ASSURANCE INSIGHTS

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

With the convergence to International Financial Reporting Standards (IFRS) underway, the decisive blocks of all converging companies will be impacted. Our 'decisive block' for this month discusses changes that will have a qualitative impact on the financial reporting carried out for your enterprise. Ind AS 16: Property, Plant and Equipment and Ind AS 40: Investment property in the days to come shall lead to a qualitative improvement in the principles of tangible asset accounting. A highlight of the 'substance over form' feature of Ind AS is the classification of tangible assets based on the acquisition intent into:

- Owner Occupied Property
- Investment property

Financial reporting professionals have a lot to ponder over. Changes such as the mandatory adoption of component depreciation, adoption of either cost model or revaluation model for reporting, continued subsequent revaluation, treatment of administrative expenses and a lot more are discussed under *Connect the GAAP*.

From Ind AS we shift to corporate governance. The need of companies today is to improve decision-making, effectively manage risks, ease access to capital and most importantly, ensure proper accountability. 'Scorecards' are just tools that ensure a better governance culture, which in turn leads to better business climate. In this issue, we take you through the governance concept of scorecards where it serves to improve the governance and performance of companies.

Lastly, under *The Companies Act, 2013: Key updates* we cover the latest development in regulatory policy.

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

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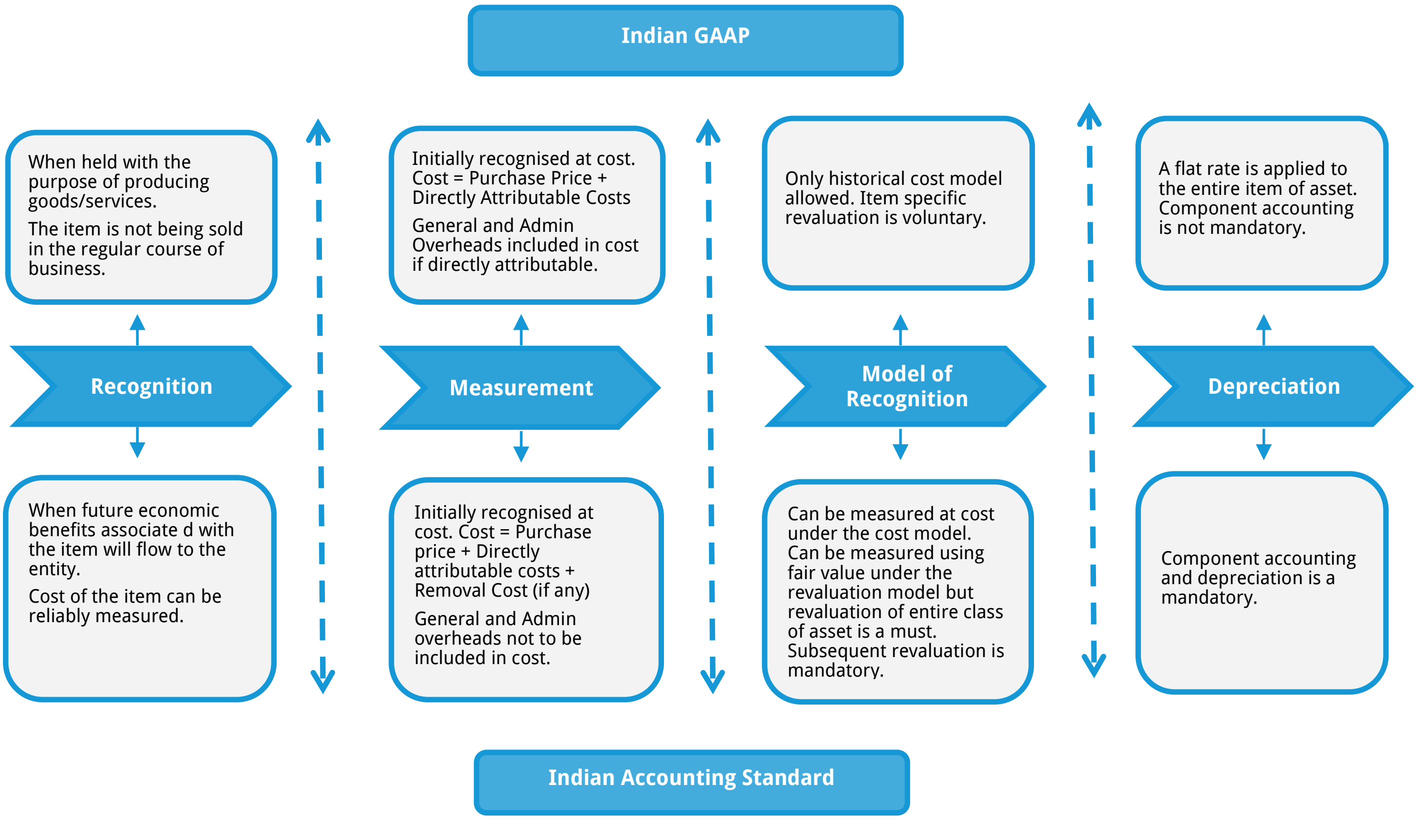
Connect the GAAP: Ind AS 16 and Ind AS 40

