledge the importance of starting early to ensure minimal disruption to conducting business as usual.
- Align all relevant stakeholders well in time to ensure that the changes are understood.
The Income Computation and Disclosure Standards (ICDS) have been notified and are applicable from Assessment Year 2016-17 onwards. Are you satisfied with the approach of the government on the notification of ICDS and do you think that the standards as currently issued, appropriately balance the perspectives of Revenue authorities and taxpayers? Are there any specific areas where concerns persist?

I feel that the government followed a proactive approach in bringing in ICDS. They have taken the public view into consideration and this consultative approach is welcome. However, while ICDS clarifies treatment from a tax perspective, the basis of comparison could have been drawn with reference to Ind AS instead of the existing accounting standards. The differences between reasonable and virtual certainty in respect of recording provisions would certainly continue to be a topic of discussion and debate.

However, the process of implementation has been conducive to organisations at large. Given the group’s international operations, we will have some impact in the area of foreign exchange.

The Companies Act, 2013 (2013 Act) has introduced Section 134 (5) (e) which requires the Directors’ Responsibility Statement to state that the directors, in the case of a listed company, have laid down Internal Financial Controls (IFC) to be followed by the company and that such internal controls are adequate and operating effectively. How have you approached this area and what have been the key considerations with respect to the implementation of reporting on IFC?

The requirements of IFC have moved us closer to SOX and through that, it has made the board responsible, however, the role and responsibility of the management towards IFC does not in any way decrease. In fact, it has increased considering the requirement of participation and liability of the management in various matters.

As a group, we have always focussed on processes and controls. However, with the new requirement, we had to fine-tune our documentation and linkages to ensure greater level of compliance and assurance. We already have had an audit tool in place that has helped us in maintaining audit trail for various maker-checker and audit testing of controls, which helped in the transition.

Have there been other areas (such as related party transactions approvals required) under the 2013 Act that have been challenging when it comes to implementation?

What has been your overall evaluation of the 2013 Act and are there any learnings on how such a significant economic legislation could be implemented for the country?

Though the 2013 Act has been a much needed and a welcome change, the process followed to make the 2013 Act a reality could have been better. While the regulators did approach various stakeholders for their views, one feels that not all the feedback was addressed adequately. Also, the piecemeal implementation of the 2013 Act could have been avoided, where we had both the old and the new Act simultaneously in operation. However, one must say that the regulators have since taken measures of easing the 2013 Act through subsequent notifications and clarifications. For listed companies, in some areas, there is still need for further alignment with the Securities and Exchange Board of India (SEBI) regulations.

While sections concerning RPT are reasonable and the regulators have taken measures to clarify ambiguities through subsequent ‘Removal of Difficulty’ notifications, certain other areas covering disclosure requirements, uploading of subsidiaries’ financial statements (especially unlisted entities) could be re-visited and the requirement could be re-assessed.

Goods and Services Tax (GST) is a path breaking business reform, and not just a tax reform for India. It is likely to trigger a major ‘business transformation’. Despite the setback of the earlier sessions of the parliament, the general view is that GST will become a reality. Viewed from this perspective, how are you approaching this area and how are you framing your plans in order to achieve significant efficiencies of business and even yield a competitive edge in the market?

As a group, we have conducted an impact assessment based on the information available in the public domain, specifically in areas concerning supply chain management, sales and procurement.

The introduction of GST would be extremely beneficial to the consumer sector considering the multiple points of production, warehousing, distribution and sale. Also, given the presence of a strong unorganised sector, GST will bring all the players on a level playing field. Further, introduction of GST would open up a lot of opportunities to organisations in terms of savings and optimisation of operating and distribution costs.

At this stage, we do not envisage a significant change to our current operating model. We have already been working at optimising from a supply chain perspective and hence, with the advent of GST do not see a major systemic change.
We have covered over 51,000 people under these programmes.

The government has introduced mandatory Corporate Social Responsibility (CSR) requirements in the 2013 Act, which requires companies to spend on social and environmental welfare, making India perhaps one of the very few countries in the world to have such a law. What were the key considerations and challenges for your company in implementing this law for the first time? Could you please elaborate on the CSR programmes being undertaken at the company?

The Godrej group has always championed CSR through various initiatives in the areas of health, environment and education and has been at the forefront conducting multiple activities across these areas, even before CSR became mandatory under the 2013 Act. Some of the initiatives that the group has undertaken under its Good and Green (G & G) initiatives as a vision to achieve by 2020 are:

- Ensure employability through skills training of a million youth
- Achieve zero waste to landfill, water positivity and carbon neutrality
- Product innovation to increase salience of ‘good’ and/or ‘green’ products in our portfolio to one-third.

Currently some of the specific initiatives by GCPL in the area of CSR include:

- ‘Saloni’ – an initiative towards women empowerment - skill building to take up employment01
- Project Vijay – a training programme to skill the youth of today in the area of sales02
- Up-skilling of rural retailers03
- Malaria awareness programme
- Urban waste management/plastic waste management projects in the area of environment conservation

What are the new learning initiatives that your company is undertaking in the area of capacity building, in order to equip the finance department/internal auditors/stakeholders/board of directors to build their knowledge base in the areas of challenge?

We give a lot of importance for learning and development initiatives. Some of our key initiatives are:

- Familiarisation session for the Board of Directors, which includes providing updates on upcoming regulatory changes (Ind AS, GST, tax regulations, IFC, etc.)
- Intense/detailed sessions on specific topics/geographies in terms of strategy, risk management, etc.

We encourage participation in refresher courses and training programmes - both internal and external that is technical as well as behavioural, for our employees. There are many leadership oriented trainings and employees are also encouraged to participate in relevant external programmes, seminars and conferences.

Apart from the above, for the finance function specifically, we strongly encourage participation in cross-geography initiatives to share experience and gain mutual learnings.

We have focussed cross-functional initiatives on Profitability Improvement (Project PI) that has now become a way of working across businesses.

With the increase in urbanisation and disposable income of people over the years, how do you see the movement of customer preferences towards premium products? What is your view over the decrease in discretionary spend by the customers and where is it headed?

Today through technology, devices, media penetration, all the consumers are connected and are well aware of what is available. It is important thus, to deliver a product in a format that is high in quality, customised to their needs and at the same time, at price points that are affordable. We have a strong focus on innovation led product premiumisation. Many of our new product developments are towards this end - whether you take the hair colour crème in a sachet, paper-based mosquito repellent, membrane-based air freshener. Our innovation rate (proportion of new products sales in total revenue) is over 15 per cent which is very healthy. We have been ranked #24 in Forbes’ list of the world’s 100 most Innovative Growth Companies 2015. There is a strong demand for such products and in my view, mass premium products in disruptive formats will have huge growth potential.

---

01. We have covered over 51,000 people under these programmes.
We are looking at disruptive business and ideas in almost all sectors, the leader being e-commerce. What do you think is the possible disruption to an FMCG business like yours?

As highlighted above if a product, which is high in quality and utility, can be delivered at an optimum price point, it can lead to considerable disruption to a similar product category. GCPL has always implemented such an approach and experienced the advantages of it. As an example, we are the pioneers in the country to introduce hair colour in crème format in sachets, which is a more convenient format, which has upgraded consumers from powder hair dye. Similarly the introduction of paper-based mosquito repellants got us a first mover advantage and made this a highly successful product in its category. Other areas of interest for us could be leveraging the e-commerce platform for our products and developing more natural products. At GCPL we already have our own range of products with natural ingredients in our strong brands and we shall continue to develop further on these. We are also investing in digital marketing.

What are the key challenges that you believe the Indian FMCG/consumer market sector are facing? And how are companies gearing to address these?

FMCG is inherently a stable, profitable business model. Hence, maintaining non-cyclical Year on Year (YoY) growth will continue to be the key challenge. The recent commodity price deflation has made it difficult to achieve the desired topline growth, but at the same time provides opportunity for investing the additional margin for innovation and growth. At GCPL, we have a 10x10 vision – to grow our revenue 10 times in 10 years – suggesting a 26 per cent topline Compound Annual Growth Rate (CAGR). We will focus both on organic and inorganic growth, and, stick to our 3*3 strategy of playing in three key categories (home care, hair care and personal care) and three emerging geographies, which has worked very well for us.

In India, rural growth opportunity is enormous, particularly in the home care and hair care space. We will focus on improving penetration – we have started a ‘Rural One’ initiative with a dedicated and empowered team for this.

Also, capitalising on international growth potential in the emerging geographies that we operate in, accelerating innovation both in existing and emerging categories in the health and wellness space will be key for us.

It is critical that companies in the consumer sector focus on who they are serving to maximise value for all their stakeholders. Companies that have steadfastly focussed on their consumers’ needs have always done well.

