Assurance EYe

Reporting Insights

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1 Future of Finance

Organizations are transforming. This is not necessarily a 'need' or 'want' anymore, but a 'must.' The global landscape has arguably never been more challenging – with external factors creating a multitude of pressures that have pushed businesses to re-examine their operating models across the entire enterprise, including the finance functions. Traditionally, decisions about finance's operating model were dominated by scale and cost, balancing business expectations with efficiency considerations which normally revolves on the norm to create and preserve value through planning, forecasting and resource allocation, performance management and financial reporting. Some of the key challenges faced by the finance function of today relate to providing financial information in near real time (rather than weeks after the year-end), keeping pace with changing skill set requirements and ensure that the chosen solution is the right fit for the process area under review.

Access to up-to-date data and technology is key to achieving transparency in today's fast-changing global landscape. This became painfully clear to many organizations during the pandemic as tax and finance teams, many of which were separated from their workplace files, struggled to meet basic compliance obligations such as filing tax returns and dealing with audit activity with tax authorities.

Finance functions can also bring more value to the entire enterprise when they have advanced technology and data at their disposal because they are able to better project the implications of broader business decisions ranging from acquisitions and dispositions to the impact of tax law changes.

To provide a new future for reporting, finance leaders should stop thinking in a linear way about how they go from where they are now to where they are trying to get to. Instead, they should take a "future-back" approach and look beyond the "now" and the "next".

Most enterprises today are asking the below questions:

- Can we create competitive advantages by automating the old reality, or do we need to rethink finance function to create value out of new services, talent, data, and technologies?
- If the rise of the digital workforce and technology-driven finance talents creates bionic teams, how will we best combine both worlds and manage them?
- How can we overcome our outdated technology landscape, remedy disparate systems, embed standardization in processes, and adopt new technologies?
- How can we ensure that transactional needs are met to allow resources to engage in value-add business partnering?

In this article, we provide an overview of how digitizing finance would help accelerate transformation to a future ready, agile finance function focused on long-term value.

01 New age technology

Data is emerging as the strategic currency of the digital age. It will be generated based on the success of how humans work together across an enterprise including functions, data and analytics teams and technology, to drive a cultural shift. In a few short years, data and analytics will drive and predict the most important decisions, processes and interactions of the enterprise. What will this data centricity mean to companies?

Instead of siloed, restricted sets of facts, a data fabric will be integrated across the enterprise. Data expertise will expand from the IT department into business group, internal operations, and customer relationships. Employees across the entire enterprise will manage, routinely access and use the data necessary to improve their decisions and processes. This is a migration from data management to data centricity.

New age technology would usher the new digital age and support the data centricity agenda. Advances in new technologies — such as in-memory computing, the cloud, analytics, mobility, artificial intelligence, blockchain and robotic process automation, Cloud and Software-as-a-service — offer Chief Financial Officers (CFOs) an exciting opportunity to reimagine what the finance function should look like. In addition, many CFOs are now key players in driving adoption of these technologies more broadly in the organization, and in leading the transformation that ensues from technology innovation.

But to make the most of new technologies' ability to save costs, manage risks and increase insight, finance leaders must challenge assumptions, take calculated risks and encourage experimentation. At the same time, they must also manage the risks inherent in each technological innovation.

Proliferation of technology brings vulnerabilities to be addressed at source. Attackers exploit vulnerabilities, create denial-of-service attacks and demand ransom. All the while, systems are taken offline, and access to the organization's data is denied. Confronted with these attacks, every organization has a duty to its customers, investors and shareholders to recover customer data and to get back up and running again; while some companies and industries can handle a few weeks of downtime, it could be catastrophic for others. Engaging outside experts can help in breaking through the echo chamber as organizations generally have limited experience in cybersecurity.

02 Staying relevant in a changing world

Gone are the days when traditional financial reporting, such as the profit and loss statement, balance sheet, cash flow and simple variance analysis are enough. Business leaders are now looking for in-depth insights that allow them to connect business activity to long-term value, model scenarios in real-time and efficiently allocate resources. If finance functions do not step up to the plate, then other functions will step into the void and risk weakening the central role of the finance function in the modern enterprise.

At the same time, many CFOs are under pressure to reduce costs and increase efficiency. This means that any additional spending to help finance functions develop their capabilities must be clearly justified by the tangible value it adds to the business.

Along with the evolution of the finance function, we can expect the balance of time spent on different areas and activities to shift. Reporting is likely to grow in complexity as banks and other organizations increase their focus on non-financial reporting. However, with the sophistication in technology and automation of reporting processes, 'human' capacity will be focused on analysis, decision-making and strategy.

03 Humans at the center – the relationship between people and tech

Pre-crisis, most organizations had been on a path to a future of work that was more agile, digital and people centered, with an evolving skill need. COVID-19 has significantly accelerated that journey for all organizations on a scale they did not dream about. People services that were once considered "nice to have" are now crucial to the success of any organization and quickly being adopted and implemented.

It would not just be technology that is transformed – employees will be transformed into more digitized, high value and strategic workers.

To keep up with the constant state of change, organizations need to quickly adapt their people to new business strategies and operating models, and upskill or reskill them to take on new roles. But trying to change the behavior of people who span different generations and process things in their own ways is easier said than done.

Many people initiatives focus on discrete skill development. While important, that does not address equally influential aspects of change, including mindsets and broader organizational enablers, such as operating model, processes, culture and KPIs.

Developing finance and accounting professionals to deliver business partnership and specialist roles requires talent management and development strategies. These strategies develop employees and support effective learning-centric approaches enabling accounting and finance professionals to

acquire required skills, expertise, and experiences and engage in reflective practice. It also involves recognizing performance and desired behaviors and providing incentives that encourage partnering and enhancing contributions to the wider organization. Talent management and development should result in interesting and exciting career paths involving greater exposure and involvement beyond the finance function.