In this article, we discuss how adoption of Ind AS 16: Property, Plant and Equipment and Ind AS 40: Investment Property will bring a change in the practices followed by corporates in accounting for tangible fixed assets. The term property, plant and equipment (PPE) is unusual to those accustomed to the Indian GAAP. PPE are revenue-generating tangible fixed assets held by an entity for more than one accounting period. Ind AS have always aimed to go beyond mere normative policies of accounting and reporting. This remains unchanged in the standards that govern tangible fixed assets. The impact would be substantial for few corporates since the recognition criteria and model of measurement itself undergoes a change. In this issue, we will discuss:

a) Overview of the Indian GAAP (Accounting Standard 10) vis-à-vis the Indian Accounting standard (Ind AS 16)
b) Recognition
   - PPE vs Investment property
   - Initial costs
   - Subsequent costs
   - Decommissioning
c) Measurement models
   - Cost model vs revaluation model
   - Accounting for revaluation model
d) Depreciation
   - Component depreciation
   - Other aspects
e) Comparison with international standards

Overview



Recognition

Property, Plant and Equipment vs Investment Property

Ind AS 16 and 40 require the management to examine the intent with which the item of property was acquired/purchased/constructed. The standards go beyond normative recognition and measurement of tangible fixed assets. By questioning the purpose of acquisition/purchase/construction, items of PPE recognised as tangible fixed assets are classified as:

- **Owner Occupied Property** – governed by Ind AS 16: Property Plant and Equipment.
- **Investment Property** – governed by Ind AS 40: Investment Property.

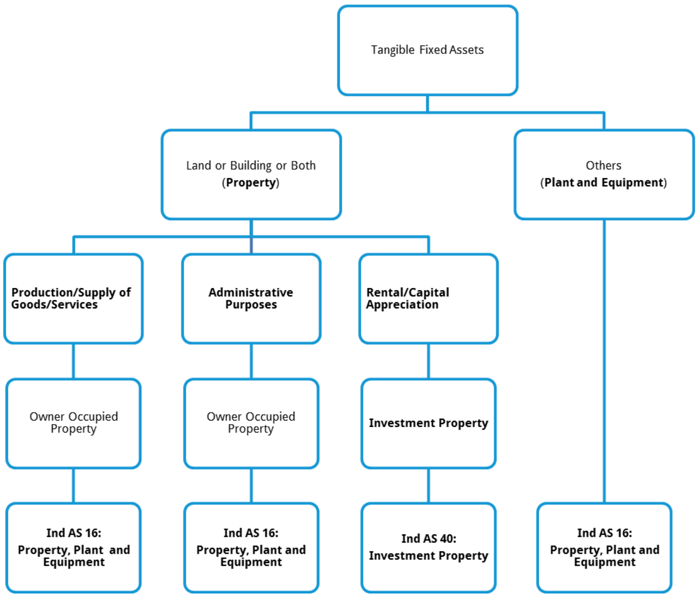


Illustration: Use of Property – Effect on Consolidated Financial Statements

A building owned by a holding company is rented out by it to its subsidiary. The subsidiary entity uses this building for the lodging and boarding purposes of its employees and executives. The lessor (in this case the holding company) for the purposes of its standalone financial statements will classify the item property (i.e. building) as an investment property as per Ind AS 40. But in the consolidated financial statements this property would not qualify as an investment property, because it is occupied by the owner from a group perspective and is used for administrative activities of the group.