The views and opinions expressed herein are those of the interviewee and do not necessarily represent the views and opinions of KPMG in India.
Foreign Direct Investment (FDI) in the retail sector
This article aims to:

Provide an overview of the FDI policy in the retail sector

The retail sector in India is estimated to be worth INR55 trillion (USD 948 billion) by 2018-19\(^1\), with a Compound Annual Growth Rate (CAGR) of 12-13 per cent. It is likely that a large part of this growth will come from sub-sectors such as retail infrastructure, rural retail, luxury market, online retail, private labels, sourcing, etc. To facilitate such growth, significant investment is required and FDI is one such source which could provide the much needed funding. Keeping this in mind, the Department of Industrial Policy and Promotion (DIPP), Government of India (GoI) has been relaxing the FDI Policy over the years relating to the retail sector. From November 2015 to 24 June 2016, the DIPP has introduced various changes, interalia a) introducing the definition of ‘manufacture’ b) relaxed conditions for FDI in Single Brand Retail Trade (SBRT) c) Definition of Indian brands d) Introducing guidelines for undertaking retail trade through e-commerce. e) Trading in respect of food products manufactured and/or produced in India. The brief snapshot of the extant FDI policy and the recent changes are tabulated below:

<table>
<thead>
<tr>
<th>Extant FDI Policy</th>
<th>Recent developments(^2) - Key changes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Manufacture</strong></td>
<td>100 per cent FDI is allowed under the automatic route</td>
</tr>
<tr>
<td></td>
<td>• Definition of manufacture has been introduced. As per the definition, manufacture means a change in non-living physical object a) resulting in a transformation into a new and distinct objective b) bringing into existence a new and distinct object with a different chemical composition or structure.</td>
</tr>
<tr>
<td></td>
<td>• An Indian manufacturer is permitted to sell its own branded products in any manner i.e. wholesale, retail including through e-commerce platforms, etc.</td>
</tr>
<tr>
<td><strong>Whole sale cash and carry business (WCCT)</strong></td>
<td>100 per cent FDI is allowed under the automatic route</td>
</tr>
<tr>
<td></td>
<td>There is no major update recently in this area.</td>
</tr>
<tr>
<td><strong>SBRT</strong></td>
<td>100 per cent FDI is allowed subject to certain conditions (with upto 49 per cent under the automatic route and the balance with the approval of the GoI)</td>
</tr>
<tr>
<td></td>
<td>• SBRT entity operating through brick and mortar stores, is permitted to undertake retail trading through e-commerce.</td>
</tr>
<tr>
<td></td>
<td>• An Indian manufacturer, the owner of the Indian brand, can manufacture, at least 70 per cent of its products in house, and source, at most 30 per cent from other Indian manufacturers.</td>
</tr>
<tr>
<td></td>
<td>• Indian brands should be owned and controlled by resident Indian citizens and/or companies which are owned and controlled by resident Indian citizens.</td>
</tr>
<tr>
<td></td>
<td>• The government may relax sourcing norms for entities undertaking SBRT having ‘state of the art’ and ‘cutting edge’ technology and where local sourcing is not possible.</td>
</tr>
<tr>
<td><strong>Multi Brand Retail Trade (MBRT)</strong></td>
<td>51 per cent FDI is allowed with approval from the GoI subject to stringent conditions</td>
</tr>
<tr>
<td></td>
<td>There is no major update recently in this area.</td>
</tr>
<tr>
<td><strong>e-commerce</strong></td>
<td>The guidelines for FDI in e-commerce were first introduced vide Press Note 3 (2016).</td>
</tr>
<tr>
<td></td>
<td>• Inventory-based model of e-commerce is not permitted.</td>
</tr>
<tr>
<td></td>
<td>• Marketplace model of e-commerce: 100 per cent FDI is allowed under the automatic route provided the prescribed guidelines are met (refer “Note 1”).</td>
</tr>
<tr>
<td></td>
<td>• The sale of services through e-commerce is under the automatic route.</td>
</tr>
<tr>
<td><strong>Trading of food products manufactured and/or produced in India</strong></td>
<td>Notwithstanding the FDI Policy on the trading sector, 100 per cent foreign investment is allowed under the approval route for trading including FDI through e-commerce, for food products manufactured and/or produced in India.</td>
</tr>
</tbody>
</table>

---

Accounting and Auditing Update - Issue no. 10/2016

*Note 1:*
The marketplace-based model of e-commerce means providing an information technology platform by an e-commerce entity on a digital and electronic network to act as a facilitator between buyer and seller.

**Other conditions**
- The marketplace will be permitted to enter into transactions with sellers registered on its platform on a Business to Business (B2B) basis.
- The marketplace may provide support services to sellers with respect to warehousing, logistics, order fulfillment, call centres, payment collection and other services.
- The marketplace will not exercise ownership over the inventory i.e. goods purported to be sold. Such an ownership over the inventory will render the business into an inventory-based model.
- Not more than 25 per cent of the sales of the marketplace will be obtained from one vendor or their group companies.
- Model goods/services made available for sale electronically on websites should clearly provide the name, address and other contact details of the seller.
- Post sales, the delivery of goods to the customers and customer satisfaction will be responsibility of the seller.
- Payments for sales may be facilitated by the e-commerce entity in conformity with the guidelines of the Reserve Bank of India.
- Any warrantee/guarantee of goods and services sold will be responsibility of the seller.
- The marketplace will not directly or indirectly influence the sale price of goods or services and must maintain level playing field.

While the clarity in the FDI policy is always welcome and is good sign for the industry, this time, it has received a mixed response from stakeholders. The key impact areas are summarised below:

**Introduction of the definition ‘manufacture’**
Prior to the introduction of an explicit definition, for the purpose of FDI policy, the definition under the excise law was typically relied on. The definition under the excise laws is very wide-ranging since this helps the government to increase the scope of taxes. However, the new definition of ‘manufacture’ under the FDI policy is restrictive and hence, there could be instances where the process can qualify as ‘manufacture’ under the excise law but not under the FDI policy. Therefore, such business models would now require changes in this context.

While being restrictive in one aspect, FDI policy, on other hand, has given the flexibility to manufacturers to trade up to 30 per cent of sales. Such flexibility has been given to Indian brands which are owned and controlled by Indian residents. In other words, foreign/global brands even if manufactured in India will not be able to enjoy this flexibility.

It has also been expressly provided in the FDI policy that the ‘manufacturer’ can sell its goods by any means including e-commerce.

**FDI policy on Indian brands**
Whether or not Indian brands could access FDI was a question mark until November 2015. The FDI policy now explicitly allows FDI in Indian brands to the extent of 50 per cent.

**Marketplace model of e-commerce**
E-commerce has grown leaps and bounds in last five years. The growth of e-commerce is perceived to have impacted the growth of offline traders and hence, there is always demand from offline retailers for guidelines that could protect their interests. A perusal of these guidelines suggests that it would address the concern of both offline and online retailers.

On one hand, the concern of offline traders on the price of goods being influenced by marketplace entities has been addressed by mandating that marketplaces maintain a level playing field, and on the other hand, the marketplace entity is being given flexibility to provide services such as warehousing, logistics, order fulfillment, call centres, etc.

Having said the above, the guidelines relating to influencing prices, restriction on sales from preferred sellers and marketplace companies may need re-visit their business model/discount strategies to a certain extent. The key impact areas are as follows:

- The guidelines provide that one seller cannot contribute more than 25 per cent of marketplace sales. Today, various marketplace companies have preferred sellers on their platform which contribute nearly 50 to 70 per cent of their sales. Such an arrangement would need a re-visit. We may now see marketplaces onboarding a large number of sellers on their platforms to fulfil customer needs. Will this increase the cost of managing operations, what will be its impact on price points, customer acquisition, etc., are some of the key areas which will require deeper analysis.
• It has also been provided that marketplace entities should not influence prices, directly or indirectly. e-commerce has flourished leaps and bounds in last five years. This is essentially on account of the customer acquisition strategies of marketplace entities which include providing deep discounts to customers. With the GoI coming down on such practices, the marketplace would need to limit the discounts offered to customers. Furthermore, such discounts need come from the seller or from the commission earned by the marketplace. The above may sound simple but has the potential to overhaul the entire strategy of marketplaces.

In the above backdrop, it is likely that the above guidelines would give an impetus to FDI in the retail sector and help it achieve its full potential.
Consumer market—Embroided by the Advertisement, Marketing and Promotion (AMP) issue
This article aims to:

Highlight the areas of litigation in relation to AMP

Over the years, an increase in the purchasing power of consumers has resulted in the significant development of consumer market industry in India. Typically, the companies operating in the consumer market industry have to cope with uncertainty resulting from severe competition in the market and the fluctuating brand loyalty of consumers. Considering that consumers today have more options available in the market, they are often attracted towards the most popular brand name. As a result, efforts with respect to marketing and promotion of the products play an essential role in creating visibility for the product and promoting sales.

In the recent years, companies in the consumer market space have been facing high-pitched transfer pricing assessments in India. These companies spend significant amount on the AMP of their products so as to create visibility and survive the cut throat competition. While doing so, the companies make payments to advertisement agencies for advertisement and promotion, sponsor events, incur expenditure on giveaways and point of sale materials, conduct market research, etc.

The Indian tax authorities allege that incurring advertisement and sales promotion expenditure results in the development and enhancement of the brand value, the legal owner of which may not be the Indian entity but a foreign one.

If a foreign entity owns the brand, then the tax authorities consider the said expenditure to be an international transaction. They expect that for creating a marketing intangible and benefitting the foreign entity by enhancing the brand value, the expenditure incurred by the Indian entity on AMP activities should be reimbursed by the foreign entity (who is the legal owner of the brand). Furthermore, it is alleged that incurring of AMP expenses on behalf of the parent entity constitutes a ‘service’ provided by the Indian entity to the foreign entity, and thus, the Indian entity is required to be reimbursed for such expenditure ‘along with a mark-up’.

It seems that the tax authorities have not taken into account that the Indian entity being the economic owner of the brand, is required to incur AMP expenditure to sustain competition, increase market share/sales and earn profits, irrespective of the fact whether it is a distributor or a manufacturer.

