ASSURANCE INSIGHTS

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We are pleased to present the February issue of SKP Assurance Insights – our newsletter that aims at providing insights into company law, accounting and assurance related developments in India.

In this issue, we discuss the various changes that have been recommended by the Companies Law Committee (the Committee) for the Companies Act, 2013 (the Act). These recommendations cover significant areas of the Act, including definitions, raising of capital, accounts and audit, corporate governance, managerial remuneration, etc. The Committee has consulted various stakeholders and have recommended these changes with the objective of improving the ease of doing business, encouraging start-ups and integrating various laws.

We also provide an overview of the accounting treatment to be used for customer loyalty programmes. With a rapid change in the business environment, customers have a variety of options to buy products and hence, it has become essential for companies to retain their customers in the current competitive market. Thus, customer loyalty programmes have been extensively used by companies.

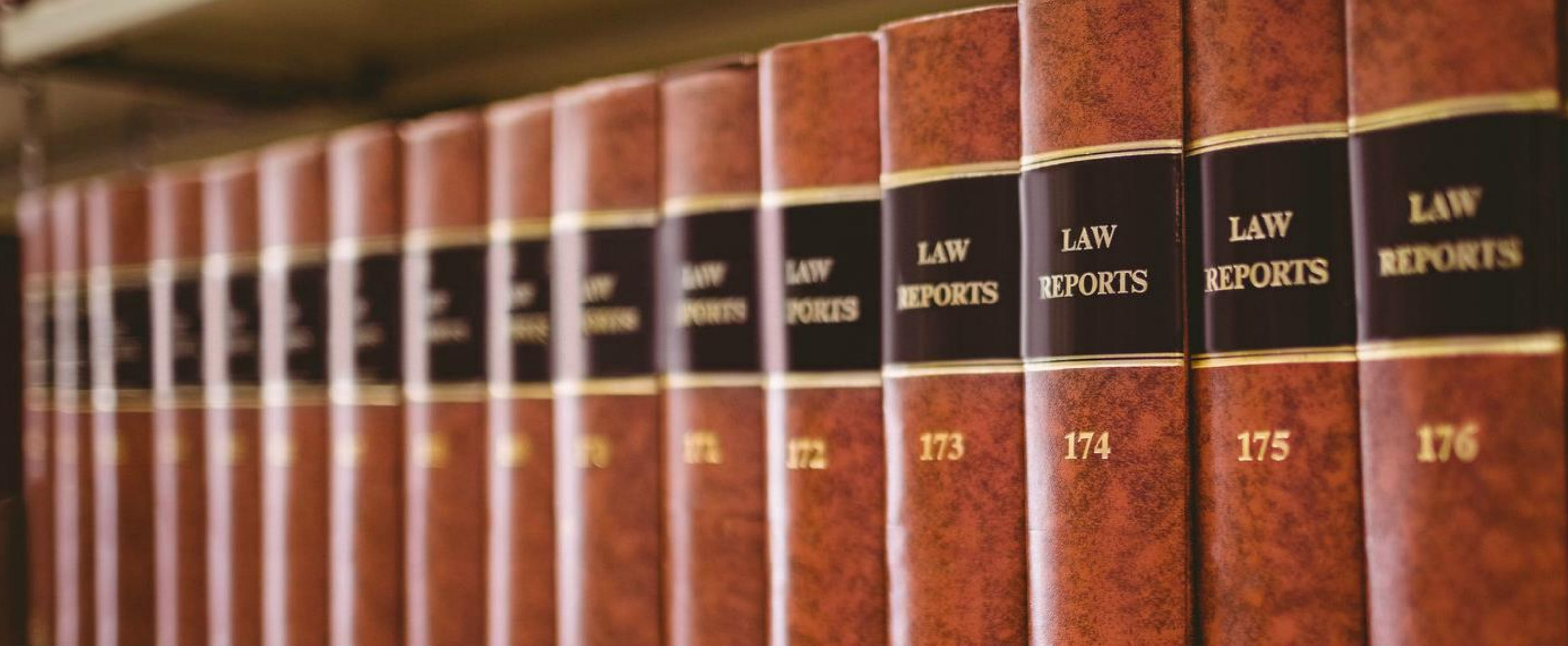
Lastly, we look at revenue leakages. During an economic recession, companies usually become less disciplined in granting discounts and providing exceptions to basic pricing, policies, terms and conditions considering the complexity of decision-making and associated pressures with regard to the volume of sales. Efficiently managing transaction pricing, enables companies to identify the hidden sources of revenue leakage. Revenue leakages reflect profits that companies actually lose from their transactions. In this article, we examine internal control measures to reduce the level of risk for revenue leakage.

We hope you find our newsletter useful and look forward to your feedback. You can write to us at skpgrp.info@skpgroup.com.

Warm Regards,

The SKP Assurance Team

In this issue



Company Law Committee – Recommendations

The Company Law Committee (the Committee) was set up to examine and make recommendations on the issues arising from the implementation of the Companies Act, 2013 (the Act). The Committee has issued its recommendations after extensive consultation with various stakeholders. These stakeholders include industry chambers, professional institutes, law firms, financial sector and other regulators.

The Committee has proposed 78 changes to the sections of the Act and approximately 50 changes to the Rules. Public comments on the recommendations were invited online till 15 February 2016.

Accounts of companies

The chapter lays out regulations for disclosures to be made in the financial statements, the Board's report and the maintenance of books of accounts and records of the company. Corporate Social Responsibility (CSR) regulations and criteria for applicability of internal audit are also laid down under this chapter.