The new people imperatives include the following:

- Operate horizontally across enterprise to deliver experiences at scale.
- Accelerate digital to unlock capacity trapped in current service delivery models - team to spend more time on what matters.
- Prioritize spend - deliver cost savings while expanding services and improving experiences.
- Enhance value - core role is to maximize human capital essential for long-term value creation.

In the transformed finance function, a rebalancing of skills and expertise will also be required. Of course, qualified accountants will still be needed to oversee and implement evolving accounting standards and other regulatory and legal requirements. However, a larger proportion of the finance function will comprise data scientists or business analysts: people who can use the data, understand the IT systems that generate it and answer questions from the business.

The success of any technology greatly depends on the skills of the people using it. In fact, staff capacity to adapt to change is the main barrier to adopting new technologies. As CFOs build tomorrow's finance function, they will need to find people with the skills — and motivation — to complement the technological innovations, as well as to embrace rapid change, different roles and new approaches.

How we look at it

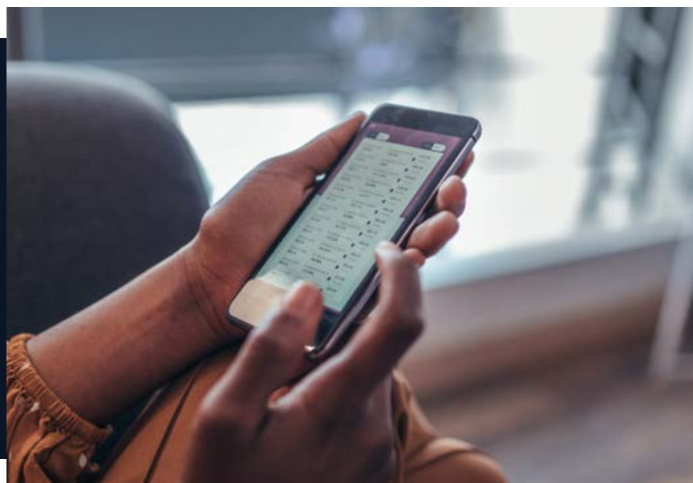
As enterprises hit the reset button, they recognize they have an opportunity to sustain the accelerated improvements they have made. Enterprises need not only change, but change the way they change. Strategic priorities that companies thought would take months to manifest and years to execute happened in weeks. The question is, how do enterprises maintain that momentum? How do they make the right decisions? How do they capture the human element as part of the decision-making criteria and process?

Organizations that put humans at center and think of long-term value will have more power and the potential to unleash. The more organizations make thoughtful, data-driven decisions, the better off employees, customers, and society will be.

We are entering a new era of finance driven by technology and data centricity – where every decision, process and interface will be driven by data. This transformation is being built on a new technology infrastructure of cloud, artificial intelligence, Internet of Things and other technologies that build a pervasive data fabric across the enterprise. While technology is at the core of this transformation, humans are at its center – a more empowered workforce that uses and advances the data centricity of the enterprise.

CFO's must now understand where and how data and technology can be used, including enterprise resource planning in the cloud, advanced data analytics, cybersecurity software and much more. Cyber risk is top of mind for organizational leaders and boards. Cyber risk should be part of the wider enterprise risk management processes that CFOs already watch closely. Finance leaders who develop a working knowledge of IT can make better strategic business decisions and continue to push forward – and fund – their companies' digital transformation.

2 An overview of recent changes to Indian Accounting Standards



The Ministry of Corporate Affairs (MCA) on 23rd March 2022 notified the Companies (Indian Accounting Standards) Amendment Rules, 2022, whereby certain important changes have been made to Indian Accounting Standards (Ind AS). All these changes are applicable from financial year beginning 1 April 2022. In this article, we provide an overview of key changes and their likely impact.

Amendment to Ind AS 16, Property, Plant and Equipment

Both Ind AS 16 and IAS 16 require that the cost of an item of property, plant and equipment (PP&E) should include any costs directly attributable to bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by the management. Specifically, one item identified is the cost of testing - whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while making the asset available for use.

In this regard, issues had arisen, viz., whether (a) the proceeds to be deducted relate only to items produced from testing, or (b) an entity deducts from the cost of PP&E any proceeds that exceed the costs of testing. The International Accounting Standards Board (IASB) has researched on the matter and noted that diverse reporting methods are applied. Some entities deduct only proceeds from selling items produced from testing; others deduct all sales proceeds until the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management (i.e., available for use). For some entities, the proceeds deducted from the cost of an item of PP&E can be significant and can exceed the cost of testing.

To address this issue, the IASB has amended IAS 16 under International Financial Reporting Standards (IFRS). The amended IAS 16 prohibits the deduction of sales proceeds from the cost of an item of PP&E. Instead, an entity would recognize such sales proceeds, together with the costs of producing those items (production costs), in profit or loss, applying the applicable IFRS. The amendments to IAS 16 also require an entity to separately identify the production costs associated with selling volumes before an asset is ready for its intended use. An entity will be required to identify and measure production costs by applying the measurement requirements in IAS 2, Inventories.

As a result of the amendment, below key challenges were expected to arise under IFRS

- Allocation of costs under IAS 2 may not be straightforward. Prior to the intended use of the asset, there could be inefficiencies and abnormal production costs, with little information about what constitutes a normal level of production.
- There may be a need to monitor and classify construction costs in more granular detail than previously required.
- There may be tax and deferred tax consequences of recognizing profit in different periods and potentially as trading profit, as opposed to through any allowances on the assets.
- There can still be challenges in determining the date assets brought into use. The changes to IAS 16 do not address this area.

Considering the challenges and views expressed by other stakeholders, the above change has not been implemented under Ind AS. On the contrary, amendments to Ind AS 16 clarify that excess of net sale proceeds of items produced over the cost of testing, if any, will not be recognized in the profit or loss but deducted from the directly attributable costs considered as part of cost of an item of PP&E.

In our view, this will absolve Indian entities from application of additional complex requirements. At the same time, it will also create an additional carve-out vis-à-vis IFRS.