Recently, there have been judgements by the Indian High Courts which have laid down certain principles to determine whether the AMP expenditure incurred by an Indian entity can be construed as an international transaction.

Revenue contentions

Summarised below are the revenue authorities’ assertions, while holding that the AMP expenditure incurred by an Indian taxpayer is an international transaction, for which it should be compensated:

- Since the brand is owned by a foreign entity, the money spent in India is adding value to the brand of the foreign entity and this entity is reaping the benefits of the enhanced value of the brand through the AMP expenditure incurred by the Indian entity

- AMP expenditure incurred by an Indian entity is essentially a service rendered by the Indian entity to its foreign entity for which it should be compensated

- For the purpose of making a tax adjustment, the tax authorities apply a bright-line test, i.e. treat the AMP expenditure incurred by the Indian entity as excessive, if the average ‘AMP expenses to sales’ ratio of the independent comparable companies is lower than the ‘AMP expense to sales’ ratio of the Indian entity

- Thus, the alleged excessive AMP is treated as an international transaction and such an excess spend after applying a mark-up (in lieu of services) is treated as a deemed income in the hands of the Indian entity.

However, the Indian taxpayers have contended that the payment of AMP-related activities to third parties cannot be construed as an international transaction in the absence of an ‘arrangement’, ‘agreement’, or ‘understanding’ between the Indian entity and the foreign entity for excessive AMP expenditure for the purpose of promoting the brand owned by the foreign entity.

Recent judicial precedents on this issue

Some of the recent judgements with respect to the litigation around marketing intangibles are discussed below.

LG Electronics India Pvt. Ltd. (ITAT Special Bench)

In 2013, the Special Bench of Delhi ITAT in the case of LG Electronics India Pvt. Ltd. held that excess AMP expenditure incurred by the Indian entity is an international transaction and the same can be benchmarked by applying the bright-line test by segregating routine and non-routine expenses (leading to the creation of marketing intangibles).

High Court judgement in the case of distributor

In 2015, the Delhi High Court pronounced an order in the case of Sony Ericsson Mobile Communications India Private Limited while setting out the following key principles on the issue of AMP for distributors:

- Arm’s length price should be determined, preferably, in a bundled manner with the distribution activity by taking suitable external comparables which have undertaken similar activities of distribution of the products and also incurred similar AMP expenses

- Bright-line tests cannot be applied to arrive at the excessive AMP expenditure
03. Maruti Suzuki India Limited vs CIT, (ITA No. 110/2014), ITA No. 110/2014 & 710/2015

04. Heinz India Private Limited vs Addl. CIT, Range 635, (ITA No. 7332), ITA No. 7332/Mum/2010

05. L'Oreal India Private Limited vs CIT, (ITA No. 7714/Mum/2012

06. Goodyear India Limited vs CIT, Circle 121 I, (ITA No. 5664/ Div 2011, Del/2012 and 916/Div 2014

Sales-related expenditure (such as discounts, free samples, sales commissions, etc.) cannot be considered as AMP expenses.

The choice of comparables cannot be restricted only to domestic companies using a foreign brand.

In the absence of suitable external comparables which perform both the functions (distribution and AMP) in a similar manner, a suitable adjustment should be made to bring international transactions and comparable transactions at par.

**High Court judgement in the case of a licensed manufacturer**

Recently, the Delhi High Court in the case of Maruti Suzuki** has passed a favourable order in the context of licensed manufacturers, and dismissed the contention of the tax authorities that AMP expenditure is an international transaction. The Delhi High Court held as under:

- In the absence of any arrangement of understanding between the foreign entity, the incurring of AMP expenses by Indian manufacturers holding licenses to manufacture products in India, using the know-how and trademarks of the foreign entity, does not result in an international transaction.

- The High Court held that the onus to demonstrate existence of an ‘arrangement’ or ‘agreement’ or ‘understanding’ between the Indian entity and foreign entity for spending excessive AMP expenditure for promotion of foreign entity’s brand in India, rests with the tax authorities.

- Bright-line test (i.e. approach of computing adjustment by computing expenditure incurred beyond the average AMP expenditure by comparable companies) is not permitted under the law.

- Even in a case where an AMP expense incurred by the Indian entity is held to be an international transaction, there are no machinery provisions under the Indian Transfer Pricing (TP) regulations to enable the revenue authorities to determine the compensation entitled to an Indian entity.

- Relying upon the observation in the Sony Ericsson Ruling, the High Court held that if the Indian entity has operating margins higher than that of the comparable companies, no separate adjustment on account of AMP expenses is warranted.

Post the High Court Ruling in the case of Maruti Suzuki, recently, various Tribunals in the cases of Heinz India Private Limited**, L'Oreal India Private Limited**, Goodyear India Limited**, provided relief basis the principles laid down by High Court.

Now, the onus would be on both sides, i.e. the revenue authorities to demonstrate that the license agreement would tantamount to ‘acting in concert’; and the Indian entity to demonstrate that there is no understanding with the foreign entity to incur ‘excess’ expenditure to promote its brand.

The findings of Delhi High Court in the case of Maruti Suzuki as well as in the case of other manufacturers facing litigation on this aspect (i.e. Whirlpool of India Limited and Honda Siel Power Products Limited) challenged the very core issue of ‘international transaction’ in absence of any understanding/agreement/arrangement. The Supreme Court has admitted a Special Leave Petition (SLP) to the tax authorities in the cases of companies who got partial relief from Delhi High Court in the cases related to Sony Ericsson.

**Concluding remarks**

The recent observations of the High Court that AMP expenses cannot be held as an international transaction in the absence of a tacit agreement/arrangement, putting the onus on the revenue authorities and rejecting the blanket approach of adopting bright-line method for proposing adjustment has currently put the issue in the favour of the Indian taxpayers, but it seems that the issue would travel to the Apex Court.

From a taxpayer’s perspective, it is important to demonstrate that there is no arrangement with the foreign entity and the AMP-related decisions are taken by the Indian entity without the involvement of the foreign entity. Further, the perspective is now moving towards the substance of the transaction rather than merely the form.

Thus, multinational companies should ensure that while drafting agreements, details with respect to the decision making and contribution by the both the entities is kept in mind. Further, a robust analysis of the functional profile of the taxpayer and the foreign entity should be undertaken in the transfer pricing documentation which should be in line with the actual conduct of both parties and an appropriate comparability analysis be carried out identifying comparable companies having a similar functional profile.

Also, though a few companies have also applied an option of Advance Pricing Agreement (APA) to resolve this complex issue and to obtain tax certainty, no APA agreement has been signed with the Government of India on this aspect till date.

Lastly, it is important for the government also to look at the current tax laws and suitably clarify/amend the existing laws rules to bring more clarity on the issue pertaining to intangibles and thereby, reduce both cost and efforts put in by the taxpayers as well as tax authorities while litigating on this issue before appellate authorities/courts.

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
Liquor industry in India
This article aims to:

Highlight certain key accounting and reporting implications in the Indian liquor industry

What is Liquor?
The origin of liquor and its close relative ‘liquid’ was the Latin verb liquere, meaning ‘to be fluid’. According to the Oxford English Dictionary, an early use of the word in the English language, meaning simply ‘a liquid’, can be dated to 1225.

Liquors, commonly referred to as ‘spirits,’ are manufactured by concentrating alcohol in fermented fruits and grains through a process of distillation. This process results in the production of ethanol, a form of alcohol that is found in all alcoholic drinks.

Alcoholic beverages can be produced through un-distilled fermentation of agricultural produce such as fruits (grapes), grains (barley, wheat, rye, oats, rice, etc.), and vegetables (sugarcane, potato). As mentioned above, liquor is produced first by fermenting these and then concentrating the ethanol through distillation. Accordingly, not all alcoholic beverages are classified as liquors. Wine and beer are examples of alcoholic drinks and are not liquor; these are fermented and not distilled. Examples of a few distilled alcoholic beverages include whisky, rum, vodka, gin, tequila.

The industry landscape
The Indian liquor industry is one of the fastest growing industries in the world. The industry landscape can be categorised in the following manner:

- Beer
- Wine
- Distilled beverages
  - Indian Made Foreign Liquor (IMFL)
  - Imported liquor
    - Bottled in origin (BIO)
    - Bottled in India (BII)
- Country liquor

Key challenges
Alcohol is a state subject as per the State List under the Seventh Schedule of the Constitution of India. Therefore, the laws governing alcohol vary from state to state. The government of each state is in receipt of the revenue generated from this industry and therefore, have formulated their own excise policies for alcoholic beverages including specific requirements in relation to manufacturing, warehousing, distribution, retailing and labeling requirements. These policies are reviewed on an annual basis and are implemented by respective ‘state excise departments’.
Accordingly, companies in this industry have to comply with the tax regime of each state which includes obtaining separate licenses for manufacture, bottling and distribution in the state in which a company has its operations. Further, there are a number of levies which are imposed at various stages of the value chain of manufacturing till the ultimate distribution of the product to the end consumer which greatly impact the pricing of the product in each state and accentuates the challenge faced in this industry especially for new entrants. Some of the taxes include state excise duty, import fees, export fees, bottling fees, labeling fees, etc.

The distribution channel of liquor to the end consumer is also diverse in accordance with respective state policies. In our experience, many states in India have adopted a varied market structure, for example

• Free market - permits the license holder to distribute liquor after obtaining a license,
• Auction market - license to distribute are auctioned on an annual basis,
• Government market - distribution is through government controlled corporations in the wholesale and/or retail market.