Declaration of dividend		Consolidated financial statements	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
The Board of Directors to declare interim dividend during any financial year out of the surplus in the profit and loss account and out of the profits of the financial year in which such dividend is sought to be declared.	The interim dividend for a particular financial year could only be declared during that financial year. This restricted the ability of companies to declare interim dividend after the close of the financial year but before the Annual General Meeting (AGM). To allow declaration of interim dividend from out of the profits of the current financial year, generated till the date of declaration, including brought forward surplus in the profit and loss account, and the same could be declared anytime up to the convening of AGM for the said financial year.	Financial statements of the holding company to highlight the salient features of the financial statements of its subsidiaries. Also, the holding company shall place the audited financial statements of its subsidiaries on its website (if any).	The step down subsidiaries of the overseas subsidiaries of a holding company to be exempted from placing financial statements on the website of the holding company, only if the consolidated financial statement was statutorily required to be prepared as per the law of the jurisdiction in which the overseas subsidiary is established and is placed on the website in the statutory format.

Financial statements and the Board's report		CSR	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
The following shall form a part of the Board's report: a) CSR policy b) Remuneration policy c) Particulars of all loans, guarantees, securities given by the company and investments made by the company d) Particulars of all related party transactions.	Only the salient points of the CSR and remuneration policies to be included in the Board's report. The detailed document shall be placed on the company website. Particulars of loans, agreements, securities provided, investments and related party transactions to be omitted from the Board's report if they are disclosed in the financial statements. The Board needs to give reference to the financial statements for the same and salient points of the same need to be discussed in the Board's report.	Eligible companies are to constitute a CSR committee of the Board consisting of three or more directors, of which, at least one director shall be an independent director. CSR rules prescribe certain incomes like dividend to be excluded from the net profit, for CSR provisions of the Act to apply. Two per cent of the average net profit of the three immediately preceding financial years should be spent in pursuance of CSR activities. Failure to fulfill the applicability criteria in a block of three immediately preceding financial years will relieve a company from its CSR obligations.	Companies not required to appoint independent directors shall constitute a CSR committee with two or more directors. The Act to specify incomes which are to be excluded from net profit to check the applicability of CSR. The applicability criteria for CSR provisions to be checked only for the previous financial year. Based on this, CSR obligations are to be fulfilled in the current financial year. Two per cent of the net profit of the previous financial year should be spent on carrying out CSR activities. Failure to meet criteria only in the previous financial year will relieve companies of their CSR obligation.

Acceptance of deposits by companies

The chapter lays down the restrictions, exceptions, compliances and investor safeguards that a company must have in place for raising public money in the form of corporate deposits.

Deposits accepted from the public		Penalties for contraventions in deposit regulations	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
At least 15% of the deposits maturing during the current and next financial years should be deposited in a separate scheduled bank account as 'Deposit Repayment Reserve'.	The deposit threshold for 'Deposit Repayment Reserve' should be raised from 15% to 20% of the deposits maturing during the current financial year only.	Fine imposed on the company shall not be less than INR 10 million and may extend to INR 100 million.	Fine imposed on the company shall be the lower of: a) INR 10 million; or *b)* Twice the amount of deposit accepted; ***and*** The maximum ceiling on fine to be borne by a company shall continue to be INR 100 million.

Other recommendations

The following amounts are to be exempted from being treated as deposits:

- Advances for more than 365 days, received in the ordinary course of business
- Compulsorily convertible debentures – term to change from 5 to 10 years
- Amounts received directly from Alternate Investment Funds (AIFs), domestic venture capital funds and mutual funds registered with the Securities and Exchange Board of India (SEBI)
- Unsecured debentures listed as per SEBI regulations
- Convertible notes

Audit and auditors

This chapter spells out the qualifications, rights, duties, the appointment and rotation criteria for the auditors of a company.

Appointment of auditors		Transitional period for rotation of auditors	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
The appointment of the auditor to be ratified by the members of the company at every AGM.	The provision regarding auditor's appointment, which requires ratification by members, is to be omitted. If the auditor is unwilling to continue beyond his five year term, then it is to be treated as resignation of the auditor. Such a vacancy shall be filled in accordance with the provisions of filling a casual vacancy in the office of the auditor.	Currently, there is no clarity on whether the transition period for rotation of auditors is based on a count that begins from the commencement of the Act or from when the company holds its AGM.	Rules to provide more clarity that transition period would be counted from AGM to AGM, and not from the commencement of the Act.
Reporting on internal financial controls		**Access to books of associate companies and joint ventures**	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
The auditors' report is required to state whether the company has an adequate internal financial control system in place. Also, the operating effectiveness of such controls is to be commented upon in the auditor's report.	The reporting obligations of auditors on internal financial controls to be with reference to the financial statements only.	Currently, the Act does not grant the auditor the right to access the books of the associate companies and joint ventures of the company whose accounts are required to be consolidated.	The auditor to be granted the right to access the books of accounts and records of the associate companies and joint ventures of the companies whose accounts are required to be consolidated.

Other recommendations

The manner of reporting on frauds detected by the auditor which previously did not have room for auditor's explanatory comments shall now have room for the same.

Appointment and qualifications of directors

The chapter lays down criteria for qualification and disqualification of directors of the company. This chapter also prescribes regulatory and secretarial compliances to be adhered to for the purpose of appointment, rotation and retirement of the directors of the company.