Initial costs

The cost of an item of PPE shall include its purchase price, non-refundable duties and taxes and any costs directly attributable in bringing the asset to the location and condition necessary for its intended use. It will also include an initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located if it is obligated to do so. Accounting Standard 10 of Indian GAAP requires the capitalisation of administrative costs specifically attributable to the construction of a project or acquisition of tangible fixed assets or bringing it to its working condition. However, Ind AS 16 requires all administrative costs in connection to items of PPE to be charged to revenue.

Subsequent costs

Subsequent costs may be divided into three reporting constituents

- Day-to-day maintenance
- Replacement
- Major inspection

Day-to-day maintenance costs generally do not meet the recognition criteria and are charged to profit or loss. The costs incurred on replacement are capitalised only if they meet the recognition criteria. Major inspections are required to continue the operation of PPE. Hence, regardless of whether they lead to replacements, major inspections are recognised as a part of the carrying amount of the item of PPE. The cost of the current major inspection shall be recognised and any balance in the carrying amount relating to the previous inspection should be de-recognised. The recognition of the current major inspection should happen irrespective of de-recognition of the previous one. In case the cost of a previous major inspection was not separately identified, an estimated cost of a similar future inspection can be used as a substitute for the carrying amount that has to be derecognised.

Decommissioning and restoration cost

As discussed under 'Initial costs', the cost of dismantling and removing the item and restoring the site on which it is located, the obligation which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during the period. If the effect of the time value of money is material, the amount of provision should be the present value of expenditures expected to settle the obligation.

In case of any change in above estimates:

- When the entity follows a cost model, effect should be given to the carrying amount of the asset. If the decrease in liability exceeds the carrying amount, the excess is recognised immediately in profit or loss.
- When the entity follows the revaluation model, effect should be given to the revaluation reserve/profit or loss depending on how the increase and decrease in revaluation on the asset was treated.

Measurement models

Cost model vs revaluation model

Items of PPE are initially recorded at cost. The management may take a stand of carrying forward the asset at cost after reducing the applicable accumulated depreciation. Thus, the entity may follow a 'cost model'. Alternatively, the entity may follow a 'revaluation model' when:

a) the management is of the opinion that after the initial recognition of the item of PPE has been done at cost, its market value(i.e. fair value) can be reliably measured, and
b) the management opines to revalue the asset at regular intervals to ensure accurate financial reporting.

In such cases, the fair value of the item after reducing accumulated depreciation shall be treated as its carrying amount. Ind AS 16 leaves the adoption of the measurement model upon the management. However, the following conditions must be fulfilled/adhered to by the management while restating its PPE at fair value:

a) Selective revaluation of only item(s) of PPE in the entire class is not allowed. The entire class of assets to which the item belongs to has to be restated at its fair value net off accumulated depreciation. This has to be done by simultaneously revaluing items within the entire class of PPE.
b) Subsequent revaluations shall have to be made with reasonable regularity. This regularity will depend upon the significance and volatility of changes in fair value. With assets that are subject to experiencing material changes in fair vale, annual revaluations may be necessitated.

It is pertinent to note that the revaluation model is not allowed for assets classified as investment property under Ind AS 40. However, entities still need to disclose fair value of the investment properties held by it.

AS 10 of Indian GAAP too has a provision for revaluing tangible fixed assets. Conceptually, these provisions are different from Ind AS 16 on counts such as:

a) Selective revaluation of assets is allowed on a systematic basis.
b) The standard does not mandate subsequent revaluations of the revalued tangible fixed asset. (*Management may voluntarily choose to do so for better reporting.*)

First time adoption and transitional provisions

Entities converging to Ind AS both voluntarily and mandatorily are required to present an opening Ind AS balance sheet. By virtue of Ind AS 101, the entities have the option of using the fair value of an item of PPE or historical cost as its deemed cost. If the fair value is adopted as the deemed cost in the opening Ind AS balance sheet, then for each line item in the opening balance sheet:

a) The aggregate of those fair values
b) The aggregate adjustment to the carrying amounts reported under Indian GAAP.

