

# ASSURANCE INSIGHTS

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

This month, we discuss the rise and recent fall of e-commerce companies which have raised numerous questions about the viability of their business models, particularly with regard to their accounting practices. Furthermore, these dotcom companies have raised capital in the stock markets of the country and the markets normally value companies based on various types of information including accounting information. This month we talk about the various types of e-commerce companies, the elements of e-commerce transactions and the revenue recognition for certain sources of revenue in this sector.

We also discuss the need for Enterprise Risk Management (ERM) and steps to implement it within the organisation. While risks are an inherent part of business which create uncertainty and might impede decisions that are taken by the management, a successful ERM reduces the likelihood and impact of risks associated with the business. It also provides several benefits in terms of well-informed strategic decisions, successful delivery of change and increased operational efficiency.

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

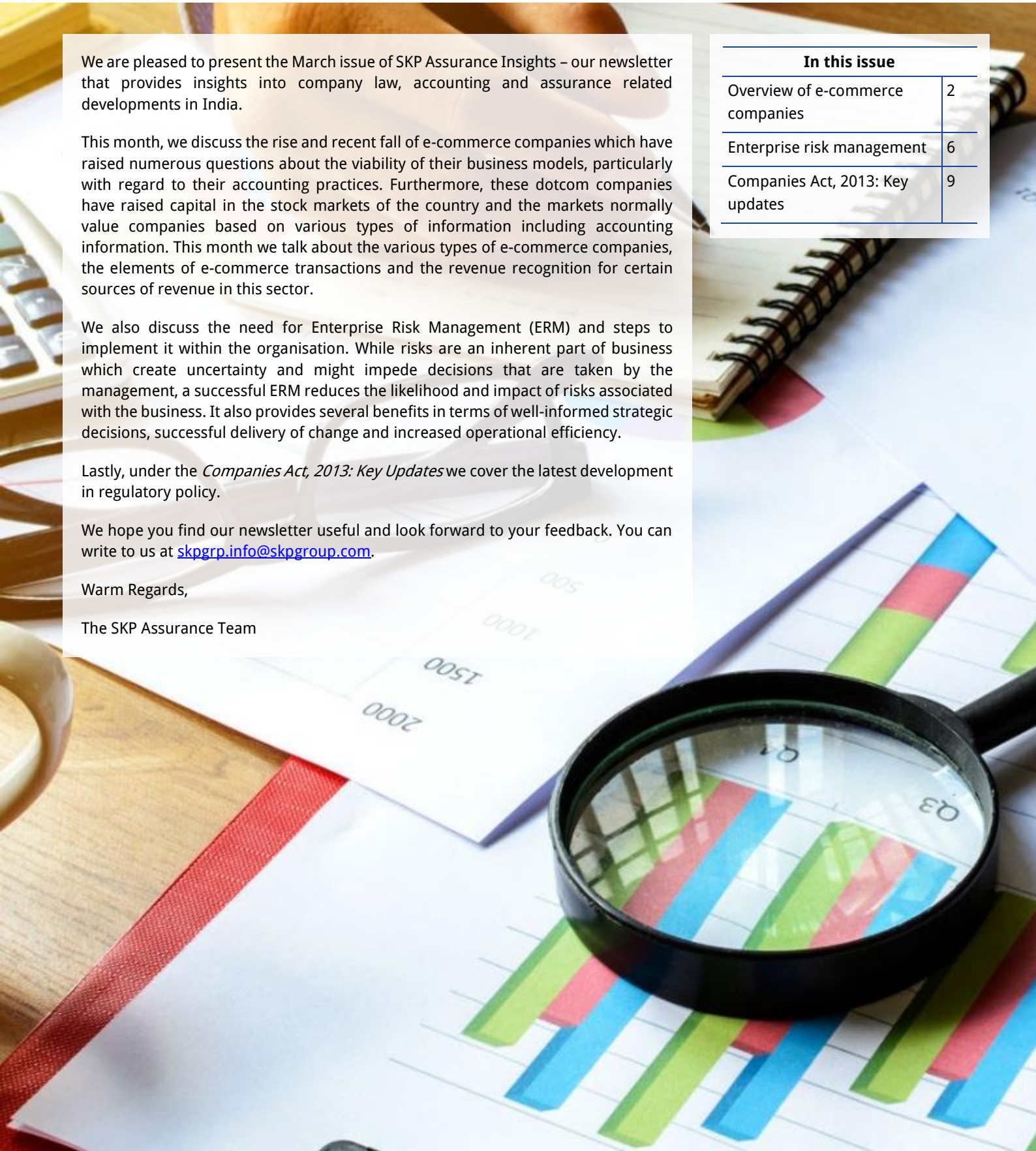
We hope you find our newsletter useful and look forward to your feedback. You can write to us at [skpgrp.info@skpgroup.com](mailto:skpgrp.info@skpgroup.com).