Independent directors		Residence requirements for directors	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
For the current financial year or two immediately preceding financial years:- The independent director is not to have any pecuniary relationships with the company or its holding, subsidiaries, associate companies, promoters and other directors.	A test of materiality to help determine whether pecuniary relationships could impact the independence of an individual to be an independent director shall be introduced.	At least one director is required to be present in India for a period of at least one hundred and eighty two days during the ***previous calendar year*** under the current residential requirements.	At least one director is required to be present in India for a period of at least one hundred and eighty two days in the ***previous financial year.***

There is no material threshold to determine if such pecuniary relationships could impact the independence of an individual.			

Disqualification from appointment of director and vacation in the office of director		**Casual vacancy**	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
The disqualifications for the appointment of a director are based on: a) Individual eligibility criteria of the director; and b) Failure of the company in which the individual is a director to: – File financial statements or annual returns for three consecutive financial years; – Repay deposits/debentures and the respective interest thereon for one year or more; and – Pay any dividend which has been declared for one year or more.	The provisions for vacation of office of the director shall consider only the disqualifications of directors based on individual eligibility criteria. Disqualification arising from the company's failure, are only to be applicable to persons who are directors at the time of non-compliance. A period of six months to be allowed to new director to get compliances in place in the case of a continuing non-compliance.	Only the Board of Directors of public companies had the right to fill a casual vacancy in the office of a director subject to the Articles Of Association of the company.	This right to be made available to the Board of Directors of private companies as well.

Other recommendations

- If a retiring director is to be reappointed on the recommendations of the Nomination and Remuneration Committee, any existing compliance for such reappointment are to be dispensed with. This relaxation also applies to independent directors.
- Expressly prohibit an existing director to act as an alternate director for another existing director in the same company.
- Procedures catering to the resignation of directors have been reduced.
- Replace Director Identification Number (DIN) with AADHAAR or any other universally accepted identification number.
- Directorship in a dormant company to be excluded in determining the maximum limit of directorships held.

Meeting of the Board and its powers

The chapter lays down powers granted to the Board of Directors of a company for lending, borrowing, investing and entering into transactions with related parties on behalf of the company. This chapter also states the restrictions imposed on the Board while exercising the powers granted to it.

Audit Committee		**Restrictions on the borrowing powers of the Board**	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
The Audit Committee must approve all transactions of a company with its related parties.	The Audit Committee can give its recommendations to the Board for not approving related party transactions which are not covered in the Act.	There are restrictions on the borrowing powers to be exercised by the Board of Directors. The borrowings should not exceed the aggregate of the paid-up	Security premium shall form a part of the paid-up share capital and free reserves for the purpose of arriving at the threshold of borrowing.

	Audit committee should be granted the power to ratify related party transactions subject to a threshold of INR 10 million. Related party transactions between a holding company and its wholly owned subsidiary which do not require Board and shareholder approval shall no longer require the approval of the audit committee. Dormant companies are not required to constitute an audit committee.	share capital and free reserves.	
Loans to directors and subsidiary companies		**Related party transactions**	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
Companies are not allowed to advance any loans either directly or indirectly to directors or to any other person, where in director holds interest. However, a company can advance loans to its wholly owned subsidiaries.	Companies should be permitted to advance loans to concerns in which directors hold interest subject to a prior approval of the company by a special resolution. The committee has specified that loans granted by holding companies to their subsidiaries must be applied by the subsidiaries only for the purposes of their principle business. Subsidiaries are prohibited from using such loan amount to grant further loans to any other party or using the same for further investment.	Members who are related parties are restricted from voting in resolutions to approve of related party contracts/arrangements.	To avoid impracticable situations, related parties like joint ventures and closely held companies should be allowed to vote in resolutions for approving related party contracts/arrangements.

Other recommendations

- Participation of directors by video conferencing will not be considered for quorum requirements. However, such participation will be considered for the purpose of sitting fees.
- Companies are allowed only two layers of investment companies for the purpose of making investments. However, recommendations have been made to remove this restriction on layering.

Appointment and remuneration of managerial personnel

The chapter lays down the basis on which remuneration paid to key managerial persons is to be calculated and lays down a ceiling limit on the payment of such remuneration. The regulatory criteria of appointing key managerial persons have also been laid out in this chapter.

Managerial remuneration		**Appointment of Key Managerial Personnel (KMP)**	
The Act	**Committee recommendation**	**The Act**	**Committee recommendation**
Currently, managerial remuneration of a public company cannot exceed 11% of the net profits of the financial year. Managerial	Government approval to be dispensed with, companies should install safeguards in the form of additional disclosures, audit and higher	The following classes of companies require whole-time KMPs to be appointed: ▪ Listed companies and unlisted public companies	The Board to be empowered to designate any whole time officer of the company as a KMP.

<table>
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<td>remuneration in excess of 11% requires government approval.</td>
<td>penalties. There is no mention of taking company approval in the form of resolution for approving remuneration in excess of 11% of the net profit.

<u>In case the managerial person is not</u>:
A promoter.
Not related to any director or the promoter of the company,
<u>And the said person</u>:
Does not hold more than two percent of the paid-up equity share capital of the company or its holding company; and
Such a person possesses the necessary technical skill and expertise.
Then only an ordinary resolution of the members is required.

In all other cases, a special resolution is required.</td>
<td>with a paid-up share capital of INR 100 million or more.