Accounting under revaluation model

The first revaluation carried out by the management is of primary importance as the treatment of subsequent revaluations would be based on its outcome.

<table>
<tr><th rowspan="2">First Revaluation</th><th colspan="2">Increase in value</th><th colspan="2">Decrease in value</th></tr>
<tr><td colspan="2">Recognise in other comprehensive income under the head revaluation surplus</td><td colspan="2">Recognise in profit and loss</td></tr>
<tr><th rowspan="2">Subsequent revaluation</th><th>Increase in value</th><th>Decrease in value</th><th>Increase in value</th><th>Decrease in value</th></tr>
<tr><td>Recognised in other comprehensive income under the head revaluation surplus, which forms part of the equity.</td><td>Debit to equity to reverse the previous increase. Balance if any available after reversal, debit to profit or loss.</td><td>Credit to profit or loss to reverse previous decrease. Balance if any, credit to equity under revaluation surplus.</td><td>Debit to profit or loss</td></tr>
</table>

Depreciation

Component approach

The Ministry of Corporate Affairs (MCA) has made componentisation mandatory from 1 April 2015 onward for all classes of tangible fixed assets held by companies. This key legal mandate by the MCA is in line with Ind AS 16 which too mandates component accounting. The rationale of componentisation is identifying 'material' parts of the asset i.e. parts which have a cost significant to the cost of the main asset (mother asset). After identifying such parts, componentisation approach compares the useful life of each such part with that of the mother asset. Material parts with the same useful life are grouped together as a 'Component' and are then depreciated.

For a more detailed and illustrative understanding of Component Accounting, read the September 2015 issue of Assurance Insights here.

Other aspects

Method of depreciation

The method of depreciation adopted for an asset is reflective of the pattern of consumption of future economic benefits to be derived from it. Whenever there is a significant change in the pattern of accrual or consumption of such future economic benefits, prudency demands a change in the method of depreciation to reflect such a change.

Any change in the method of depreciation shall be accounted prospectively as a change in accounting estimate in accordance with Ind AS 8: Accounting Policies, Changes in Accounting Estimates and Errors. Presently under Indian GAAP, the effect of any change in the method of depreciation is to be accounted for retrospectively.

Deviation from estimated residual value and useful life

Ind AS 16 mandates that the review of residual value and useful life at each financial year end. In case there are deviations from what has been earlier estimated by the management, the said deviation shall be quantified and accounted for in accordance with Ind AS 8: Accounting Policies, Changes in Accounting Estimates and Errors.

Comparison with international standards

Particulars	IFRS	Ind AS	US GAAP
Overhaul costs	Requires capitalisation of major overhaul cost representing replacement of an identified component	Similar to IFRS	Alternative accounting methods are allowed for recognising the major overhaul costs. Cost in respect of identified component can be expensed or accounted for as separate component or capitalised and amortised over the period benefited by the overhaul.
Component depreciation	Mandatory to follow the component approach of depreciation	Similar to IFRS	Does not generally require the component approach
Review of residual values and useful lives	Mandatory to review residual values and useful lives at each balance sheet date	Similar to IFRS	Though it is appropriate to reassess significant assumptions, it does not explicitly require an annual review of the residual values and useful life
Recognition of investment property	Investment property is separately identified from other PPEs	Similar to IFRS	No specific definition is available for investment property
Model of measurement for investment property	Two alternatives are available – cost model or fair value model	Only cost model is allowed	Except for investor entities, only cost model is used by most entities. Fair value alternative is not available for leased property

In retrospect

Ind AS 16 and Ind AS 40 bring qualitative practices to the accountant's table. The key highlights of these new standards are:

- Intent-based classification of tangible fixed assets
- Component accounting
- Fair value based revaluation model

Training will play a vital role in the adoption of these new standards as entities converge to globally accepted best practices.

The importance of corporate governance scorecards in today's business scenario

Corporate governance is the system by which companies are directed and controlled. Good governance is an essential ingredient for corporate success and sustainable economic growth. It is defined as a set of mechanisms through which firms operate when ownership is separated from management. They provide guidelines on how the company can be directed or controlled in order to fulfil their goals and objectives in a manner that adds to the value of the company and is also beneficial for all stakeholders in the long term. Stakeholders in this case would include everyone ranging from the board of directors, management, shareholders to customers, employees and society. The management of the company thus assumes the role of a trustee for all the others.