Amendment to Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets

Ind AS 37 defines an onerous contract as a contract in which unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract. If a contract is determined to be onerous at any stage, then the entity needs to recognize provision in its financial statements for the expected losses on the contract. Expected losses are measured at the lower of cost to fulfil the contract and any termination penalty. If a contract can be terminated without incurring a penalty, then it is not onerous.

Before the amendment, meaning of the term 'costs of fulfilling the contract' was unclear leading to diversity in practice and two approaches were followed, viz., the 'incremental cost' approach and the 'direct cost' approach. Under the first approach, only incremental costs of fulfilling a contract, e.g., direct labor and materials, were considered to determine onerous provision. In contrast, under the 'direct cost' approach, both incremental costs and an allocation of other costs incurred to fulfil the contract (e.g., allocated depreciation, other shared costs) were also considered.

The amendment specifies that for determining onerous contract provision and comparison with termination penalty, cost of fulfilling a contract should comprise both incremental costs and an allocation of other costs that relate directly to fulfilling contracts. The amendment will likely require entities, which were earlier using the incremental cost approach, to recognize larger provisions for onerous contracts.

Example

XYZ Limited has entered into a revenue contract with the following requirements

- Total economic benefits expected to be received from the contract: INR 1,100
- Direct material costs: INR 450
- Direct labour costs: INR 600
- Allocation of cost for activities directly related to complete the contract: INR 100
- Termination penalty: INR 120

Identification of onerous contract provision

Particulars	Incremental cost approach	Direct cost approach
Estimated revenue	1,100	1,100
Estimated cost to complete the contract		
Direct material costs	450	450
Direct labour costs	600	600
Allocation of other direct costs	NA	100
Total cost to complete	1,050	1,150
Do the costs increase estimated revenue?	No	Yes
Onerous contract?	No	Yes
Determination of Onerous Contract provision		
Excess of estimated cost over revenue	NIL	50
Termination penalty	100	100
Onerous contract provision	NIL	50

Post amendment, i.e., from financial year beginning 1 April 2022, only direct cost approach needs to be followed. The amendment will apply to all contracts existing at that date, i.e., 1 April 2022. At the date of initial application, the cumulative effect of applying the amendments is recognized as an opening balance adjustment to retained earnings or other component of equity, as appropriate. Comparatives are not restated on transition.

Amendment to Ind AS 109, Financial Instruments

When an entity restructures or changes terms of its existing loan liability with an existing lender, it is required to assess qualitatively or quantitatively as to whether the restructuring results in substantial modification to terms of loan. The quantitative assessment is based on difference in present value of cash flows under the old and new contractual terms (commonly known as '10% test'). The outcome of this assessment decides amount of gain or loss to be recognized in profit or loss:

a) If the present value of cash flows under the new terms (including any fees paid) has a variance of 10% or more as compared to the present value of remaining cash flows under the old terms, the existing loan is derecognized from the balance sheet and a new loan recognized at its fair value, i.e., using current market rate of interest. The difference between the carrying amount of the existing loan and the fair value of the new loan is recognized as gain or loss in the profit or loss.

b) If the variance is less than 10%, the existing loan is not derecognized, but a modification gain or loss is recognized in profit or loss. The modification gain or loss is difference between the original and the modified cash flows discounted at the original effective interest rate.

In a debt modification exercise, the borrower could pay fees either to the lender or third parties (e.g., legal fees paid to lawyers). Before the amendment, Ind AS 109 was unclear which fees should be included in the 10% quantitative test. The amendment clarifies that only fees paid or received between the borrower and the lender, including fees paid or received on each other's behalf, are included in the assessment. Fees paid to third parties (e.g., fee paid to lawyers) are not included in the 10% test.

Entities are not required to apply the change retrospectively. The amendment is applicable to financial liabilities that are modified or exchanged on or after the beginning of the annual reporting period in which the entity first applies the amendment.

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

This amendment deals with a scenario where a subsidiary adopts Ind AS later than its parent. In such a scenario, paragraph D16 of Ind AS 101 provides an exemption whereby subsidiary can opt to measure its assets and liabilities based on the amounts appearing in the parent's consolidated financial statements, subject to certain specific adjustments.

Let us assume that the subsidiary has a foreign operation on which it needs to calculate foreign currency translation reserve (FCTR) and accumulate the same as a separate component of equity. A question had arisen whether the exemption given in Ind AS 101 can also be applied to measurement of FCTR. The IFRS Interpretation Committee (IFRIC) of the International Accounting Standards Board (IASB) had earlier considered this question and concluded that the exemption in Ind AS 101 applies only to measurement of assets and liabilities and not FCTR. This implied that the subsidiary will either set FCTR at zero (basis other exemption in Ind AS 101) or calculate it retrospectively. Consequently, subsidiary's FCTR amount will be completely different from that of the parent.

To address this matter, a change has now been made to IFRS 1 and also Ind AS 101 allowing subsidiary to measure FCTR for all foreign operations at carrying amount as per the parent's consolidated financial statements, based on the parent's date of transition to Ind AS.

It may be noted that in most cases, Ind AS roadmap requires parent and subsidiary companies to adopt Ind AS from the same date. Hence, this amendment will generally have minimal or no impact on Indian companies.

Amendment to Ind AS 103, Business Combinations

Ind AS 103 specifies that assets and liabilities recognized in a business combination must meet the respective definitions of assets and liabilities in the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI. After the acquisition date, an acquirer accounts for most types of assets and liabilities recognized in a business combination in accordance with other Ind AS standards applicable to those items.

Since the notification of Ind AS 103, the Framework for the Preparation and Presentation of Financial Statements has been replaced by the Conceptual Framework for Financial Reporting under Ind AS. To address this matter, consequential wordings in Ind AS 103 have also been changed. It may be noted that there are certain differences in definition of asset and liability under the Framework and the Conceptual Framework which may have caused some unintended consequences in the financial statements post business combination accounting. To avoid such unintended consequences, other appropriate changes in requirements related to contingent liability and contingent asset recognition have been made.