Warm Regards,

The SKP Assurance Team

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## Overview of e-commerce companies

The e-commerce industry in India has boomed, and an increasing amount of consumers are shopping online. Everything from luxury products to groceries are now available online. As the Indian economy grows, consumption is expected to rise and this sector is expected to grow as well.

As the e-commerce industry emerges, relatively little industry-specific accounting guidance is available to address the accounting challenges faced by this sector.

In this issue, we share some of the highlights of the Guidance Note on Accounting by Dot-Com Companies, which was issued by the Institute of Chartered Accountants of India in 2001. We also discuss the types of e-commerce companies in India, the elements of e-commerce transactions and explain revenue recognition according to AS 9 for certain sources of income.

### Types of e-commerce companies

There are two categories of dotcom companies, online content companies and internet commerce companies.

#### Online content companies

These companies focus on content sites which:

- provide news, information and knowledge
- provide internet navigation services
- publish, provide or present proprietary, advertising, and/or third party content.

#### Internet commerce companies

These companies sell products and services over websites on the internet and include online dealers.

On the basis of the types of transactions carried on by such companies, the sites are typically classified into:

- Business-to-Business (B2B)
- Business-to-Consumer (B2C)

- Consumer-to-Consumer (C2C)
- Consumer-to-Business (C2B)

#### **Business-to-Business (B2B)**

Transactions on these sites take place between industrial manufacturers, wholesalers or retailers.

Special features of these transactions are high volumes per customer, lesser number of customers, secured payment systems, privacy of information, etc. Some of the sites in this category are indiaMART.com, tradeindia.com and india.Alibaba.com.

#### **Business-to-Consumer (B2C)**

- Sites sell products or services directly to consumers.
- Transactions on these websites are characterised by low volumes per consumer and a large number of consumers. Examples of sites in this category are rediff.com, Sunglassesindia.com, indiatimes.com.

#### **Consumer-to-Consumer (C2C)**

- Sites enable consumers to buy and sell from each other through auction or other similar sites. Examples of sites in this category are baze.com and olx.com.

#### **Consumer-to-Business (C2B)**

- Sites enable consumers to set prices and business enterprises bid to offer products and services. One such example in this category is priceline.com.

### Elements of e-commerce transaction

In an e-commerce transaction, all the traditional elements of commerce exist, though with some differences. The following elements are ordinarily present in an e-commerce transaction:

- a product or service;
- a place, here, a website, that displays the products/services and where a business transaction takes place;



- a way for people to visit the place (website);
- a way to accept orders, e.g. an online form;
- a way to accept money – normally through credit cards. Alternatively, the companies may use more traditional billing techniques either online or through mail;
- a facility to ship products to customers (often outsourced). In the case of software and information, the product can be transferred over the web through a file download mechanism;
- a way to accept rejected or returned goods and services;
- a way to handle warranty claims, if necessary; and
- a way to provide customer service (often through e-mail, online forms, online knowledge bases and frequently asked questions (FAQs)).

Apart from the above elements of e-commerce transactions, certain other facilities may also be provided on the website, for example, information of the exact status of an order.

## Revenue recognition as per AS 9

Revenue from sales or service transactions should be recognised when the performance requirements set out for the sale of goods and rendering of services are satisfied according to the criteria mentioned below. However, at the time of performance it should not be unreasonable to expect an ultimate collection. If at the time of raising any claim it is unreasonable to expect an ultimate collection, revenue recognition should be postponed.

Performance should be regarded as achieved when the following conditions for the **sale of goods** have been fulfilled:

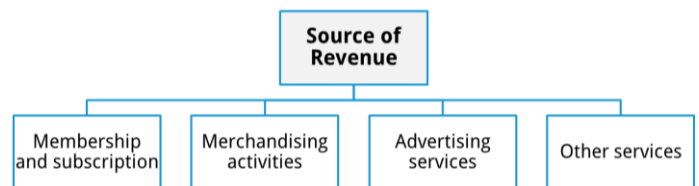
- a) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- b)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

In a transaction involving the **rendering of services**, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of consideration that will be derived from rendering the service.