Liquor in India is not sold on certain designated dates (usually gazetted holidays) during the year which are known as 'dry days'. In addition, certain states have complete prohibition on sale of liquor and are therefore known as ‘dry states’. These include the states of Gujarat, Bihar, Nagaland, Mizoram, Manipur, and the Union territory of Lakshadweep. The governments of certain other states such as Kerala, have also announced policies to prohibit sale of liquor in the state over a period of time.

Brand building is considered to be extremely challenging as there is a prohibition on direct advertising of liquor brands. Further, there is an inherent volatility in the prices of major raw materials, glass (for bottling), Extra Neutral Alcohol (ENA) and molasses, owing to seasonality factors and demand supply pressures and as a result of government policies. These factors, along with state tax policies, therefore, add volatility to the margins of liquor companies who also have to guard against the manufacture and sale of spurious liquor.

**Accounting and reporting implications**

In this article, we are focussing on two issues - one, arrangements with contract bottling units and two, revenue recognition in relation to sales made to corporations.

**Arrangements with contract bottling units**

Selling liquor across states generally attracts higher excise duty as compared to liquor manufactured and sold within a state. The higher excise duty on liquor imported from other states results in a higher price which puts a pressure on sales volumes. As a result, almost all liquor manufacturers are either set-up distilleries in the state where they want to have a distribution network or partner with a local state distiller or brewer known as Contract Bottling Units (CBU) in order to remain competitive. Typical features of such arrangement may include:

• An agreed consideration in the form of fee per case is paid to the CBU by a liquor manufacturer in lieu of production overheads.
• All other cost of production and dispatch such as purchase of raw material, freight, etc. are incurred by the CBU (as a principal) but in substance, these are on account of the liquor manufacturer except to the extent of wastage in excess of agreed limits and statutory compliances. The CBU purchases the raw material from vendors approved by the liquor manufacturer.
• The liquor manufacturer funds the working capital requirements of the CBU. In order to facilitate this, each CBU will usually open a designated bank account which will be operated by the representatives of the liquor manufacturer.
• The sales are legally in the name of the CBU but at the instance of the liquor manufacturer i.e. the liquor manufacturer has the onus of identification of customers, determining the sales price and the relevant terms and condition of the sale. The responsibility of the CBU ceases at the time of making sale in accordance with the stated terms.
• The CBU is debarred from creating any lien on inventory and debtors in relation to the goods manufactured on behalf of the liquor manufacturer.

• The liquor manufacturer is also generally responsible to bear the insurance risk of inventories and transit and also reimburses the cost of various import and export permits to the CBU.

• A periodic statement of profit and loss is drawn up by the CBU and the net gain or loss on the transaction undertaken by the CBU on behalf of the liquor manufacturer are transferred to the liquor manufacturer’s account.

• In the event of termination of such agreements, the inventory will be transferred at cost by the CBU to the liquor manufacturer.

• In certain circumstances, the CBU may be barred from entering into similar arrangement with other competitive liquor manufacturer.

Thus, while the sales are legally and contractually made by the CBU in its own name, in substance these are made at the behest of the liquor manufacturer. Accordingly, a question arises in terms of the manner of presentation of revenue from sale made by such CBU i.e. either on a gross (sales to customers) or on a net basis (conversion charges received from the liquor manufacturer) in the financial statements of the CBU.

Paragraph 10 of AS 9, Revenue Recognition, states that "revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed".

Paragraph 11 of AS 9 further states that "in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

i. The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership, and
ii. No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.”

Thus, the main principle enunciated in paragraph 11(i) of AS 9 is that sales should be recognised when either of the following two conditions are satisfied:

a. The property in the goods has been transferred to the buyer for a price, or

b. All significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control over the goods.

In general, property refers to a person’s legal right of whatever description. It is the right to possess, use and enjoy a determinate thing. Accordingly, it is important to analyse whether either of the two conditions above have been satisfied by liquor manufacturer or the CBU.

Reading the requirements of AS 9, it seems that the CBU’s role is limited to manufacturing the products in the quantity and as per the quality specified by the liquor manufacturer. For such services, the CBU earns a consideration in the form of a fixed amount per case manufactured and actual cost incurred on specified items. It is the liquor manufacturer and not the CBU who bears the significant risk and rewards of the product and has control of the products. The margin of the CBU remains fixed irrespective of the changes in the sale price or the related material cost of the product. In essence, if it is the liquor manufacturer who has the effective control of stocks at all times even though these are in physical possession of the CBU i.e. the CBU can distribute these only at the behest of the liquor manufacturer, is not permitted to create a lien and is also required to hand over unsold inventory at cost in the event of termination of the agreement. Accordingly, there could be an argument that the revenue accruing to the CBU is in the form of the fee earned per case.

However, it is pertinent to note that AS 9 also gives credence to the legal position by including the definition of sale as per the Sale of Goods Act, 1930 by giving reference to the ‘transfer of property in the goods’ apart from principles based on economic substance i.e. transfer of significant risks and rewards, as a trigger for
revenue recognition. Thus, the key aspect which merits an evaluation is to determine whether the CBU owns property in the goods at any time. While the CBU performs the transactions at the behest of the liquor manufacturer, all legal documentation such as purchase orders, invoices, excise duties, sales tax and the legal permits as per requirement of the relevant state are in the name of the CBU. Thus, even though there may be a contractual arrangement between the liquor manufacturer and the CBU, there could be an argument that for external stakeholders being excise authorities, suppliers of raw materials and debtors that the CBU is conducting these transactions on its own account.

Thus, in view of the above complexity, a liquor manufacturer should apply judgement and may seek a legal advice in order to ascertain the true owner of the property in goods which will be therefore, be one of the guiding principles insofar as presentation of revenue is concerned.

Revenue recognition in relation to sales made to corporations

As mentioned earlier, market structure involves government market wherein the distribution is through government controlled corporations (‘corporations’) in the wholesale and/or retail market.

In this regard, each corporation will generally enter into an agreement with the liquor manufacturer in relation to purchase and onward sale of liquor produced by the liquor manufacturer. Such agreements also contain clauses to the effect of levy of demurrage charges, payment terms and circumstances in which the loss associated with unsold stocks will be required to be borne by the liquor manufacturer. The agreement also envisages a specific right to return goods after a particular period of time in relation to expired goods in order to ensure that expired goods can not and should not be sold in the market.

Over the years, certain corporations have been additionally including a clause in the agreement with the liquor manufacturer to the effect that the supply of liquor to the corporation against order for supplies shall be construed as an ‘agreement to sell under Section 4(3) of the Sale of Goods Act’, 1930. The sale shall be concluded only when the liquor is delivered to the buyers by the corporation. The corporation would take necessary care of the stocks held for sale as it is reasonably possible and expected of it.

A question therefore arises on the timing of revenue recognition in sales made to such corporation i.e. on dispatch of goods to the corporation or as and when the goods are delivered to the buyers i.e. distributors by the corporation.

As per the Sale of Goods Act, 1930:

a. A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price.

b. There may be a contract of sale between one part-owner and another.

c. A contract of sale may be absolute or conditional.

d. Where under a contract of sale the property in the goods in transferred from the seller to the buyer, the contract is called a sale, but where the transfer of the property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, the contract is called an agreement to sell.

e. An agreement to sell becomes a sale when the time elapses or the conditions are fulfilled subject to which the property in the goods is to be transferred.

Additionally, some of the corporations have, in the past, also represented to the government authorities that they are the legal owners of the goods. Accordingly, there is divergent in practice on revenue recognition in relation to sales made to corporations.

In practice, certain liquor manufacturer concludes that significant risks and rewards associated with ownership have been transferred to the corporation along with the transfer of the property in goods since the corporations have complete physical control over the goods and the liquor manufacturer would usually not have any right to take back or have line on such goods. Accordingly, revenue is recognised at the time of dispatch/delivery to the corporation in accordance with the general terms of sales contained in the agreement.

However, it would be appropriate that a liquor manufacturer clearly states the revenue recognition policy on such sales.

Based on the facts and circumstances, it can also be considered that the property in the goods vests with the liquor manufacturer and is not transferred to such corporations at the time of dispatch. As per the agreement, the property in such goods will transfer only when it is delivered to the buyers by the corporation which will also coincide with the transfer of risks and rewards. Hence, it would be prudent for the liquor manufacturer to recognise revenue at the time of sale to the customer of the corporation and not at the time of dispatch of goods to such corporation. From Indian GAAP perspective, such corporations are, therefore, considered as a distribution agent of the liquor manufacturer which hold the goods in trust for the liquor manufacturer till sale is concluded.

Thus, in order to determine when revenue should be recognised, one should apply judgement and care should be taken in order to ascertain the facts and circumstances as the terms of agreement with corporations could vary from state to state.

Conclusion

There are numerous aspects in the Indian liquor industry which are complex and yet interesting akin to the blends used in whisky or whiskies. The challenges associated with this sector in India are largely due to complex state tax regulations and other restrictions. The adoption of Ind AS is also expected to have an impact on the revenue recognition accounting policy of this sector.
Fraud in the consumer market sector
This article aims to:

Provide an overview on the areas of fraud risk in the consumer markets sector

As is the case with any other sector, companies in the retail and consumer space also face a large number of business challenges such as a shrinking economy, escalating costs and a weak monsoon for two consecutive years. Additionally, companies are required to meet the consumer demands of product innovation to stay modern and profitable. Such challenges sometimes result in pressure on companies and their business partners to perform. Such pressure provides opportunities and incentives for fraudsters who may be employees or business partners, to commit economic crimes.