The amendment will avoid potential confusion from having more than one version of the framework in use and address some of the issues that such alignment may have caused. From financial statement's perspective, it is not expected to have any material impact.

Amendment to Ind AS 41, Agriculture

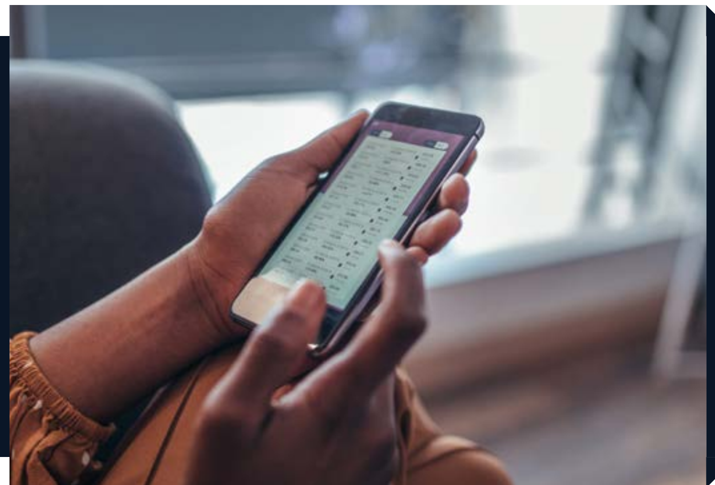
Prior to the amendment, Ind AS 41 require an entity to exclude taxation cash flows from its discounted cash flow model, in determining the fair value of its biological assets. In contrast, Ind AS 113 Fair Value Measurement does not specify whether an entity uses pre-tax inputs or post-tax inputs to determine fair value; rather, it merely requires an entity to use internally consistent assumptions about cash flows and discount rates. To ensure a consistent valuation approach, this amendment removes the requirement to exclude cash flows for taxation when measuring fair value. Rather, in-line with Ind AS 113, the entities will have an option to use either pre-tax or post-tax cash flows and discount rates provided that they use internally consistent assumptions.

Ind AS 113, requires that assumptions used to measure fair value reflect what market participants would consider. Considering this, in our view, the assumptions about cash flows and discount rates should reflect market participants' views, which in practice are predominantly performed on a post-tax basis.

How we look at it

Whilst the objective of these changes is to align Ind AS with IFRS, Ind AS 16 amendment is at variance from IFRS and will create an additional carve-out vis-à-vis IFRS. Some of these changes may require companies to evaluate accounting currently followed and incorporate the impact carefully.

3 An overview of accounting and tax considerations of Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs)



InvITs and REITs (Trusts) are new instruments in the market, sometimes not noticed by investors because of the puny size of the number of InvITs/REITs listed in comparison to their equity counterparts. But their puny size belies their huge asset values of over Rs 2.5 lakh crore built within last 5 years. These instruments have offered a new avenue for investing even for retail investors. These alternatives that these trusts have tapped as sources have provided a new avenue and alleviated the pressures on traditional sources like banks and financial institutions.

Trusts raise funds from investors by issuing units. These funds are invested in cash generating infrastructure/real-estate projects - generally which are annuity bearing. The cash earned is periodically distributed to the unitholders and it provides a constant stream of revenue to these unit holders. InvITs/REITs are constituted as trusts under Indian Trusts Act and registered and governed by Securities and Exchange Board of India (SEBI). The projects/assets are normally housed in Special Purpose Vehicles (SPVs) which are owned by the trusts. These trusts are pass-through vehicles under the tax laws so as to ensure that the income gets taxed in the hands of unitholders.

In India, SEBI Regulations [SEBI (Infrastructure Investment Trusts) Regulations, 2014 and SEBI (Real Estate Investment Trusts) Regulations, 2014] and the circulars issued thereunder govern all the InvITs/REITs. Typically in an InvIT/REIT, there are various parties involved. A sponsor which settles the trust and which is usually the entity which initially transfers the project SPVs to the trust; an investment manager which has the overall responsibility to run the operations of the InvIT/REIT and a trustee which has a fiduciary role for the unitholders. In that sense the structure including governance is very different from what one would typically see in a listed company set-up. Additionally, a trust in India is required to mandatorily distribute minimum 90% of funds generated at least every six months.

Accounting Considerations for Investments Trusts

01 Applicability of GAAP - Ind AS v/s Indian GAAP

InvITs/REITs are trusts and not companies. Accordingly, Companies Act is not applicable to these entities. They come under the SEBI framework and by virtue of SEBI regulations, Ind AS becomes applicable to these trusts. One unconventional aspect is also that private unlisted InvITs/REITs also get covered under SEBI framework (unlike companies where SEBI regulates only listed companies) and hence Ind AS consequently becomes applicable.

02 Unit capital classification

A InvIT/REIT is a vehicle which is structured to distribute cash flows. In India (unlike in some other countries), it is mandatory for these trusts to distribute at least 90% of the funds generated (termed as 'Net Distributable Cash Flows' or 'NDCF'), which technically makes a significant portion of the instrument a liability and balance small portion as equity, effectively making the instrument a compound financial instrument. The current language under SEBI circulars suggests that unit capital is to be classified as equity and this is the position which InvITs and REITs have generally adopted in India. Globally, there is a diverse practice and the classification depends on the specific terms of such units, which are different across countries. Hence, one cannot adopt accounting followed in another country without understanding the terms applicable in that country. For e.g. in Singapore, unit capital is classified as equity as per the guidance issued by local regulator (possible reason being that distribution is

not mandatory but is required in case the trust wishes to avail tax deduction for the distributions made and avoid getting taxed at trust level). In Hong Kong, Australia, etc certain trusts have treated unit capital as financial liability basis their evaluation of the terms of the issued units (eg: limited life trusts, puttable units, multiple classes of units, etc.)