The KMP to be appointed includes Managing Director (MD), Chief Executive Officer (CEO), Whole Time Director (WTD) in the absence of MD and CEO, Chief Financial Officer (CFO), and Company Secretary (CS).
Companies other than listed and unlisted public companies (having paid-up share capital of INR 50 million or more).

KMP to be appointed includes CS.
Currently, only the CEO, MD, manager, CS, WTD and CFO are designated as KMP. Also, the positions of chairperson, MD or CEO cannot be held by the same individual.</td>
<td>A whole time KMP may hold more than one position in the same company at the same time.</td>
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To read the entire Committee report, click here.

Customer Loyalty Programmes

A requirement of the changing economy

The Indian economy is going through a phase of tremendous transformation. There have been many changes in the technologies and business environment. In the current market scenario, the choice of products and services have increased so much that a customer always has an alternative. As many organisations provide similar or identical products, it becomes a necessity for the entity to retain a customer by introducing different marketing strategies. One of the marketing strategies adopted is 'Customer Loyalty Programmes' (CLP). Many companies believe that customer retention programmes are as valuable as the events for attracting new customers to increase their market share.

What is a customer loyalty programme?

In a CLP, the entity grants points/awards to customers with each purchase of goods and services from the entity. The customer may redeem these points to receive free or discounted goods or services in the future. These programmes incentivise customers to purchase additional goods or services.

Different forms of CLPs

The popularity of CLPs has been increasing drastically. Many industries have adopted this concept. This is being used extensively by industries such as:

- Retailers
- Airlines
- Hotels
- Bankers
- Fuel outlets

The following are popular or widely used forms of rewarding customers with awards

- Awards that entitle the customer to discounted/free goods or services by the same store (e.g. airlines, super markets, hyper markets, online stores etc.);
- Awards that entitle the customer to discounted/free goods or services provided by another entity (e.g. banking companies issuing credit or debit cards as the case may be);
- Arrangements in which third party organisations provide services of redeeming awards against goods and services of the issuing entity or of others (e.g. travel companies)

Accounting treatment

Industries wherein CLP exists have been following different models for customer retention which has also led to different accounting practices followed by different entities across industries. Currently, there are two models prevailing in India for accounting of CLP:

1) Deferment model
2) Provision model

Deferment Model

The transaction is treated as a multiple element transaction, one element being the initial sale and the other being the future sale, either free or discounted price against redemption of the loyalty programmes benefit. Accordingly, revenue relating to the obligation towards award credit/future redemption of benefits under the programme is deferred and recognised in the period in which the obligations are fulfilled.

Provision Model

The transaction is treated as a single element transaction and recognises revenue for the entire transaction at the time of the sale. However, since a further cost is expected to be incurred in future with regard to the obligation to provide free/discounted goods or services, a provision is recognised towards the cost of such free/discounted goods or services as marketing expenses at the time of initial sale.

Though both the treatments are in line with the matching concept, they lead to a difference in the timing of recognition of revenue and costs. However, after the issuance of International Financial Reporting Interpretations Committee 13 (IFRIC 13) and Indian Accounting Standard 15 (IND AS 115), the view that this type of transaction has multiple elements is emerging and is becoming more popular compared to the single element transaction which is the provision model. The consideration received is towards fulfilling two obligations rather than just providing the initial goods or services. The deferment model is the preferred model although it is complex compared to the provision model. This requires the quantification of liabilities at the fair value of the award credits/obligations to be fulfilled in the future and data for estimating the expected redemptions to establish patterns which may not be readily available.

Example for awards that entitle the customer to discounted/free goods or services by the same store

A super market X awards 50 points for every purchase of INR 100. These points can be exchanged for goods sold in the super market. The customer has a three year period over which he/she can use the points. Unutilised points will lapse on the expiry of three years from the date of grant. For every 1,000 points goods with a retail sale price of INR 100 can be obtained. The customer need not wait for the accumulation of points to redeem. If the entity provides these goods itself, its cost is INR 20. The entity has sold goods of INR 300 under this scheme. It has thus awarded 150 points in connection with the sale of goods of INR 300. In year 1, the entity expects that 100 of these points will be redeemed. In year 2, the entity revises the estimate of the estimated redemption to 90 points. The actual redemption is as under.

Year 1: 50 Points redeemed

Year 2: 10 Points redeemed

Year 3: 20 Points redeemed and 10 points expired.

Acronyms for the purpose of explanation
Points awarded (PA)
Points expected to be redeemed (PER)
Points redeemed (PR)
Retail price of the product (RPP)
Points required for obtaining free or discounted product (PRDP)
Value of the awards/points (VP)
Fair value of the total awards/points (FVP)

Deferment Model

Year 1
Value of the awards/points

INR 100 (RPP) * 150 (PA) / 1000 (PRDP) = INR 15 (VP)

Since in year 1, only 100 points are expected to be redeemed, the fair value of the total awards/points works out to INR 10

INR 15 (VP) * 100 (PER) / 150 (PA) = INR 10 (FVP)

Accounting for initial sale of goods

Bank account	Dr	300
To sales account	Cr	290
To deferred revenue (liability under customer loyalty programme)	Cr	10
Accounting of the sales and fair value of 100 points expected to be redeemed.		

At the time of redemption of the points

Deferred revenue (liability under customer loyalty programme)	Dr	5
To sales account	Cr	5
Since 50 points are redeemed at the year end, revenue of INR 5 will be recognised in year 1 [50 (PR) / 100 (PER) * INR 10 (FVP)]		

Cost for the redemption of the points

Cost of goods sold (COGS)	Dr	1
To inventory	Cr	1
Since 50 points are redeemed at the year end, cost of INR 1 will be recognised in year 1 [50 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

Year 2
During year 2, 10 points have been redeemed bringing the total points redeemed to 60 (50+10) points. The entity expects total of 90 points to be redeemed. It will recognise revenue of INR 1.67 which is explained below.