The management generally regards fraud risk as a routine part of its risk management framework, and many times not fully aware of its true nature and impact. However, it has become imperative for this sector to take proactive strides to manage the risk of future fraud due to its strategic consequences on the reputation and profitability of the companies. Some instances of frauds in the industry are given below:

Areas of fraud risk

Procurement fraud

Irregularities within the procurement cycle is a common problem for any organisation and can have a major impact considering the potential financial losses as well as damage to its goodwill.

In tough times where the top line and volume growth is difficult to achieve it is important for an organisation to preserve its profitability by minimising costs and mitigating losses due to fraud in the procurement cycle.

Perpetrators of fraud: employees in collusion with third parties

Commonly perpetrated frauds are as follows:

1. Payments made to fictitious companies or legitimate companies that do not provide products/services to the company
2. Bid rigging/bid splitting leading to favouritism of vendors and inflation of costs for personal benefit
3. Collusion between vendors and employees to fund kickbacks paid to employees in the procurement function
4. Conflicts of interest situations, could be detrimental to the interests of the company due to the procurement not having been made at arm’s length prices
5. Duplicate payments made to a vendor without the services being rendered/products supplied to justify the second payment
6. Lower quality/quantity of material supplied by vendors, but invoices issued to the company for a higher quality/quantity of material.

Supply chain and distribution fraud

In a global economy, companies deal with multiple people/entities in their supply chain process and it could become difficult to identify and control fraud risk in this process. Fraud anywhere in the supply chain can have a negative impact on the operations of an organisation, especially for a company with widespread operations, due to the sheer size of the country. A few examples of fraud risk are listed below.

Perpetrators of fraud: employees in collusion with third parties

Commonly perpetrated frauds are as follows:

1. Theft of inventory by employees of a company due to the lack of sufficient controls
2. Shoplifting by customers from retail outlets or theft by delivery centre employees
3. Pilferage of inventory by manipulation of the barcode/Point of Sales (POS) systems
4. Manipulation of financial statements by overstatement of inventory to inflate profits.

Misuse of sales and marketing spends

Many retail establishments maintain an optimum level of stock, with markets being catered through distributor channels on a regular basis. Credit risk is passed on to the distributors, with several outlets across diverse geographies being served by them. Various sales schemes are launched by companies through their distributors for sales promotion as well as to generate higher sales volumes. However, there is a significant risk of fraud due to the involvement of numerous third parties located across the country and for the ease with which these frauds can be perpetrated.
Perpetrators of fraud: employees or employees in collusion with third parties

Commonly perpetrated frauds are as follows:
1. Non-receipt or part receipt of the eligible benefits of sales promotion and trade schemes by the recipient (dealer/customer)
2. Fictitious claims submitted by distributors to siphon money from the company in collusion with company employees
3. Inappropriate utilisation of sales budgets resulting in undue benefit to one or more parties
4. Subsidies paid to distributors for various purposes although they are not eligible for the same
5. Manipulation of sales data and other relevant information to demonstrate achievement of the eligibility criteria for incentives
6. Routing of scheme claim cheques in favour of family and friends
7. Collusion between vendors and sales employees leading to inflation of vendor invoices and kickbacks for gift procurements made for sales promotion schemes
8. Payments made for displays of brand activation without actually renting the display/shelf-space.

Bribery and corruption risk

The retail and consumer markets sectors in India also face the risks of bribery and corruption due to the numerous government touch points at various stages of business. This risk acts as a necessary evil and adds to the cost of doing business. It has become imperative for organisations to take mitigating measures, considering the cost of bribery and corruption and code of conduct implications. The governments are also implementing a stringent anti-bribery and corruption regulations to bring to book errant companies and key management personnel by levying serve penalties and/or criminal actions. Many companies with a global footprint and aspirations also find themselves working in different markets and jurisdictions, resulting in their exposure to different anti-bribery and corruption regulations.

Perpetrators of frauds: employees or employees in collusion with third parties

Commonly perpetrated frauds are as follows:
1. Facilitation of payments made to various approving government authorities and/or to win business from them
2. Payments to obtain licenses/certificates/registrations routed through third parties
3. Misrepresentation of transactions entered into on account of bribery and corruption in accounting records.

Confidential consumer data theft or Intellectual Property (IP) infringement

IP such as registered trademarks/copyrights, product innovations, and product designs are critical intangible assets that are often a significant competitive advantage. In typical IP infringement incidents, the attackers attempt to steal sensitive IP information from their targets. Sometimes such cyber-attacks are also aimed at causing disruption of daily operations and key functions within the target organisation. The impact of such attacks are not only financial losses caused to the company but also damage to market reputation and customer confidence.

Perpetrators of frauds: employees or employees in collusion with third parties

Commonly perpetrated frauds are as follows:
1. Theft of either customer data or product information or supplier details, which are confidential and could be sold to competitors
2. Theft of sensitive information relating to the innovation and research done by the company
3. Business disruption (outage of production lines, e-commerce sites, trading exchanges, amongst others, theft of credit card data from online portals, etc.).

Other areas of fraud

Product counterfeiting

The consumer products sub-sectors that are exposed to the risk of counterfeiting in India include consumer goods, alcohol beverages, personal care products, tobacco, mobile phones, and mobile phone components, and computer peripherals. Technological advancement, especially in the print industry, has helped counterfeiters create replicas of leading FMCG brands, thereby, making the FMCG and alcoholic beverage sector more vulnerable to the illicit trading of counterfeits in India. Such deceptive counterfeiting, results in the loss of goodwill and trust, with consumers blaming genuine brands for poor quality of the goods purchased by them, consequently resulting in the loss of brand equity.

The ICC-FICCI publication - Counterfeiting, Privacy and Smuggling in India - Effects and Potential Solution refers to a study by AC Nielsen\(^2\) which mentions that, 30 per cent of FMCG business is lost to fake products, and 80 per cent of the consumers who purchase these products believe that they had bought originals. According to a study done by KPMG in India with FICCI\(^3\), the estimated value of counterfeits in India is over INR1 trillion in 2014. In 2012, a large multinational apparel brand’s India unit initiated a raid on manufacturing units that were producing fakes and found that one such factory producing counterfeit products, was much bigger than the brand’s own authorised manufacturing unit.

Economic adulteration

Another growing risk is that of economic adulteration i.e. faulty and low quality products being sold in retail outlets to consumers or faulty products being mixed with good quality products. Adulteration fraud is largely seen in the food and agricultural products sectors.

In summary, the consumer and retail sectors in India are at a heightened risk of fraud and misconduct and therefore prone to attacks by fraudsters. These sectors often feature in the list of the major sectors prone to fraud, as concluded by a survey conducted by KPMG in India in 2012.

---

\(^1\) ICC-FICCI publication – Counterfeiting, Privacy and Smuggling in India - Effects and Potential Solution - published in September 2013
\(^2\) KPMG in India-FICCI report on ‘Sell SMART – Moving towards a SMARTer consumer market’ published during 2015
\(^3\) KPMG in India - FICCI report – India – Effects and Potential Solution published in September 2013
Internal financial controls
This article aims to:

**Highlight the key challenges/dilemmas that companies are facing while implementing Internal Financial Controls (IFC)**

**Suggest an approach to manage these challenges while developing their compliance programmes with regards to IFC**

**Introduction**

The Companies Act, 2013 (2013 Act), has introduced various regulatory requirements that India Inc. must comply with. These requirements are largely in line with the governance standards being followed by mature global economies. This is a good initiative to align certain governance practices followed by India Inc. with those followed by global companies. However, it may also be noted that whilst doing so, we would also need to ensure that the Ministry of Corporate Affairs (MCA) makes an effective balance between the ambit of these provisions and the practicality of implementing and monitoring them. The specific sections pertaining to Internal Financial Controls (IFC) are very important and cast onerous responsibility on the company, Key Managerial Personnel (KMP), directors and also external and internal auditors. For listed companies, the directors’ responsibility statement to state that IFC are adequate and operating effectively and the Board’s report to state the adequacy of IFC with respect to financial statements. For other companies, the Board’s report to state the adequacy of IFC with respect to financial statements. The MCA has not issued any further guidance with regards to IFC and its applicability and coverage for the management. Companies are still facing challenges and are grappling with what needs to be done specifically and what should be the outcome, based on which the Board and management can determine whether the IFC are adequate and working effectively. The guidance issued by the Institute of Chartered Accountants of India (ICAI) in September 2015, however, provided a detailed approach to be followed by independent auditors with regards to their audit procedures. Hence, companies are currently adopting the guidance note for their IFC programmes. Companies may face certain challenges/dilemmas with respect to implementing IFC across their organisations. Through this article we would like to highlight the key challenges/dilemmas that companies are facing including a suggested approach to manage these challenges while developing their compliance programmes with regards to IFC.

**Comprehensiveness of coverage**

The IFC definition places a lot of emphasis on the existence of and compliance with policies/procedures, safeguarding of assets, accuracy of financial reporting and prevention and detection of fraud and errors. Board and management should develop and implement a framework which encompasses all areas pertaining to process controls, financial reporting, governance and fraud risk management controls. The presence of all these controls should form part of the Board and management assessment. Companies may sometimes focus only on certain aspects and not follow the complete framework. Companies in the consumer markets sector generally have detailed Standard Operating Processes (SOPs) in place, however these SOPs may not specifically cover risk and control aspects of a process and could only cover step by step activities required in a process. IFC requires that the specific risks and controls need to be identified in these processes as well.