Governance scorecards - tools to measure and motivate adherence to good corporate governance practices

Corporate governance entrusts responsibility on the management to conduct business with integrity and fairness, to make necessary and material disclosures and decisions to various stakeholders of an organisation. Good corporate governance brings real benefits to companies. It improves their decision making and risk management, ensures proper accountability, and builds stakeholders' confidence. Scorecards can help them measure their achievements and tell them where they need to improve. A corporate governance scorecard is a measure to encourage and motivate adherence to good corporate governance practices.

What can a scorecard help achieve?

While the primary purpose of a corporate governance scorecard serves to improve the governance and performance of the company, it can also help the company and its board to achieve the following:

- Improve governance practices
- Improve overall functioning of the board
- Enhanced transparency towards all stakeholders
- Improve the company's reputation in the market and among shareholders
- Help report to regulators and the stock exchange

Steps in building a scorecard for a company

Now, after understanding the importance of inculcating good governance practices within an organisation and measuring it through a structured scorecard mechanism, one has to start thinking about developing a scorecard for the organisation. The following are the broad level steps involved in developing a governance scorecard:

Establish the objectives for the scorecard

The management of an organisation while using scorecard should set clear objectives to be achieved, which would be to:

- Enhance governance standards and practices within an organisation
- Improve the company visibility as well as investability and reputation in the market
- Adequate disclosures while reporting to regulators and stock exchange

Management involvement and engaging key stakeholders

For any organisation the starting point for any ethics and compliance program is the board and senior management. The board should exercise leadership and understand the need for good governance and that the benefits of a scorecard project will have greater implications on success.

The management has to identify and engage the key stakeholders who can help make things happen. Failing to engage stakeholders would imply not taking advantage of the potential contributions of others, including their goodwill and resources.

Building the scorecard

The OECD Principles of Corporate Governance (OECD Principles) can be used as the main benchmark for developing the scorecard, given its global acceptance by policymakers, investors and other stakeholders. Consequently, many of the items in the scorecard may be best practices which go beyond the requirements of a country's legislation; in such cases the company can think of referring to international or sector specific benchmarks.

The scorecard should cover the following five areas of the OECD Principles:

a) **Rights of shareholders**
b) **Equitable treatment of shareholders**
c) **Role of stakeholders**
d) **Disclosure and transparency**
e) **Responsibilities of the board**

Weightage needs to be allocated to each of the above principles. The scorecard structure must adopt the structure of the code, provide a comprehensive picture of governance practices, and generate a numerical score.

Once a working version of the scorecard has been completed, it should be reviewed by the key stakeholders. Stakeholder involvement and feedback may generate greater "buy-in."

A pilot test should be conducted for the scorecard so that it can highlight problems early on. A pilot test helps ensure that the scorecard works and that the stakeholders' concerns are understood and addressed.

Detailed guidance for using scorecard and conduct the scoring

Detailed guidance notes for scorecard usage need to be developed and disseminated so that everyone involved in the project understands the requirements and ensures consistency in assessments against each category and the indicator mentioned in the scorecard.

The scoring assessment may be conducted either on web based applications, spreadsheets or text documents depending on the time, financial and human resources available. The following is an example of a governance scorecard about the shareholders rights category.

ABC Company

Corporate Governance Scorecard

Overall Score: _____%

Categories and indicators	**Grading (1-10)**	**Weightage**	**Score per category**	**Comments**
Shareholder's/Owner's Rights		10%		
Shareholder meetings are convened and they participate effectively and vote in the meetings - the shareholders meeting notice, agenda and other materials are sent to shareholders well in advance, shareholders are encouraged to propose items to the agenda, participate in the meeting, nominate proxy, etc.	0	30%	0%	
Shareholders participate in and are informed on basic decisions - voting rights do not deviate from their ownership rights, participate in decisions related to amendments to governing documents, extraordinary transactions, etc.	0	25%	0%	