At the end of year 2

Redemption of points

Deferred revenue (liability under customer loyalty programme)	Dr	1.67
To sales account	Cr	1.67
The entity expects total of 90 points to be redeemed. It will recognise a revenue of INR 6.67, out of which revenue of INR 5 has already been recognised in the books. [60 (PR) / 90 (PER) * INR 10 (FVP)]		

Cost for the redemption of the points

COGS	Dr	0.20
To inventory	Cr	0.20
Since 10 points are redeemed at the year end, cost of INR 0.20 will be recognised in year 2. [10 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

Year 3

At the end of year 3

Since the remaining points are either redeemed or expired at the end of the third year, the balance deferred revenue should be recognised in the current year.

On redemption or lapse of points

Deferred revenue (liability under customer loyalty programme)	Dr	3.33
To sales account	Cr	3.33
Out of total deferred revenue of INR 10, INR 6.67 has been recognised in the earlier years and the balance amount should be recognised in the current year.		

Cost for redemption of points

COGS	Dr	0.40
To inventory	Cr	0.40
Since 20 points are redeemed at the year end, cost of INR 0.40 will be recognised in year 3 [20 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

Provisional Method

Year 1

Accounting for initial sale of goods

Bank account	Dr	300
To sales account	Cr	300
Recognition of revenue at initial stage, sale of INR 300.		
Marketing expenses	Dr	2
To provision for marketing expenses	Cr	2
Expected COGS for redemption of 100 points is INR 2. [INR 20 (COGS) * 100 (PER) / 1000 (PRDP)]		

On redemption of points

Provision for marketing expenses	Dr	1
To inventory	Cr	1
Redemption of 50 points in year 1, INR 1 [50 (PR) / 1000 (PRDP) * 20 (COGS)]		

Year 2

On redemption of points

Provision for marketing expenses	Dr	0.20
To inventory	Cr	0.20
Since 10 points are redeemed at the year end, cost of INR 0.20 will be recognised in year 2. [10 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

On revision in the estimate

Provision for marketing expenses	Dr	0.20
To excess provision written back	Cr	0.20
Since the expected points to be redeemed have been 90 instead of 100, the provision made for 10 points have been reversed. [10 (points reduced due to revised estimate) * INR 20 (COGS) / 1000 (PRDP)]		

Year 3

On redemption of points

Provision for marketing expenses	Dr	0.40
To inventory	Cr	0.40
Since 20 points are redeemed at the year end, cost of INR 0.40 will be recognised in year 3 [20 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

For points lapsed

Provision for marketing expenses	Dr	0.20
To excess provision written back	Cr	0.20
Since 10 points have lapsed at the year end, cost of INR 0.20 will be reversed in year 3 [10 (points lapsed) / 1000 (PRDP) * INR 20 (COGS)]		

Comparison

	Deferment model	**Provision model**
Year 1		
Revenue recognised	295	300
COGS for initial sale (assumption)	(270)	(270)
COGS (points)	(1)	(2)
Profit	**24**	**28**

Year 2		
Revenue recognised	1.67	0
Provision written back		0.20
COGS (points)	(0.2)	0
Profit	**1.47**	**0.20**
Year 3		
Revenue recognised	3.33	0
Provision written back	0	0.2
COGS (points)	(0.4)	0
Profit	**2.93**	**0.20**

It is clear from the above example that under the provision model, the profit of the company is substantially booked in the first year. However, in the deferment model, the profit of the company is deferred in the first year and spread over a period of three years as it is the period of expiry of loyalty points.

Example of awards that entitle the holder to discounted/free goods or services provided by another entity

A super market X awards 50 points for every purchase of INR 100. These points can be exchanged for goods sold in the super market X or other entity Y. The customer has a three year period over which he/she can use the points. For every 1000 points, goods with a retail sale price of INR 100 can be obtained either in super market X or entity Y. If X provides these goods, it costs INR 20 and if they are provided by entity Y, super market X will have to pay INR 40 to entity Y. The entity has sold goods of INR 300 under this scheme. It has thus awarded 150 points in connection with the sale of goods of INR 300. In year 1, the super market X expects that 100 of these points will be redeemed of which 60 will be redeemed at its own store and 40 will be redeemed by entity Y. In year 2, the entity revises the estimate of estimated redemption to 90 points of which 54 points are expected to be redeemed in its own store and 36 points in entity Y. The actual redemption is as follows

Year 1: 50 points redeemed – 30 points in super market X and 20 points in entity Y

Year 2: 10 points redeemed – 8 points in super market X and 2 points in entity Y

Year 3: 12 points redeemed in super market X and 10 points lapsed.

Deferment Model

Year 1

Value of the awards/points

[INR 100 (RPP) * 150 (PA) / 1000 (PRDP)] = INR 15 (VP).

Since in year 1 only 60 points are expected to be redeemed, the fair value of the total awards/points works out to INR 6 [INR 15 (VP) * 60 (PER) / 150 (PA)]. Since 40 points are expected to be redeemed by entity Y, provisions will have to be made for the payment to entity Y for the 40 points expected to be redeemed in entity Y.