**Remediating gaps is time consuming – Timely measures can help**

One of the key areas that management may focus on during an IFC implementation would be to give themselves an adequate time to remediate control gaps. During the first year of implementation, companies may require substantial time for remediating controls as the control failures may be more in terms of evidencing control activities. Hence, companies that started earlier had an advantage.
Maintaining independence during the IFC evaluation

One of the key considerations for management would be to maintain independence in designing and evaluating their IFCs. Certain audit committees have expressly requested that IFCs should be looked at by independent teams to ensure there is objectivity in the implementation and evaluation process. Certain companies have however adopted a hybrid approach of independent and self-evaluation to bring in cost and time efficiencies in the implementation process. We recommend that a reasonable level of independence be maintained during the IFC implementation and evaluation process to objectively assess IFC effectiveness. This will also help in identification and timely escalation of any control design gaps for remediation and monitoring.

In-house versus outsourced debate

Another key consideration that management teams are grappling with is whether IFC implementation should be conducted in-house or be outsourced to independent consulting firms. Companies that have in-house management bandwidth may still need to upskill the available resources to ensure that the quality of implementation is up to the mark and meets the stakeholders’ requirements (board as well as the auditors). Although this option may be the most cost effective option, this could still carry a risk that the documentation quality may not meet the stakeholders’ requirements. A gradual transition approach from outsourced to in-house over a few years may help in better stakeholders’ expectation management and handle implementation challenges during the initial years.

IFC responsibility goes beyond the finance department

IFC is often perceived to be yet another finance function initiative and prerogative. However, senior management members need to create sufficient levels of awareness across the organisation and functions that the responsibility for ensuring effectiveness of IFC goes beyond the finance function. A successful IFC implementation would require commitment from all departments across the organisation. This can be achieved through ongoing communication from senior management and setting the tone at the top, right at the outset.
Obtaining timely stakeholder buy-in

Key stakeholders involved in an IFC implementation would be the Board of Directors, external auditors, senior management members and department heads. Throughout the IFC implementation it is important to obtain timely buy-in from each of these stakeholders to ensure that the IFCs have adequate ownership.

The role of external auditors becomes especially critical as they would also be commenting on the effectiveness of the IFCs independently. As a result they should be involved in the implementation process at each stage right from the scoping phase up until the test of effectiveness, so they are aligned to the management’s approach and there are no surprises at the end of the year with respect to the adequacy of coverage and nature of documentation.

Similarly board and audit committee members should be periodically updated on the status of the documentation as well as the remediation of gaps so they have visibility into the effectiveness of the IFC implementation. In addition, senior management involvement in the IFC evaluation is also imperative, as at the end of it all, it is their responsibility to establish an effective internal control framework.

Assessing the impact of gaps as at the year end and the implications of non-compliance

The 2013 Act does not define thresholds or materiality levels to ascertain whether controls are effective or ineffective. As a result, ascertaining materiality thresholds for control failures identified during an IFC evaluation is one of the major challenges companies may face. Presently there is no guidance available from the ICAI or MCA on this aspect, so companies should consult with their statutory auditors and boards on the acceptable materiality thresholds at the outset of an IFC implementation exercise to avoid surprises during the year end. Similarly, there is currently limited visibility on the consequences of non-compliance with the requirements or qualifications in the IFC report by the external auditors.

Change management and assessing the effort year on year

An important area for management to consider would be to address the changes in processes, policies and procedures that may impact the IFC documentation. The management may often come across a situation where certain processes may change during the course of the year after the initial documentation/testing is completed. In such cases, depending on the timing and nature of the change, the management must take a call on whether updating the documentation could be deferred or needs to be completed at the start of the year. For all significant changes impacting the financial statements, the management could test these controls as well as update the documentation prior to the year end. However, changes which may not have a financial impact may be excluded and can be updated during the subsequent year.

Also each year, the management may assess the need for updating the documentation, coverage and control testing as well as define a formal process to update the changes prior to testing the controls. Change management is extremely critical as the documentation should reflect the controls which represent the current processes.

Similarly, each year the scope and coverage may be reassessed considering the changes in the organisation or group structure, new divisions, acquisitions or mergers.

Aligning the IFC activities with the internal audit remit could be a possible option that companies may explore. During the subsequent years, the management may also use the IFC framework to identify opportunities to further improve the framework and use it as an enabler to improve the overall control environment. We expect that organisations may focus on automating controls, this would not only ensure better control effectiveness and simplify the process but can also reduce the testing effort. In addition, as the IFC framework matures in an organisation, greater emphasis is likely to be on the IT application controls and implementing a robust general IT control framework as any failures in the IT control environment may have a significant impact on the overall internal financial control effectiveness.

Additionally, companies may strengthen anti-fraud controls to prevent, detect, manage and report fraud scenarios in a more effective manner. Companies in the consumer markets sector need to identify their industry specific and company specific key fraud areas and then develop controls to prevent and detect frauds. Marketing spends, procurement, employee expenses, quality control, logistics are areas which are highly prone to frauds in companies in this sector and often specific fraud risk controls do not exist in these areas.

Conclusion

The management needs to consider each of the aspects discussed above for their IFC implementation journey. Though the answers to these questions may vary from company to company depending on the state of maturity, effectiveness of existing assurance mechanisms, and extent of documentation already in place, the general guiding principle would be ‘substance over form’ for each of these aspects. Shortcuts to IFC implementation may not help in the long run as it’s a way of life and the more the processes and controls are embedded in to an organisation’s culture, the more successful and sustainable the effectiveness of the IFC framework is likely to be.
Regulatory updates
The central government constitutes NCLT and NCLAT and notifies the related sections of the Companies Act, 2013

Background
The Companies Act, 2013 (2013 Act) proposed the constitution of the National Company Law Tribunal (NCLT) to replace the erstwhile Company Law Board (CLB). The National Company Law Appellate Tribunal (NCLAT) was proposed under the 2013 Act as the appellate authority for appeals against the order of the NCLT, instead of the High Court. While the 2013 Act is already operational and became largely effective from 1 April 2014, the sections relating to NCLT and NCLAT and corresponding rules were not notified pending their constitution. Until the NCLT and the NCLAT were constituted, the CLB and the High Court continued to exercise their powers under the Companies Act, 1956 (1956 Act).

New development
On 1 June 2016, the Ministry of Corporate Affairs (MCA) notified the following:

- The constitution of the NCLT and NCLAT to exercise and discharge the powers and functions as conferred on it under the 2013 Act. For this purpose, the central government constituted 11 benches of the NCLT consisting of a principal bench at New Delhi and one each at 10 different locations including New Delhi.01
- Certain sections of the 2013 Act enabling the exercise of power by the NCLT and NCLAT have also been notified.02
- With the constitution of the NCLT, the CLB constituted under the 1956 Act stands dissolved and all matters or proceedings pending before the CLB would be transferred to NCLT, which shall dispose such matters or proceedings in accordance with the provisions of the 2013 Act or 1956 Act.03

These notifications are effective from 1 June 2016 (being the date they are published in the official gazette).

Overview of notified sections
The following table provides a brief description of the new sections notified by MCA.