In India, classification of unit capital as equity has generally been adopted by the industry, however regulators need to clarify the appropriate treatment aligned to the requirements of Ind AS due to varying practices across countries.

03 Business acquisition vs Asset acquisition

InvITs/REITs are asset intensive vehicles and they are housed in SPV's which are acquired by the trust when it is set-up and later through its life. Whenever the trust acquires a project SPV, an assessment is required as to whether it is a business acquisition or asset acquisition since the accounting and disclosures could be significantly different. Ind AS 103 provides detailed guidance on what constitutes a business. Moreover, there is a 'concentration test' introduced in recent years in Ind AS 103 (in line with its US GAAP counterpart) which provides that if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, then the acquisition may be treated as asset acquisition without further assessment. The classification of business or asset impacts how the assets/liabilities acquired are measured initially, accounting for goodwill, deferred taxes, treatment of acquisition costs, contingent consideration accounting and the extent of disclosures required in financial statements. These impacts are not limited to the year of acquisition but could also carry in future years. Hence it is very important to carefully examine the pros and cons before concluding on the position.

04 Contingent consideration/ Earn-outs

As part of the acquisition deals undertaken by InvITs/REITs, it is not uncommon to have a portion of total consideration dependent on future performance of the project or on the outcome of an event/litigation. Such contingent consideration is initially recognized at fair value. Accounting for changes in contingent consideration post acquisition date depends on the reasons for such changes as well as the classification of the contingent consideration (equity vs liability). If the change is due to additional information about facts and circumstances that existed at the acquisition date (and it is within the measurement period of 12 months), then adjustments are done to the initial acquisition accounting. Changes in contingent consideration arising from events after the acquisition date are measured at fair value through profit or loss in case of liability classification whereas in case of equity classification, no remeasurement is required because equity is residual.

05 Service concession arrangements

The participation of private sector in development of infrastructure facilities has increased tremendously under the public-private partnership models, be it highways, power generation/transmission, gas pipelines, airports, etc. Such projects need to be evaluated for applicability of Appendix C of Ind AS 115 (service concession arrangements or SCA). If the arrangement is a SCA, then the entity will recognize the assets either as financial assets or intangible assets depending upon the terms of the arrangement. SCA accounting has significant implications on the financial statements including the presentation of assets, timing of revenue recognition, bifurcation of total cash earned between finance and non-finance, etc. It also has implications on compliances with debt covenants, asset cover for lenders, Minimum Alternate Tax computation, Non Banking Financial Companies /Core Investment Companies evaluation, etc.

06 Investments in trusts and consolidation of trust

Accounting treatment for investments in the units of trust needs to be evaluated based on the requirements of Ind AS 32 given the mandatory requirement of minimum distribution of 90% of the distributable cash flows which could result in the investment in units being accounted for differently than what could have been the case had those units been classified as equity investments (InvIT/REITs classify the units issued as 'Equity' because of SEBI circular requirement which does not apply to an investor in such units).

An investor would consolidate/equity-lift an InvIT/REIT if it meets the criteria of control/significant influence under Ind AS. Sponsors are required to own certain minimum stake of 15% in InvIT/REIT, however they could choose to hold more than the minimum. The investment manager is generally a subsidiary of the sponsor or it could be a group entity of the sponsor. Detailed evaluation would be required to determine if a sponsor needs to consolidate or equity lift the profits of the trust. The evaluation will take into account factors like the sponsor's stake in the trust, restrictions on sponsor for voting in general meetings on related party transactions, the dispersion of unit holdings among other unitholders, historical voting patterns, kick-out rights available to the other unitholders for removal of the Investment Manager, etc.

Tax considerations for investment trusts

Investment trusts normally have a pass-through status for income taxes. The approach adopted to achieve tax neutrality vary across jurisdictions like in US, Singapore, etc. where the trusts have to distribute their income as a condition for claiming deduction for tax purposes. In Australia, the tax laws provide for 'attribution' model as against 'distribution' model where income of the trust is attributed to unitholders for tax purposes and the unitholders need to pay tax on such attribution without the obligation of the trust to distribute cash.

In India, exemption approach has been adopted wherein income in the form of interest and dividends earned by the trust from the project SPVs is fully exempt u/s 10(23FC) of the Income Tax Act (the IT 'Act'). Any other income of the trust (like interest on fixed deposit, gain on mutual funds, etc) is taxed based on applicable provisions of the IT Act.

Taxability of amounts distributed by the trust in the hands of unitholders depends on the nature of the income up streamed from the SPVs to the trust. Section 115UA(1) of the IT Act provides that the income distributed by the trust shall be deemed to be of the same nature and in the same proportion in the hands of the unitholder as if such income was received by or accrued to the trust. If the SPV up streams cash to the trust in the form of interest on loan, then it is taxed as interest income in the hands of unitholders when distributed by the trust. Similarly, dividend income from SPVs to trust is taxed as dividend in unitholders' hands on distribution.

Distributions classified as interest income in the hands of unitholders are taxed at rates as applicable for resident and non-resident unitholders. Distributions classified as dividends are exempt in the hands of unitholders except for distributions by trust out of dividends from those SPVs who have adopted the concessional tax regime (under section 115BAA/115BAB of the IT Act). Distributions by the trust out of any other income of the trust are exempt in the hands of unitholders since such income is already subjected to tax at trust level.

There are certain tax benefits for the sponsor too. The acquisition of project SPV by the trust from the sponsor by issuing units to the sponsor is treated as exempt transfer for capital gains purpose. The sponsor is liable to capital gains only when it sells the units so received. Further, for capital gains computation on sale of units by sponsor, the cost of acquisition of such units is considered the same as the cost of acquisition of the shares of project SPV and the period of holding of units includes the period of holding of SPV shares.