At the time of initial sale

Bank account	Dr	300
To sales account	Cr	294
To deferred revenue (liability under CLP)	Cr	6
Accounting of the sales and fair value of 60 points expected to be redeemed		
Marketing expenses	Dr	1.60
To provision for redemption in entity Y	Cr	1.60
Amount to be paid to entity Y for expected 40 points to be redeemed, cost is INR 1.60 [40 (PER) * INR 40 (to be paid on redemption of 1000 points) / 1000]		

At the time of redemption of the points

Deferred revenue (liability under CLP)	Dr	3
To sales account	Cr	3
Since 30 points are redeemed at the year end in super market X, revenue of INR 5 will be recognised in year 1. [30 (PR) / 60 (PER) * INR 6 (FVP)]		

Cost for the redemption of the points

COGS	Dr	0.60
To inventory	Cr	0.60
Since 30 points are redeemed at the year end, cost of INR 0.60 will be recognised in year 1 [30 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

At the time of redemption of the points at entity Y

Provision for redemption in entity Y	Dr	0.80
To cash and bank	Cr	0.80
Since 20 points are redeemed at entity Y, the payment of INR 0.80 will be made. [20 (PR) * INR 40 (to be paid on redemption of 1000 points / 1000]		

At the end of 2 year

Redemption of points

Deferred revenue (liability under CLP)	Dr	1.22
To sales account	Cr	1.22

The entity expects total of 90 points to be redeemed. It will recognise revenue of INR 4.22, out of which revenue of INR 3 has already been recognised in year 1 and hence, the balance of INR 1.22 is to be recognised [38 (PR) / 54 (PER) * INR 6 (FVP)]		

Cost for the redemption of the points

COGS	Dr	0.16
To inventory	Cr	0.16
Since 8 points are redeemed at the year end, cost of INR 0.20 will be recognised in year 2. [8 (PR) /1000 (PRDP) * INR 20 (COGS)]		

At the time of redemption of the points at entity Y

Provision for redemption in entity Y	Dr	0.08
To cash and bank	Cr	0.08
Since 2 points are redeemed at entity Y, the payment of INR 0.80 will be made. [2 (PR) * INR 40 (to be paid on redemption of 1000 points / 1000]		

Year 3

At the end of 3 year

Since the remaining points are either redeemed or expired at the end of the year 3, the balance deferred revenue should be recognised in the current year.

On redemption or lapse of points

Deferred revenue (liability under CLP)	Dr	1.78
To sales account	Cr	1.78
Out of the total deferred revenue of INR 6, INR 4.22 has been recognised in the earlier years and the balance amount should be recognised in the current year.		

Cost for redemption of points

COGS	Dr	0.24
To inventory	Cr	0.24
Since 12 points are redeemed at the year end, cost of INR 0.40 will be recognised in year 3. [12 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

In the third year, no points have been redeemed with entity Y and hence, the provision made for redemption of points with entity Y has to be written back.

Provision for redemption in entity Y	Dr	0.72
To provision written back	Cr	0.72
Since no points are redeemed with entity Y and the points have lapsed, the provision needs to be written back in the books.		

Provisional Method

Year 1

Accounting for initial sale of goods

Bank account	Dr	300
To sales account	Cr	300
Recognition of revenue at initial stage, sale of INR 300		
Marketing expenses	Dr	2.80
To provision for marketing expenses	Cr	1.20
To provision for redemption of points in entity Y	Cr	1.60
The expected COGS for redemption of 60 points is INR 1.20 [INR 20 (COGS) * 60 (PER) / 1000 (PRDP)] and the provision for entity Y is INR 1.60 [40 (PER)* INR 40 (to be paid on redemption of 1000 points) / 1000]		

On redemption of points in super market X

Provision for marketing expenses	Dr	0.60
To inventory	Cr	0.60
Redemption of 30 points in year 1 by super market X is INR 0.60 [30 (PR) / 1000 (PRDP) * INR 20 (COGS)]		

At the time of redemption of the points at entity Y

Provision for redemption in entity Y	Dr	0.80
To cash and bank	Cr	0.80
Since 20 points are redeemed at entity Y, the payment of INR 0.80 will be made. [20 (PR) * INR 40 (to be paid on redemption of 1000 points) / 1000]		

Year 2

On redemption of points

Provision for marketing expenses	Dr	0.16
To inventory	Cr	0.16
Since 8 points are redeemed at the year end, cost of INR 0.16 will be recognised in year 2. [8 (PR) /1000 (PRDP) * INR 20 (COGS)]		

On revision in the estimate

Provision for marketing expenses	Dr	0.12
Provision for redemption in entity Y	Dr	0.16
To excess provision written back	Cr	0.28
Since the expected points to be redeemed have been 90 instead of 100, the provision made for 6 points for super market X have been reversed – INR 0.12 [6 (points) * INR 20 (COGS) / 1000 (PRDP)] and for entity Y, 4 points have been reversed - INR 0.16 [4 (points) * INR 40 (to be paid on redemption of 1000 points) / 1000]		

At the time of redemption of the points at entity Y

Provision for redemption in entity Y	Dr	0.08
To cash and bank	Cr	0.08
Since 2 points are redeemed at entity Y, the payment of INR 0.80 will be made. [2 (PR) * INR 40 (to be paid on redemption of 1000 points) / 1000]		

Year 3

On redemption of points

Provision for marketing expenses	Dr	0.24
To inventory	Cr	0.24
Since 12 points are redeemed at the year end, cost of INR 0.40 will be recognised in year 3. [12 (PR) /1000 (PRDP) * INR 20 (COGS)]		

For points lapsed

Provision for marketing expenses	Dr	0.08
To excess provision written back	Cr	0.08
Since balance points have lapsed, the balance provision has been written back.		