## Revenue Recognition of e-commerce companies

E-commerce companies are often valued based on revenue multiples and hence, it is one of their most important metrics. Revenue is susceptible to misuse and fraud. Therefore, it is subject to constant scrutiny by the regulators.

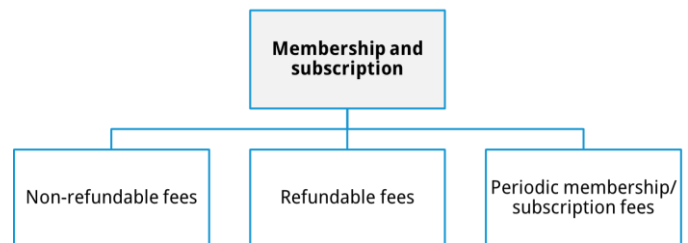
- Revenue recognition for e-commerce companies is primarily based on the source of revenue. Accounting principles applicable to specific sources of revenue for e-commerce companies are discussed below:



### Membership and subscription

In order to avail the services provided by websites, consumers are usually required to pay membership fee or a subscription fee.

The categories of fees received towards membership and subscription by e-commerce companies and their revenue recognition are explained below:



#### Non-refundable fees

- The initial membership fee is of the nature of an entrance fee which should be capitalised.
- The revenue is recognised over a period of not less than five years, on a systematic and rational basis, i.e. on time proportion basis or any other basis, e.g. usage basis.
- Revenue in respect of non-refundable fees to be recognised on a systematic basis which should not exceed the corresponding periodic subscription.

#### Refundable fees

- The amounts received from customers should be credited and retained in a liability account such as the 'Customers Refundable Fees Account'.
- The revenue from such transactions should be recognised only when it becomes reasonably certain that conditions would not be fulfilled.

### Periodic membership/subscription fees

- Should be recognised as revenue over the period of the subscription, in accordance with the established principles of accrual accounting.

## Merchandising activities

This activity involves sale of goods or services online to third parties.

One of the significant questions when accounting for e-commerce companies is whether to recognise revenues on gross or net basis. This issue typically arises in the B2C sites.

To assess whether the revenue should be gross or net, the following aspects of a dotcom company should be considered:

- If it acts as a **principal** in the transaction, i.e. it assumes significant risks and rewards of ownership, such as the risk of loss in collection, delivery, or returns; or
- If it acts as an **agent** or broker for the sale of goods or rendering of services, i.e. does not assume significant risks and rewards of ownership; compensation being commission or fee. In this case, the dotcom company is merely engaged in providing the service of bringing the purchaser and the seller together.

Revenue recognition should be carried out as follows:

- **For Principal** - Revenues and the related costs should be recognised on a gross basis (i.e. sale value of product as revenue and cost of purchase of product as cost of sale).
- **For Agent** - Only the service charges are booked as revenue, similar to commission.

One of the indicators for determining the timing of revenue recognition is who bears the insurance cost/risk.

- If the risk is borne by a third party (logistic service provider) then the companies would recognise revenue on the dispatch of goods from the warehouse.
- If the risk is borne by the company, then it may be appropriate to recognise revenues only once the products are delivered to the customer.

Additionally, in practice, the customers may return the goods sold. Generally, when the buyer has a right of return and there is uncertainty about the possibility of return, revenue is not recognised until the shipment has been accepted by the customer or the goods have been delivered and the time period for rejection has elapsed.

In assessing the possibility of return, the entity should make reliable estimates based on its experience.

Revenue recognition for some of the merchandising activities are:

### a) Auctions

Some entities host auction sites as part of their online activities where users can purchase or sell goods or services. The revenues generated from this activity are:

- **Listing Fees** This is an up-front fee that the company receives at the time a seller registers for a listing to be maintained over a specified period of time. It is appropriate that listing fees are recognised over the period of the contract or arrangement.
- **Transaction Fees** This fee is for facilitating transactions and is usually based on a percentage of the revenue earned by the seller from the online sale. Such fees should be recognised as revenue by the dotcom company upon completion.

### b) Shipping and handling

E-commerce companies selling products online often charge customers for shipping and handling activities.

- If products sold online are invoiced to the customers at a composite rate including shipping and handling charges, it may be appropriate to include such charges as a component of sales revenue.
- If such charges are recovered as an absolute amount or as a percentage of the sale value separately, they should not be included in sales revenue but should be recorded separately and should not be included in computing the value of turnover to be disclosed in the statement of profit and loss.