<table>
<thead>
<tr>
<th>Sections notified</th>
<th>Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 7(7) except clauses (c) and (d)</td>
<td>Incorporation of company: NCLT to pass orders such as for regulation of management of the company, direct that the liability of the members be unlimited or pass an order for winding up in cases where a company has been incorporated by furnishing any false or incorrect information or suppressing any material fact or information or by any fraudulent action. Sections 7(7)(c) and (d) of the 2013 Act which provide powers to NCLT to remove the name of the company from the Register of Companies and for winding up have still not been notified.</td>
</tr>
<tr>
<td>Second proviso to Section 14(1) and Section 14(2)</td>
<td>Alteration of articles: If a company passes a special resolution to alter the articles that has the effect of converting a public company into a private company, this would require approval of the NCLT. A copy of the order approving the change shall be filed together with a printed copy of the altered articles within a period of 15 days in the manner prescribed.</td>
</tr>
<tr>
<td>Section 35(3)</td>
<td>Issue and redemption of preference shares: NCLT to approve issue of new redeemable preference shares against unredeemed preference shares when a company is not in a position to redeem such preference shares or to pay dividend and the company has obtained the consent of the holders of three-fourths in value of such preference shares.</td>
</tr>
<tr>
<td>Proviso to Section 61(1)(b)</td>
<td>Power of limited company to alter its share capital: NCLT to approve consolidation and division of share capital which results in changes in the voting percentage of shareholders.</td>
</tr>
<tr>
<td>Section 62(4) to (6)</td>
<td>Further issue of share capital: Company to appeal to the NCLT in case of conversion of debentures issued or loan obtained, from any government by a company, into shares of the company where the terms and conditions of such conversion are not acceptable to the company.</td>
</tr>
<tr>
<td>Section 71(9) to (11)</td>
<td>Debentures: Debenture holders/trustees to file a petition to the NCLT in case a company fails to redeem debentures or pay interest thereon, or in cases where the trustees feel the company has insufficient funds and it is unlikely that the company would be able to discharge the principal amount, when due. Further it grants power to the NCLT to order the company to redeem the debentures forthwith on payment of principal and interest due thereon or impose restrictions on the incurring of further liability. If any default is made in complying with the order of the NCLT, then the 2013 Act specifies penalties including imprisonment of officers of the company.</td>
</tr>
<tr>
<td>Sections notified</td>
<td>Overview</td>
</tr>
<tr>
<td>------------------</td>
<td>----------</td>
</tr>
<tr>
<td><strong>Section 75</strong></td>
<td>Damages for fraud: In case the company fails to repay the deposit or part thereof of any interest within the specified time as per Section 74* of the 2013 Act (extension if any granted by the NCLT) and it is proved that the deposit had been accepted to defraud the depositor or for fraudulent purposes, Section 75 of the 2013 Act provides that every officer of the company who was responsible for acceptance of such deposits will be personally responsible without any limitation of liability for the losses/damages incurred by the depositors.</td>
</tr>
<tr>
<td>*Section 74 of the 2013 Act is not yet notified</td>
<td></td>
</tr>
<tr>
<td><strong>Section 97, 98 and 99</strong></td>
<td>Power of Tribunal to call annual general meeting and meeting of members: NCLT to call an annual general meeting or meeting of members in the specified cases. Further, in case where a company fails to comply with directions of the NCLT, Section 99 of the 2013 Act grants power to the NCLT to punish the company and every officer who was responsible for such default with a fine as prescribed.</td>
</tr>
<tr>
<td><strong>Section 119(4)</strong></td>
<td>Inspection of minute-books of general meeting: Under the 2013 Act, any member is entitled to request a copy of any minutes of general meeting of a company. If any such request is refused by the company, NCLT can, by order direct an immediate inspection of the minute-books of general meeting or direct that the copy required should be sent to the person requiring it.</td>
</tr>
<tr>
<td><strong>Section 130 and 131</strong></td>
<td>Re-opening of accounts or voluntary revision of financial statements or Board’s report: Re-opening of accounts can be done based on order of court of competitive jurisdiction or the NCLT on request of the statutory regulatory body or any person in case the earlier accounts were prepared in a fraudulent manner or affairs of the company were mismanaged during the relevant period, casting a doubt on the reliability of financial statements. Section 131 of the 2013 Act allows voluntary revision of financial statements or Board’s report based on the NCLT order if directors of the company are of the view that financial statements/Board’s report does not comply with the requirements of the 2013 Act.</td>
</tr>
<tr>
<td><strong>Second proviso to Section 140 (4) and Section 140(5)</strong></td>
<td>Removal, resignation of auditor and giving of special notice: NCLT to order removal of an auditor of a company either through suo moto or an application made by central government or any other person concerned, if he/she had committed any fraud. Such an auditor would not be eligible for appointment as an auditor of any company for a period of five years against whom order has been passed by NCLT for his/her removal from any company and he/she would also be liable for action under Section 447.</td>
</tr>
<tr>
<td><strong>Section 169(4)</strong></td>
<td>Removal of directors: A director who is removed from a company may make representation to the company in the manner prescribed in this Section. The NCLT has been granted powers to restrict such representations in cases where this option has been abused by the director or for needless publicity for defamatory matters, etc.</td>
</tr>
<tr>
<td><strong>Section 213</strong></td>
<td>Investigation into company’s affairs in other cases: NCLT can order an investigation into the affairs of company based on request by shareholders or any other person in specified circumstances.</td>
</tr>
<tr>
<td><strong>Section 216(2)</strong></td>
<td>Investigation of ownership of company: NCLT to order investigation into the affairs of the company with regards to the membership of the company and any other matters relating to the company.</td>
</tr>
<tr>
<td><strong>Section 218</strong></td>
<td>Protection of employees during investigation: An approval of the NCLT is required by the company for any action proposed against an employee during the course of any investigation of the affairs/other matters or during any proceedings under Section 210, 212, 213, 216, 219 and Chapter XVI of the 2013 Act.</td>
</tr>
<tr>
<td><strong>Section 221 and 222</strong></td>
<td>Freezing of assets of company on inquiry and investigation and imposition of restriction upon securities: NCLT to pass orders for freezing of assets of a company or to order investigation and imposition of restriction upon certain securities.</td>
</tr>
<tr>
<td><strong>Section 224(5)</strong></td>
<td>Actions to be taken in pursuance of inspector’s report: In case a fraud has taken place in the company and any director, key managerial personnel, other officer of the company or any other person of the company or entity has taken advantage due to such fraud, then the central government may file an application to the NCLT for passing appropriate orders with regard to disgorgement of such asset, property, or cash, as the case may be.</td>
</tr>
<tr>
<td><strong>Section 241 to 244 (except Section 242(1)(b) and 242(2) (c) and (g))</strong></td>
<td>Prevention of oppression and mismanagement: NCLT to pass orders for prevention of oppression and mismanagement by a company.</td>
</tr>
<tr>
<td><strong>Section 245</strong></td>
<td>Class action: Members or depositors can file an application before NCLT and seek order on matters specified in Section 245.</td>
</tr>
</tbody>
</table>
### Sections notified Overview

<table>
<thead>
<tr>
<th>Section 415 to 433</th>
<th>NCLT and NCLAT: Provisions relating to operations, functioning and constitution of members of the NCLT/NCLAT.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 434(1)(a) and (b) and 434(2)</td>
<td>Transfer of certain pending proceedings: The CLB stands dissolved and proceedings/cases pending before the CLB will stand transferred to the NCLT from the appointed date (1 June 2016).</td>
</tr>
<tr>
<td>Section 441</td>
<td>Compounding of offences: The 2013 Act provides powers to the NCLT relating to compounding of offences.</td>
</tr>
<tr>
<td>Section 466</td>
<td>Dissolution of CLB and consequential provisions: Constitution of NCLT and NCLAT and transfer of employees of CLB to the NCLT/NCLAT.</td>
</tr>
</tbody>
</table>

Source: MCA notifications dated 1 June 2016 and First Notes: The central government constitutes NCLT and NCLAT and notifies the related sections of the Companies Act, 2013 dated 23 June 2016

---

### Notification of provisions relating to special courts

The MCA through its notification S.O. 1795 dated 18 May 2016 notified the provisions relating to special courts as contained in Section 2(29)(iv), Section 435-438 and 440 of the 2013 Act.

The 2013 Act defines that special courts are courts constituted under its Section 435. Section 435 provides that the central government may, for the purpose of providing a speedy trial of offences under the 2013 Act, by notification, establish or designate as many special courts as may be necessary.

Further, the newly notified sections provide that the special courts are subject to the jurisdiction of the relevant High Court in the same manner as how the criminal courts come under it, under the Code of Criminal Procedure, 1973. Section 438 provides that the provisions of the Code of Criminal Procedure, 1973 shall apply to the proceedings before a special court and for the purposes of the said provisions, the special court shall be deemed to be a Court of Session and that the person conducting a prosecution before a special court shall be deemed to be a public prosecutor. The maximum sentence of imprisonment in a special court shall not exceed one year.

### Companies (Corporate Social Responsibility Policy) Amendment Rules, 2016

The MCA through its notification G.S.R. 540(E) dated 23 May 2016 issued the Companies (Corporate Social Responsibility Policy) Amendment Rules, 2016 (CSR amendment rules) to amend the Companies (Corporate Social Responsibility Policy) Rules, 2014.

The amended rules amended the provisions relating to the medium through which CSR activities can be carried out.

The new provisions widened the scope as it allows companies to undertake approved CSR activities through any other company provided such company or trust or society shall have an established track record of three years in undertaking similar programmes or projects; and the company has specified the projects or programmes to be undertaken, the modalities of utilisation of funds of such projects and programmes and the monitoring and reporting mechanism.

Additionally, it provides that the company can undertake approved CSR activities through companies established under Section 8 of the 2013 Act or registered trust or a registered society established by the central/state government or any entity established under an Act of Parliament or state legislature.

### SEBI Board meeting

The Securities and Exchange Board of India (SEBI) through its press release PR No. N98/2016 dated 19 May 2016 released the minutes of its board meeting. The following important matters were discussed:

**Dividend distribution policy for listed companies**

SEBI approved the proposal to formulate and disclose the dividend distribution policies in the annual reports and on the websites of the top 500 listed companies (by market capitalisation).

The following items may be included in the policy:

- The circumstances under which the shareholders can or cannot expect dividends
- The financial parameters that will be considered while declaring dividends
- Internal and external factors that would be considered for the declaration of dividends
• Policy as to how the retained earnings will be utilised
• Provisions in regards to the various classes of shares.

Further, it provides that whenever the company proposes to declare dividends on the basis of the parameters other than what is mentioned in such a policy or proposes to change its dividend distribution policy, the same along with its rationale should be disclosed in the audit report.

Offshore Derivative Instruments (ODIs)

SEBI also approved the following additional measures for the purpose of enhancing transparency and control over the issuance of ODIs:
• Applicability of Indian Know Your Customer (KYC)/Anti Money Laundering (AML) norms for client due diligence
• Prior permission for transferability of ODIs
• Reporting of complete transfer trail of ODIs
• KYC review
• Reconfirmation of ODI positions
• Periodic operational evaluation.

SEBI revises the process for listed entities to disclose the impact of audit qualifications97

With a view to streamlining the existing process for review of audit qualifications contained in the audit reports of the listed entities, the SEBI, in consultation with SEBI Advisory Committees, the Institute of Chartered Accountants of India (ICAI), stock exchanges and industry bodies, has notified the SEBI (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2016 on 25 May 2016. In addition, on 27 May 2016 SEBI issued a circular, CIR/CFD/CMD/56/2016 (the SEBI Circular) which prescribes operational details to be followed by listed entities for implementing this process.