In the third year, no points have been redeemed with entity Y and hence, the provision made for redemption of points with entity Y has to be written back.

Provision for redemption in entity Y	Dr	0.56
To provision written back	Cr	0.56
Since no points are redeemed with entity Y and the points have lapsed, the provision needs to be written back in the books.		

Comparison

	Deferment Model	Provision Model
Year 1		
Revenue recognised	297	300
COGS for initial sale (assumption)	(270)	(270)
COGS (points)	(0.60)	0
Provision for entity Y	(1.60)	(2.80)
Profit	**24.80**	**27.20**
Year 2		
Revenue recognised	1.22	0
Provision written back	0	0.28
COGS (points)	(0.16)	0
Profit	**1.06**	**0.28**
Year 3		
Revenue recognised	1.78	0
Provision written back	0.72	0.64
COGS (points)	(0.24)	0
Profit	**2.26**	**0.64**

Thus, the cumulative profit for three years taken together under both the models in aggregation remains the same.

Examples of arrangements in which third party organisations provide services of redeeming awards against goods and services of the issuing entity or of others

ABC Limited runs a loyalty card scheme independently. The customer is given a loyalty point card. The customer can spend and earn the loyalty points from the list of vendors. The points earned by the customers can be redeemed at any of the vendors, as per the scheme. The value of 1 point issued is INR 1. The issuing vendor will pay INR 0.90 per point to ABC Limited and earns a margin of INR 0.10 for each point redeemed.

An airline company issues 1 point for every INR 100 spent. Those points can be redeemed at any of the vendors as per the scheme. During the year, the airline company has issued 1 million points for revenue of INR 100 million.

The car rental company redeems these points of 100 thousand for free rides.

In the books of airline company

At the time of issue of points:

Bank account	Dr	10,00,00,000
To revenue account	Cr	9,91,00,000
To ABC company	Cr	9,00,000
1 million points are issued, the company will pay the administrator INR 0.90 per point		

Settlement of liability

ABC company	Dr	9,00,000
To bank account	Cr	9,00,000
Payment of the liability		

In the books of the car rental company

At the time of sale

ABC company (receivable)	Dr	90,000
To revenue account	Cr	90,000
At the time of redemption of points by customer for car rental, 100 thousand points are redeemed		

Factors affecting quantification of the Deferment Model

Fair value

The fair value of the consideration received or receivable from customers should be allocated. The fair value may be arrived by estimating the fair value of points or the fair value of the goods and services sold i.e. the amount for which the awards or points could be sold separately. The changes in the assumption for the estimate of the fair value may change. Hence, the company needs to set up the procedure for estimating the fair value of the points and apply the same consistently over a period of time at every reporting date.

Assumption for redemption

There is a high chance that some of the points will not be redeemed by the customers. The company will need to make an estimate for the future redemption of these points. The change in the estimate by the company will change the provision for expenses or deferment of revenue. The company may obtain historical data to arrive at the future redemption.

Other factors

The popularity of the loyalty programmes or the goods or services offered, past experience of the entity on redemption of points and validity of the programmes impact the deferment of revenue.

When incentives could result in a loss on future sale

In an unlikely situation where the expected cost of the obligation under the loyalty programmes are higher than the revenue deferred at the time of initial sale, the arrangement would be considered an onerous contract and the cost which is in excess of the revenue has to be provided for.

Indian perspective

In India, most companies do not treat transactions of sale of goods and services under loyalty programmes differently from normal sales. An appropriate provision of marketing expenses is made towards the costs of meeting obligation arising under the loyalty programmes. However, IND AS 115 – Revenue from Contracts with Customers provide clear guidance in terms of recognition of revenue for customer options for additional goods or services under Appendix B to the said IND AS. It states that if a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contact, then an entity may, as a practical alternative to estimating the stand alone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration.

Hence, any transaction in which a customer has a material right to acquire future goods or services is viewed as two transactions. The consideration received or to be received is bifurcated into two parts, one towards the initial sale and the other towards the price of an option granted to buy future goods and services for free or at discounted price. The fair value of options is recognised at a later date when the options are redeemed.

Revenue leakage: Measures and controls

Given the present scenario, many organisations are under tremendous pressure to manage their funds and need to tap all possible sources to harness capital from alternative channels. Senior management must prioritise practices of minimising revenue leakage to make every penny in the organisation count.

Revenue leakage could occur due to intentional acts (frauds), system flaws, expenditure leakages, misappropriation of assets, sub-optimised pricing and discounting structures, ineffective risk management, inefficient or inaccurate order/billing /cash collection/cash application management processes/systems, and fraudulent activity. Revenue leakage is also known as green fraud, i.e. leakage related activities that when prevented or detected early, lead to improved financial results. Revenue leakage can take place nearly everywhere, from individual internal functions to customer-facing transactions. Revenue leakages could be found across operations; hence it is very difficult to analyse where to start when there are so many prospects for potential loss.