How we look at it

With the government's focus on infrastructure development through monetizing existing assets and the launch of national monetization pipeline with estimated monetization potential of Rs. 6 lakh crore in 4 years, scope for investment trusts in India is set to grow manifold in coming years. Considering the breadth of industries which can form part of the investment trusts, accounting and tax issues will evolve. Many of these will not have ready solutions and sometimes global practices may be misleading because of differences in regulatory framework across countries. Hence, trusts would need to ensure that they work with a strong set of accounting and regulatory advisors who can advise them on complex issues as they arise keeping in mind Indian regulatory framework.

4 Accounting solutions

This section provides practical application issues with reference to liquidated damages and capitalization of depreciation charge for the right-of-use asset.

Liquidated damages arising on delays by contractor

Fact pattern

An entity that employed a contractor received, in accordance with the terms of the contract, liquidated damages arising because of delays by the contractor. The liquidated damages are directly linked to the amount of lost revenue from the asset not being completed on time.

Issue

Are liquidated damages received upon delays by a contractor deducted from the cost of the related asset or recognized as income?

Viewpoint

Paragraph 16 of IND AS 16 Property, Plant and Equipment states:

"the cost of an item of property, plant and equipment comprises:

- its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
- any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management…"

Normally, acquisition of property, plant and equipment does not give rise to income. Therefore, in the absence of specific reference to compensating for losses in a liquidated damage clause, the liquidated damages received are deducted from the cost of the related assets.

The rationale for this approach is consistent with the conclusion that, rather than damages for delay, the contract provides for an additional payment in the event of early completion. For example, if rather than a CU 100 penalty for late delivery on a CU 1,000 contract after 1 January 200X, as the contract had a value of CU 900 but provided for an additional payment of CU 100 for an early completion before 1 January 200X. Therefore, the cost of the asset is the total price paid to acquire it, including the premium for early completion (i.e., CU 1,000 if finished before 1 January 200X and CU 900 if finished after 1 January 200X). This gives the same result as with liquidated damages.

However, when the liquidated damages clause in a contract refers to compensating the affected party for any revenue lost or reimbursement of specific costs incurred because of delay in the completion of the project, then recognizing liquidated damages as revenue or deducting against specifically reimbursed costs is more consistent with the purpose of the liquidated damages clause.

Capitalization of depreciation charge for the right-of-use asset as part of construction costs of a building

Fact pattern

Scenario 1 – Land is leased and building constructed would be sold in the ordinary course of business

On 1 January 20X0, an entity enters into a lease of land for a term of 40 years. The entity intends to construct a building on the land and, as part of its ordinary business activities, plans to sell the building once construction is completed. However,

the entity must obtain planning permission for the building, and this process takes 3 years. Therefore, the land lease commences on 1 January 20X0. Construction of the building begins on 1 January 20X3 and is completed 2 years later.

Assume the construction is completed and the transaction to sell the building occurs on 1 January 20X5. The transaction qualifies as a sale under IND AS 115. Entity A retains the land lease and enters into a sublease with buyer.

Scenario 2 – Land is leased and the building constructed will be owner-occupied

The fact pattern is the same as Scenario 1, except that the entity occupies the building itself once construction is completed which occurs on 1 January 20X5. The entity applies the cost model for its property, plant and equipment.

Scenario 3 – Existing building is leased and leasehold improvements are made

On 1 January 20X0, the entity enters into 10-year lease of a building (for example a store) and a 10-year lease of the underlying land. To make the building suitable for its requirements, the entity makes substantial leasehold improvements beginning on the commencement date of the leases. From lease commencement through the period when the leasehold improvements are being constructed, the entity cannot begin its intended operations until the work is completed. On 1 April 20X0, the building is available to begin the entity's operations.

Issue

Does the depreciation charge for the right-of-use asset of a lease constitute part of the cost of:

1. constructing an asset that is accounted for under Ind AS 2, Inventories and will be sold?
2. constructing an asset that is accounted for under Ind AS 16, Property, Plant and Equipment and will be utilized for the entity's own use?
3. leasehold improvements to an asset that is held for own use?

Viewpoint

Scenario 1

The entity intends to hold the building for sale in the ordinary course of business; therefore, the building meets the definition of inventories under paragraph 6 of Ind AS 2.

Paragraph 10 of IND AS 2 states:

"The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition".

Paragraph 12 of IND AS 2 states:

"The cost of conversion of inventories include (...) a systematic allocation of fixed (...) production overheads (...) such as depreciation and maintenance of (...) right-of-use assets used in the production process."

Paragraph 31 of IND AS 116 states:

"A lessee shall apply the depreciation requirements in Ind AS 16 Property, Plant and Equipment in depreciating the right-of-use asset, subject to the requirements in paragraph 32."

Paragraph 48 of IND AS 16 states:

"The depreciation charge for each period shall be recognized in profit or loss unless it is included in the carrying amount of another asset."

When an entity leases land in relation to the construction of real estate that meets the definition of inventory, the entity needs to determine whether the depreciation cost of a right-of-use asset represents a cost of conversion in bringing the inventories to their present location and condition as specified in IND AS 2. If the entity concludes that this is the case, the related depreciation expense should be included in the cost of the inventory. Otherwise the entity should apply the depreciation requirements in IND AS 16.

Scenario 2

When an entity leases land in relation to the construction of real estate that meets the definition of property, plant and equipment, the entity needs to determine whether the depreciation cost of the right-of-use asset represents a cost that is directly attributable to bringing the asset to a condition necessary for it to be capable of operating in the manner intended by management as specified in IND AS 16.

If the entity concludes that this is the case, the entity has an accounting policy choice between view 1 (capitalise as part of construction costs) and view 2 (expense as incurred). An entity must apply the selected accounting policy consistently.

View 1: Capitalize as part of construction costs

Paragraph 10 of IND AS 16 states

"An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include those incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. The cost of an item of property, plant and equipment may include costs incurred relating to leases of assets that are

used to construct, add to, replace part of or service an item of property, plant and equipment, such as depreciation of right-of-use assets. "

The depreciation charge for the right-of-use asset is a directly attributable cost in the terms of paragraph 16(b) of IND AS 16, which states that the cost of property, plant and equipment comprises (among other things):

"any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management."