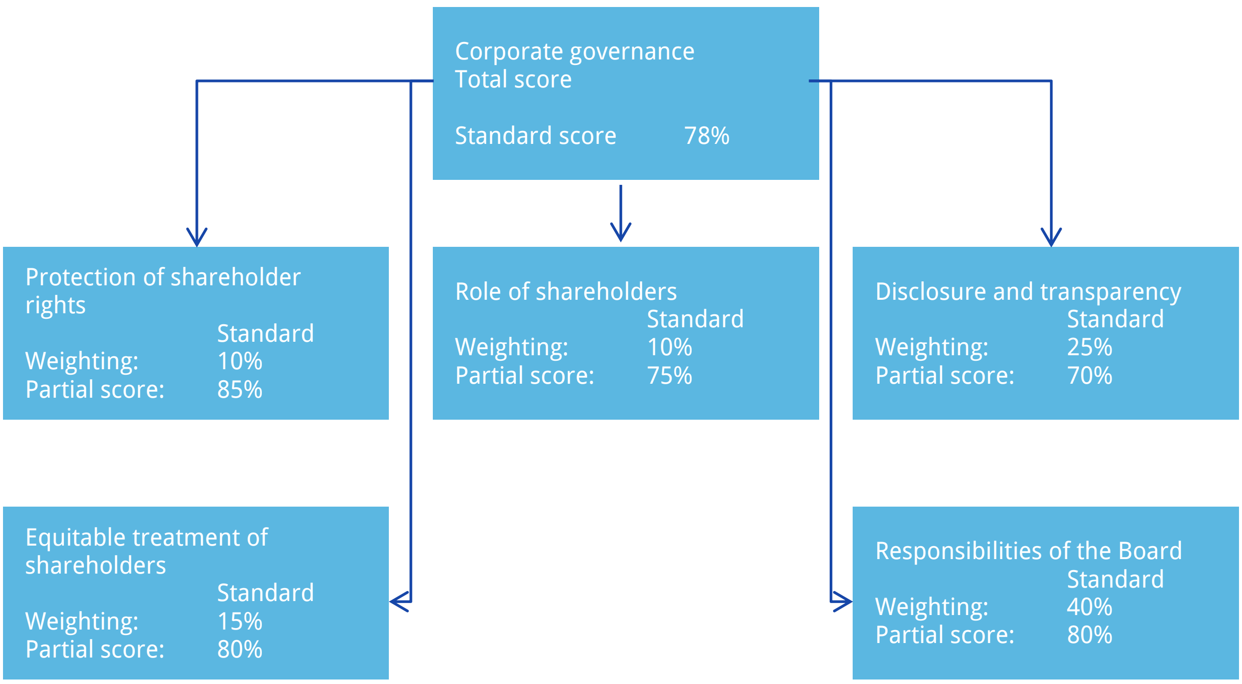
Corporate Governance Scorecard				
Overall Score: _____%				
Categories and indicators	**Grading (1-10)**	**Weightage**	**Score per category**	**Comments**
Shareholder's/Owner's Rights		10%		
Basic shareholder rights are ensured - secured ownership registration, right to elect board members, sharing in company profits, etc.	0	30%	0%	
Disclosures to shareholders - full and timely disclosure of material transactions to shareholders, disclosure of all material shareholder and similar agreements, etc.	0	15%	0%	
		100%	0%	

Results

The scorecard and assessment are intended to raise corporate governance standards and practices within an organisation. Once the relevant data is collected, the next step is to convert it into useful information for e.g. a gap analysis to show where their governance falls short of the benchmark code will provide sufficient information to develop an action plan.

If the scorecard was administered in the form of a computer spreadsheet, a report can usually be generated once the final indicator scores are introduced. If reports are used to advise companies on how to improve their governance practices, spreadsheets should be supplemented with more analytical information. To be complete, narrative reports should include recommendations for how to improve governance practices.

ABC Company
Summary of the results



Measurable outcome: The case of Galenika Fitofarmacija[1]

In 2010, the local chamber of commerce approached Galenika Fitofarmacija, a Serbian company to participate in a scorecard project sponsored by IFC. Galenika Fitofarmacija's initial reaction was that it was not in need of external capital and did not need to improve its governance. The company had a good reputation and carried no debt. The benefits of a governance assessment were thus unclear.