Some examples of expenditure leakage:

- Orders from fictitious vendor.
- Kickback received for allowing the supplier to inflate prices.
- When the advertiser charges for advertising that has not been carried out.
- Vendors/Contractors charge for work not performed.
- Sales person reimburses fictitious travel expenses

Impact of revenue leakage on business and operations

Revenue leakage can impact the organisation's ability to meet its objectives in any of the following ways:

- Reduced customer confidence
- Decline in revenues
- Turn down in market share
- Regulatory/analyst scrutiny

The table below illustrates the possible risk and the impact it has on business:

Type of Risk	Impact of Business
Operational Risk	Inefficient business operations or loss of earnings.
Reputational Risk	External and internal image of the organisation.
Reporting Risk	False misstatement or disclosure.
Financial Risk	Over or under statement of revenues, or cost.
Strategic Risk	Impact on strategic new products, services or alliances.
Compliance/Legal Risk	Potential civil, criminal or regulatory liability.

Businesses may also be impacted by lower profitability, downgrades from credit rating agencies, rise in cost of capital, etc.

Indicative factors signalling revenue leakage

Indicative factors signalling revenue leakage are:

- Sale at 'any cost'
- Complex rating/discounting structure
- Significant number of manual procedures
- Decentralised and autonomous sales processes
- Clients with networks and multiple locations
- Weak internal control over revenue
- Rapid adoption of new technologies/systems
- Accelerated product development
- Rapidly shifting competitive landscapes

- Limited/inaccurate reporting to analyse operations
- Poor system integration
- Fraud
- Lack of data consistency across different systems
- Inconsistent procedures and policies across organisations
- Insufficient internal controls
- Internal or external collaboration
- Management over-ride

Investigating all revenue streams to explore possibilities of revenue leakages:

- Check the invoicing process for incorrect information and unauthorised customer discounts. Also, pay attention to delays in entering new customers on billing records. Check collections for outstanding debt and customer disputes as well as flaws in collection/recovery systems.
- Quotations: Not accounting for all costs in the supply stream, obtaining insufficient quotations.
- Data entries should be closely examined for: inaccurate data or errors.

Internal control on revenue leakage - Techniques to reduce the level of risk for revenue leakage

In an increasingly complex and changing environment, the threat of revenue leakage and fraud is at its peak. Internal controls against such threats are important which can also help raise revenues, cut costs, and increase profit margins over a period of time. The following are a few suggested measures that will help control revenue leakages:

- The formation of a strong revenue assurance team
- Moving towards system automation by implementing key controls
- Conducting periodic review and MIS Reporting for monitoring revenue
- Conduct a fraud risk assessment
- Accurate and timely customer billing to ensure correct revenue recognition
- Motivation/incentive/rewards to employees
- A culture of double check and auditing of systems must be created to ensure that potential or actual issues are captured

Techniques to mitigate revenue leakage

Detective Process	Corrective process	Preventive process
• Monitoring • Auditing • Investigating	• Information correction • Process correction • People correction • Technology correction	• Synchronisation • Integrity check • Pre-process check • Post-process check

1) **Detective Process**
A detective process helps identify any ambiguity in the system.

2) **Corrective Process**
The corrective process helps correct the process structures in order to minimise the modifications identified in detective techniques.

3) **Preventive Process**
The preventive process is precautionary activities performed to avoid a high risk situation.

Revenue Assurance Function

The revenue assurance function identifies and addresses revenue leakage and deals with the increased risk of fraud. It is important to take preventive measures by placing greater emphasis on early identification of possible revenue leakage, and by setting clear KPIs across the business.

The approach towards addressing the revenue leakage problem should begin with the formation of a dedicated cross–functional revenue assurance team at the corporate level whose mandate would be to detect and plug revenue leakage in the organisation’s revenue chain in a consistent and systematic manner. Currently, most of the Revenue Assurance teams report to the CFO, who is a powerful sponsor able to ensure that the necessary action is taken. However, considering the volume of fraud and revenue leakage across the industry, the function needs to exert greater influence at the very top of organisations.

By implementing robust internal controls within an organisation, there would be significant benefits in terms of:

- Improved Profitability.
- Maximise revenue recovery by covering a wide range of leakages over the entire sales cycle.
- Focus on your core business and reduce back-office administrative tasks.
- Defining integrity and ethical value of the employee.
- An organisation structure that promotes separation of duties and decrease conflict of interest.
- Assigning authority and responsibility so people understand their roles and responsibilities.
- Competent, knowledgeable personnel who are informed of policies and procedure.
- Information systems that have built-in-business rules and controls.

Internal Auditors can form creative solutions as they work closely with the business. Such a team can increase the management's participation in the process and reinforce risk and the control ownership.

Conclusion

Given how revenue recognition and any leakages impact the top line, these must be identified and fixed on a real-time basis. Gaining an in-depth understanding of business and revenue models across the value chain is a pre-requisite. It is essential to implement activities to ensure continuous monitoring and take corrective actions against vulnerable areas identified during the assessment. Many companies have benefited from exercises focused on revenue leakages, by not only successfully plugging the gaps but also enhancing their existing revenue-related processes to ensure an accurate booking of revenue with minimum or zero leakages in the top line.

About SKP

SKP is a long established and rapidly growing professional services group located in six major cities across India. We specialise in providing sound business and tax guidance and accounting services to international companies that are currently conducting or initiating business in India as well as those expanding overseas. We serve over 1,200 clients including multinational companies, companies listed on exchanges, privately held firms and family-owned businesses from more than 45 countries.

From consulting on entry strategies to implementing business set-up and M&A transactional support, the SKP team assists clients with assurance, domestic and international tax, transfer pricing, corporate services, and finance and accounting outsourcing matters, all under one roof. Our team is dedicated to ensuring clients receive continuity of support, right across the business lifecycle.

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