In particular, in this scenario the depreciation charge is an unavoidable cost of developing the property, because without the lease of land no construction of the building can occur.

View 2: Expense as incurred

Paragraph 10 of IND AS 16 states that the cost of an item of property, plant and equipment may include the depreciation of right-of-use assets but does not require it. Therefore, an entity may elect, by an accounting policy choice, not to capitalize these costs as part of the construction cost of the building.

If an entity concludes that the depreciation cost of the right-of-use asset does not represent a cost that is directly attributable to bringing the asset to a condition necessary for it to be capable of operating in the manner intended by management as specified in IND AS 16, the entity needs to apply view 2 (i.e. recognize the depreciation cost as an expense when incurred) above.

Scenario 3

When an entity leases real estate (land and building) in relation to the construction of leasehold improvements that meet the definition of property, plant and equipment, the entity needs to determine whether the depreciation cost of the right-of-use assets represents a cost that is directly attributable to bringing the asset to a condition necessary for it to be capable of operating in the manner intended by management as specified in IND AS 16.

In this scenario there are additional arguments for expensing the depreciation of the right-of-use asset: Under this scenario, the depreciation of the right-of-use asset is for the use of the existing building itself (whereas in Scenarios 1 and 2, the building does not yet exist). The way in which an entity uses a building, for example, by making leasehold improvements or by using the building in its current state, does not affect the depreciation charge incurred. If one follows this argument, the entity recognizes the depreciation charge as an expense as incurred.

However, the fact pattern states that the entity is not permitted to use the building for its intended purpose while the leasehold improvements are made. This provides support for the argument that the depreciation cost of the right-of-use asset during the period in which the building is not used, represents a cost that is directly attributable to the construction of the leasehold improvement and should therefore be capitalized.

If the entity concludes that this is the case, the entity has an accounting policy choice between view 1 (capitalize as part of construction costs) and view 2 (expense as incurred) in Scenario 2. Otherwise the entity should apply view 2 (expense as incurred).

An entity must apply the selected accounting policy consistently. Further, to the reasons for the conclusion refer Scenario 2 above.

5 Key Regulatory updates

This section provides an overview of the key regulatory updates for the period April 1, 2022 to June 30, 2022.

Supreme Court holds that secondment of employees between group companies is a taxable service

The Honourable Supreme Court in M/s Northern Operating Systems Private Limited vs C.C.,C.E. & S.T. – Bangalore (Adjudication) heard the issue relating to the levy of service tax on secondment of employees by the foreign group company to the Indian entity wherein the salary is disbursed by the foreign company and the same is later reimbursed by the Indian entity at actuals.

The Honourable Supreme Court interalia observed that the crux of the issue is taxability of the cross charge which is primarily based on who should be reckoned as an employer of the secondee. The Honourable Supreme Court held that in the extant case, the taxpayer (i.e. Indian entity) was the service recipient of the overseas company, which can be said to have provided manpower supply service or a taxable service. To access the Supreme Court judgement, click here.

MCA UPDATES

Deferral of requirements for maintenance of accounting software which has a feature of recording audit trail

Companies (Accounts) Rules, 2014 interalia provide that from financial year commencing on or after April 1, 2022, every company which uses accounting software for maintaining its books of account, should use only such accounting software which has a feature of recording audit trail of each and every transaction, creating an edit log, etc

The MCA has extended the applicability date to financial year commencing on or after April 1, 2023.

These amendments are effective from the date of publication in the Official Gazette i.e. March 31, 2022. To access the notification, click here.

Extension of timelines for conducting AGM/ EGM through electronic means

MCA has extended the timelines for conducting

- Annual General Meetings (AGMs) by companies whose AGMs is due in the year 2022. Such Companies are allowed to conduct AGM through video conference or other audio-visual means on or before December 31, 2022 as per the prescribed framework. To access the MCA circular, click here.
- Extra Ordinary Meetings (EGMs) through video conference or other audio-visual means or transact items through postal ballot upto December 31, 2022 as per the prescribed framework. To access the MCA circular, click here.

SEBI UPDATES

FAQs/clarifications on related party transactions (RPT's)

- NSE vide circular dated April 25, 2022 has issued FAQs to primarily provide guidance on disclosure obligations relating to RPT. To access the FAQs click here.
- SEBI vide circular dated April 8, 2022 has clarified that the shareholders' approval of omnibus RPTs approved in an AGM would be valid upto the date of the next AGM for a period not exceeding 15 months. Further, in case of omnibus approvals for material RPTs, obtained from shareholders in general meetings other than AGMs, the validity of such omnibus approvals would not exceed 1 year. To access the circular, click here.

NSE circular on maintenance of information on the website of listed entities

NSE vide circular dated July 4, 2022 has advised the listed entities as follows:

- Disseminate all disclosures, specified under Regulation 46 and Regulation 62 of Securities and Exchange Board

of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 under separate section of the website of the listed entity in the prescribed manner.

- The website of the listed entity needs to be updated with effective date or last amended date of the policies uploaded on the website. To access the circular, click here.

Updated operational circular for issue and listing of non-convertible securities, commercial paper, etc

SEBI vide circular on April 13, 2022 has issued the updated operational circular which provide a chapter-wise framework for the issuance, listing and trading of non-convertible securities, securitized debt instruments, security receipts, municipal debt securities or commercial paper. To access the circular, click here.

Alignment of regulatory framework for security cover, etc and issuance of enabling provisions

SEBI (Listing Obligations and Disclosure Requirements), 2015, SEBI (Debenture Trustee) Regulations, 1993 and SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 were amended to align the frameworks regarding 'security cover', credit ratings and due diligence certificate. These amendments are effective from the date of publication in the Official Gazette i.e April 11, 2022.