However, a number of factors persuaded Galenika Fitofarmacija to participate.

Transparency improved dramatically. In just one year, Galenika Fitofarmacija moved from a position of weakness to one of strength in terms of disclosure. It became the first Serbian company to make its dividend policy public. It also disclosed its articles of incorporation, remuneration policies, its code of corporate governance, the résumés of board members and top management, annual and semi-annual financial statements, and information on general assemblies, including agenda items and minutes, on the web.

Such practices brought the company close to international levels of best practice. In recognition of Galenika Fitofarmacija's commitment to good governance, the Belgrade Stock Exchange included the company's shares in the BELEX 15 stock index, which drew a positive reaction from investors. Shortly after its inclusion in the index, the company experienced a period of greater trading volume.

Board members and executives found that using the scorecard helped them better understand governance and how good governance can reduce the potential for procedural conflicts between controlling and minority shareholders.

Overall, the board felt that the scorecard process added tangible value to the enterprise. The board of directors also felt that good governance would be a future selling point in any potential expansion.

Summary of outcomes

As a result of its participation in the scorecard activity, Galenika Fitofarmacija:

- Developed written policies and procedures;
- Enhanced transparency towards all shareholders and the markets;
- Created recognition of the company as a governance leader and a quality investment;
- Developed commitment to good governance at board and executive levels;
- Created a better understanding of governance and how it affects company operations;
- Enhanced the protection of minority shareholders;
- Provided a better understanding of governance strengths and weakness; and
- Led to a roadmap for future improvement.

Scorecards – continuous refinement

The story does not end with a single scorecard assessment. Once companies have undergone an initial scoring, they are likely to understand the benefits of good governance may require further assistance. The scorecard and methodology should be reviewed periodically, and if necessary, changes should be made to reflect the latest developments in corporate governance.

[1] IFC Corporate Governance Knowledge Tool, Corporate Governance Scorecards, Assessing and Promoting the Implementation of Codes of Corporate Governance.

Companies Act, 2013: Key updates

The Companies (Share Capital and Debentures) Third Amendment Rules, 2015

The Ministry of Corporate Affairs (MCA) has issued the Companies (Share Capital and Debentures) Third Amendment Rules, 2015. The MCA has made additions to the class of companies that can issue secured debentures, whose redemption shall be between ten to thirty years from the date of issue of such debentures. Some of these points are as follows:

- Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014 along with its amendments state:
  An issue of secured debentures may be made, provided the date of its redemption shall not exceed ten years from the date of issue. Provided that the following class of companies may issue secured debentures for a period exceeding ten years but shall not exceed thirty years.

  i. Companies engaged in setting up of infrastructure projects;
  ii. 'Infrastructure Finance Companies' as defined in clause (vii)(a) of sub-direction (1) of direction 2 of Non-Banking Financial (Non-deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
  iii. ***'Infrastructure Debt Fund Non-Banking Financial companies' as defined in clause of (b) direction 3 of Infrastructure Debt Fund Non-Banking Financial Companies (Reserve Bank) Directions, 2011.***
- The aforesaid **sub-clause** (iii) has been substituted with the following points:
  iii. 'Infrastructure Debt Fund Non-Banking Financial Companies' as defined in clause (b) of direction 3 of Infrastructure Debt Fund Non-Banking Financial Companies (Reserve Bank) Directions, 2011;
  iv. Companies permitted by a Ministry or Department of the Central Government or by the Reserve Bank of India or by the National Housing Bank or by any other statutory authorities to issue debentures for a period exceeding ten years

Source: The Companies (Share Capital and Debentures) Third Amendment Rules, 2015

The Companies (Management and Administration) Third Amendment Rules, 2015

- In accordance with section 92 of the Companies Act, 2013 and the rules made thereunder, every company shall prepare an Annual Return in the prescribed form i.e. Form No. MGT 7, containing the particulars as they stood on the close of the financial year.
- The MCA has issued a new Form No. MGT 7 (Form of Annual Return) in this amendment.

Source: The Companies (Management and Administration) Third Amendment Rules, 2015

Note: These Rules shall come into force from the date of their publication in the Official Gazette.

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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