Background

SEBI, on 2 September 2015 notified the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations). These prescribed the requirements for listed entities to submit audited financial results for the financial year along with Form A, for an audit report with an unmodified opinion and Form B for an audit report with a modified opinion. Form B and the accompanying annual audit report would be reviewed by the stock exchanges and SEBI’s Qualified Audit Report Review Committee. Based on the direction issued by SEBI, the listed entity would be required to carry out the necessary steps for rectification of the modified opinion and/or submission of revised pro forma financial results.

SEBI, through its press release - PR No. 56/2016 on 12 March 2016, announced a revised procedure for review of the audit qualifications contained in the audit reports in order to disseminate the impact of the audit qualifications on the financial statements without any delay.

Overview of revised procedure

The SEBI Circular prescribed the following operational details for implementing the revised procedure as per the amendment to the Listing Regulations:

1. Listed entities need to disseminate the cumulative impact of the audit qualifications in a separate format called ‘Statement on Impact of Audit Qualifications’, simultaneously, while submitting the annual audited financial results to the stock exchanges.
2. This is expected to ensure that the information is available to investors, without delay, enabling them to take well-informed investment decisions.
3. The existing requirement of filing Form A or Form B for audit reports with unmodified or modified opinions respectively, has been dispensed with.
4. For audit reports with an unmodified opinion, the listed entity shall furnish a declaration to that effect to the stock exchange(s) while submitting the annual audited financial results.
5. For audit reports with a modified opinion, a statement showing the impact of audit qualifications shall be filed with the stock exchanges (separately for standalone and consolidated financial statements) in the format specified in Annexure I to the SEBI Circular.
6. Schedule VIII of the Listing Regulations, comprising the manner of reviewing Form B accompanying annual audited results has been deleted.
7. The existing requirement of making adjustments relating to the qualification in the books of accounts of the subsequent year is dispensed with.
8. The management of the listed entity shall have the option to explain its views on each audit qualification.
9. Where the impact of the audit qualification is not quantified by the auditor, the management shall make an estimate. In case the management is unable to make an estimate, it is required to provide reasons for the same. In both the scenarios, the auditor shall review and provide comments on the management’s response.
10. The statements on the impact of audit qualifications filed by the listed entities shall be a part of regular monitoring by the stock exchanges as specified in Regulation 97 of the Listing Regulations. In case of non-compliance, the stock exchanges are required to take action against such entities as deemed fit and report to SEBI on a regular basis. The stock exchanges need to coordinate with one another in case the scrip is listed on more than one stock exchange.

The revised procedures are applicable for all the annual audited standalone/consolidated financial results (as applicable) submitted by the listed entities for the period ending on or after 31 March 2016.

07 SEBI circular CIR/CFD/CMD/56/2016 dated 27 May 2016 and KPMG in India First Notes: SEBI revises the procedure for listed entities to disclose the impact of audit qualifications dated 7 June 2016.
The RBI issues a scheme for Sustainable Structuring of Stressed Assets

The Reserve Bank of India (RBI), through its notification, DBR.No.BP.BC.103/21.04.132/2015-16 dated 13 June 2016, has issued guidelines for a scheme for Sustainable Structuring of Stressed Assets (the scheme) to facilitate the resolution of large borrower accounts that are facing severe financial difficulties.

The scheme is an optional framework for the resolution of large stressed accounts in addition to the Strategic Debt Restructuring (SDR) mechanism that was previously introduced by the RBI. It was issued in order to facilitate the deep financial restructuring necessary for a sustained revival of large projects, even without a change in promoters as was envisaged under the SDR mechanism.

Overview of the scheme

The scheme is applicable for debt relating to projects that have commenced commercial operations and where the aggregate exposure of all institutional lenders exceeds INR500 crore (inclusive of all facilities extended). In addition, the debt should be deemed sustainable by the Joint Lenders Forum (JLF) or consortium of lenders, based on an independent Techno-Economic Viability (TEV) assessment conducted by an independent, credible professional agency. The level of sustainable debt so determined should not be less than 50 per cent of current funded liabilities.

Determining sustainable debt

Sustainable debt (referred to as Part A) is determined as the level of debt (including new funding that may be required within the next six months) that can be serviced (including interest and principal) over the respective residual maturities of existing debt, from all sources, based on the cash flows available from current as well as immediately prospective level of operations. This requires consideration of free cash flows (i.e. cash flow from operations less committed capital expenditure) available for servicing debt as per the latest audited/reviewed financial statements.

The difference between the aggregate current outstanding debt from all sources and Part A is referred to as Part B.

Resolution plan

The resolution plan under this scheme should be agreed upon by a minimum of 75 per cent of lenders by value and 50 per cent by number. It is required to have the following features:

- No fresh moratorium should be granted on interest or principal repayments for servicing Part A of the debt. Further, there should be no extension of the repayment schedule or reduction in the interest rate for Part A. This part of the loan shall also continue to have at least the same amount of security cover as was available prior to this resolution.

- Part B of the existing debt shall be converted into either equity or redeemable cumulative optionally convertible preference shares (Part B instruments). Where the resolution plan does not involve a change in promoter, lenders may also convert a portion of Part B into optionally convertible debentures. The terms for exercise of any conversion options are to be clearly defined. Further, appropriate covenants may be included to cover the use of cash flows beyond projected levels towards servicing of these quasi-equity instruments.

- As part of the resolution plan, the current promoter may continue to hold enough shares to exercise control over the borrowing entity. Alternatively, the current promoter may be replaced with a new promoters either under the SDR mechanism or based on the Prudential Norms on Change in Ownership of Borrowing Entities (outside SDR scheme). The lenders may also acquire a majority shareholding through conversion of debt into equity and either permit the current management to continue or effect a change in management to another agency/professionals.

- Where the resolution plan does not involve a change in promoter/management, the existing promoters shall dilute their shareholdings at least in the same proportion as that of Part B to the total existing debt, either by conversion of debt into equity or sale of their equity to lenders. The promoters should also provide a personal guarantee to the JLF/consortium for the Part A amount.

An Overseeing Committee constituted by the Indian Banks’ Association (IBA) will act as an advisory body to review the resolution plan for reasonableness and compliance with the RBI guidelines.

Valuation of Part B instruments

The fair value for Part B instruments issued under this scheme should be determined as follows:

- Equity shares issued to banks should be marked to markets at least on a weekly basis (preferably daily basis). Unlisted equity shares or shares for which current quotes are not available should be valued at the lower of the following:
  - Break-up value (as per the company’s latest audited balance sheet), or
  - Value based on the Discounted Cash Flow (DCF) method where the discount factor is the actual interest rate charged to the borrower plus 3 per cent, subject to a floor of 14 per cent. For this valuation, only cash flows occurring within 85 per cent of the useful economic life of the project shall be considered.

- Redeemable cumulative optionally convertible preference shares/optionally convertible debentures should be valued on a DCF basis with a discount rate that includes a minimum mark-up of 1.5 per cent over the weighted average actual interest rate charged to the borrower. If preference dividends are in arrears, the value determined on the DCF basis should be further discounted by at least 15 per cent if arrears are for one year, with an increment of 10 per cent in the discounting factor for each additional year of arrears.
KPMG in India’s IFRS institute

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

IFRS Notes
Banks to submit pro forma Ind AS financial statements

24 June 2016

On 23 June 2016, the Reserve Bank of India (RBI) issued a circular (reference DBR.BP.BC.No.107/21.07.001/2015-16) (the RBI circular) providing directions to all scheduled commercial banks (excluding regional banks) to submit their pro forma financial statements prepared on the basis of the Indian Accounting Standards (Ind AS) for the half-year ended 30 September 2016, latest by 30 November 2016.

Banks will be guided by the Ind AS notified by the Ministry of Corporate Affairs (MCA) from time to time and should also refer to the report published by RBI’s Working Group on “Implementation of Ind AS by Banks in India” in October 2015.

This issue of IFRS Notes provides overview of the RBI circular.

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

The RBI issues a scheme for Sustainable Structuring of Stressed Assets

23 June 2016

The Reserve Bank of India (RBI), through its notification, DBR No. BP BC.103/21.04.132/2015-16 dated 13 June 2016, has issued guidelines for a scheme for Sustainable Structuring of Stressed Assets (the scheme) to facilitate the resolution of large borrower accounts that are facing severe financial difficulties.

The scheme is an optional framework for the resolution of large stressed accounts in addition to the Strategic Debt Restructuring (SDR) mechanism that was previously introduced by the RBI. It was issued in order to facilitate the deep financial restructuring necessary for a sustained revival of large projects, even without a change in promoters as was envisaged under the SDR mechanism.

This issue of First Notes aims to provide overview of the scheme.

The RBI issues a scheme for Sustainable Structuring of Stressed Assets

23 June 2016

The Reserve Bank of India (RBI), through its notification, DBR No. BP BC.103/21.04.132/2015-16 dated 13 June 2016, has issued guidelines for a scheme for Sustainable Structuring of Stressed Assets (the scheme) to facilitate the resolution of large borrower accounts that are facing severe financial difficulties.

The scheme is an optional framework for the resolution of large stressed accounts in addition to the Strategic Debt Restructuring (SDR) mechanism that was previously introduced by the RBI. It was issued in order to facilitate the deep financial restructuring necessary for a sustained revival of large projects, even without a change in promoters as was envisaged under the SDR mechanism.

This issue of First Notes aims to provide overview of the scheme.

Feedback/queries can be sent to aaupdate@kpmg.com

Previous editions are available to download from:
www.kpmg.com/in

Follow us on:
kpmg.com/in/socialmedia