Key amendments to SEBI (Listing Obligations and Disclosure Requirements), 2015 include the following:

- Term 'asset cover' has been substituted with 'security cover' (Regulation 54 and 56)
- Listed entity should maintain 100% security cover sufficient to discharge both principal and interest (earlier: only principal) (Regulation 54)
- Maintenance of security cover for secured listed non-convertible debt securities (earlier: listed non-convertible debt securities) (Regulation 54)

To access the amendments to SEBI (Listing Obligations and Disclosure Requirements), 2015, click here, SEBI (Debenture Trustee) Regulations, 1993, click here and SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021, click here.

Further, SEBI has issued a circular to prescribe a revised format of security cover certificate (to be submitted by the listed entity), enhanced monitoring by Debenture Trustee and revision in timelines thereof. Key requirements include the following:

- Responsibilities of Board of Directors and Debenture Trustees enhanced e.g. Board to frame policies for proactive and effective monitoring of breach of covenants, Debenture Trustee to record reasons for reduction in the computed value of security cover on quarter over quarter.
- Listed entity to prepare security cover certificate on a quarterly basis as per the format prescribed therein. The revised format has been prepared to provide a holistic picture of all the borrowings and the status of encumbrance on the assets of the listed entity. Statutory auditor to certify the book values of the assets provided in such certificate.
- Listed entity is required to furnish compliance status of financial covenants of on a quarterly basis to Debenture Trustee. Statutory auditor is required to certify the quarterly compliance status.
- The Debenture trustees are required to submit the security cover certificate to the stock exchange and make website disclosure of the security cover certificate and quarterly compliance report within 75 days from the end of each quarter except last quarter of financial year. The disclosure for the last quarter is required to be made within 90 days from the end of the last quarter.

The provisions with respect to 'Revised format of the Security Cover' and 'Monitoring of Covenants' are applicable w.e.f. October 1, 2022. Other provisions of the circular come into effect immediately. To access the circular, click here.

Reduced timelines for listing of units of REITs and InvITs

SEBI vide circular dated April 28, 2022 has reduced the timelines for the allotment and listing of units of REITs and InvITs after the closure of issue to 6 working days (earlier: within 12 working days). The provisions of the circular would be applicable to the public issue which opens on or after June 1, 2022.

To access the circular for REITs click here and for InvITs click here.

SEBI amend norms relating to disclosure of holding of specified securities

SEBI vide circular dated June 30, 2022 has interalia amended the format for disclosure of holding of specified securities and shareholding pattern as under:

- In the disclosure of public shareholding, names of the shareholders holding 1% or more than 1% of shares of the listed entity is to be disclosed.
- Names of the shareholders who are persons acting in concert, if available, should be disclosed separately.

The circular would come into force with effect from the quarter ending September 30, 2022. To access the circular, click here

RBI UPDATES

Moving to Scale Based Regulations (SBR)

RBI has prescribed the following pursuant to the SBR framework which is applicable to NBFCs from October 1, 2022:

- Additional disclosures in financial statements of specific NBFC layers. These guidelines are be effective for annual financial statements for year ending 31 March 2023, and onwards. To access the notification click here.
- Introduced certain regulatory restrictions on lending of loans and advances in respect of NBFCs placed in different layers. These guidelines are effective from October 1, 2022. To access the notification click here.
- Prudential guidelines on exposure norms aim at addressing credit risk concentration in NBFCs – Upper Layer. The guidelines are effective from October 1, 2022. To access the notification click here.
- Capital requirements for NBFC - Upper Layer. To access the notification click here.
- Provisioning for Standard assets by Non-Banking Financial Company – Upper Layer. These guidelines shall be effective from October 1, 2022. To access the notification click here.

RBI issues guidelines on Compensation of Key Managerial Personnel (KMP) and Senior Management in NBFCs

RBI vide notification dated April 29, 2022 has provided broad guidance to NBFCs and their Nomination and Remuneration Committees in formulating the compensation policy of KMP and members of senior management of all NBFCs under SBR framework, except those categorized under 'Base Layer'3 and Government owned NBFCs. These guidelines come into effect from April 1, 2023. To access the notification click here.

Provisioning requirement for investment in Security Receipts (SRs)

In respect to the SRs outstanding as on the date of issuance of Master Direction on Transfer of Loan Exposures (i.e. September 24, 2021), RBI has decided that (in respect of prescribed entities) the difference between the carrying value of such SRs and the valuation arrived at as on the next financial reporting date after the date of issuance of Master Direction on Transfer of Loan Exposures may be provided over a 5 year period starting with the financial year ending March 31, 2022 - i.e. from FY2021-22 till FY2025-26. Subsequent valuations of investments in such SRs on an ongoing basis should, however, be strictly in terms of the provisions of the above Master Direction.

All lending institutions should put in place a board approved plan to ensure that the provisioning made in each of the financial years is not less than 1/5th of the required provisioning on this count. To access the notification click here.

ICAI UPDATES

ICAI issued Implementation Guide on reporting under Rule 11(e) and Rule 11(f) of the Companies (Audit and Auditors) Rules, 2014

ICAI has issued an Implementation Guide to provide guidance on funding of transactions as prescribed under Schedule III to the Companies Act, 2013 and Rule 11(e) of the Companies (Audit and Auditors) Rules, 2014 and on the payment/ declaration of dividend as prescribed under Rule 11(f) of the Companies (Audit and Auditors) Rules, 2014.

To access the Implementation Guide click here.

Standard on Assurance Engagements (SAE) 3410 "Assurance Engagements on Greenhouse Gas Statements" made effective by ICAI

ICAI has decided the effective date of application of SAE 3410 as follows:

- Voluntary for assurance reports covering periods ending on March 31, 2023.
- Mandatory for assurance reports covering periods ending on or after March 31, 2024.

To access the ICAI announcement click here

Other ICAI publications:

ICAI has issued the following publications:

- Educational material on Ind AS 34, Interim Financial Reporting - To access the educational material click here.
- Technical guide on financial statements of Limited Liability Partnerships - To access the technical guide click here.
- Technical guide on financial statements of non-corporate entities - To access the technical guide click here.

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