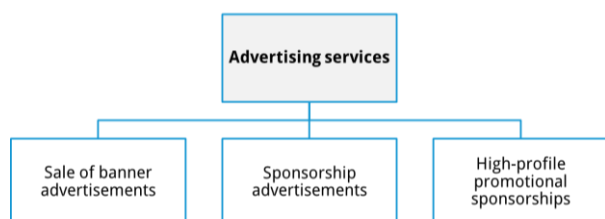
### c) Multiple element arrangements

A multiple element arrangement generally exists where a dotcom company agrees to deliver more than one product/service concurrently and deliver certain additional products/services in future. It is customary to bundle such products and services for a consolidated price.

For accounting purposes, it is appropriate to 'unbundle' the separate elements of the arrangement or contract using company-specific fair values in respect of which objective evidence is available. Unbundling of revenues is not required if all the elements fall within the same accounting year.

## Advertising services

There are three sources of advertising revenues as illustrated below:



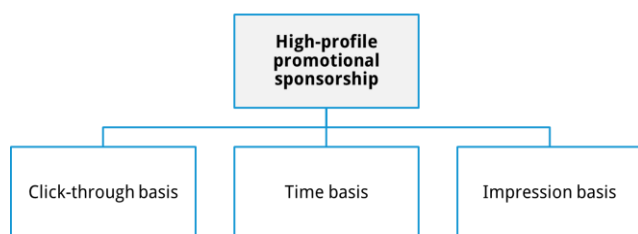
### Sale of banner advertisements

Usually hosted for a short duration on websites

### Sponsored advertisements

Contracts have longer durations than banner advertising contracts and also involve more service integration.

### High-profile promotional sponsorships



### Click-through Basis

Dotcom companies charge customers on the basis of clicks on the banner or advertisement by visitors of site.

### Time Basis

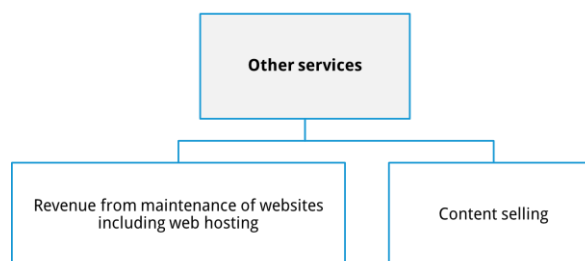
Revenue should be booked on a straight-line basis over the period for which the banner is to be hosted on dotcom companies' site.

### Impression Basis

Impressions are the number of times a banner or advertisement appears on the site. Revenue, in this case, should be booked on a straight-line basis, and not on the number of clicks.

## Other services

There are two types of revenue from other services as illustrated below:



### Revenue from maintenance of websites including web hosting

Revenue should be recognised over the period for which the website is to be hosted or maintained.

### Content Selling

Determine the time at which the delivery of the content is considered to be complete and recognise the corresponding revenue. Usually, it is the time when the content is downloaded.

## Advertising barter transactions

Sometimes dotcom companies enter into a contract with each other, in which they exchange rights to place advertisements on each other's websites or web pages. The consideration for the advertising barter transactions should be recognised only when the fair values of similar transactions are readily determinable from the entity's history i.e. fair values of transactions that have occurred not later than six months preceding the sale of similar advertising to unrelated buyers. This is to ensure that the comparable values are current and reflect the best estimate (a price at which a buyer is willing to buy and a seller is willing to sell), considering all other economic circumstances are the same. If economic circumstances have changed in last six months and transactions are not representative of the current fair value for the advertising surrendered, then a shorter, more representative period should be used. It is inappropriate to consider cash transactions subsequent to the barter transaction to determine fair value.



## Enterprise Risk Management

Industries mainly focus on operational or compliance-related risks and fail to focus on strategic and emerging risks which eventually end up impacting the organisation's success. Hence, a systematic and disciplined approach is required to manage the overall risk effectively at an enterprise level in order to continue operations and achieve the organisation's objectives.

Enterprise Risk Management (ERM) is defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework as "a process, effected by an entity's Board of Directors (Board), management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives".

ERM is an ongoing process, rolling through the entity and effecting every level/layer of people working in the organisation, applying strategy across the enterprise to identify potential risk affecting the organisation and mitigating that risk within its risk appetite to provide reasonable assurance to the management for achieving entity objectives.

### Need for ERM in an organisation

ERM enables the management of an organisation to effectively deal with any uncertainty having potential risks and opportunities, thereby providing value to its stakeholders. ERM would support the management in achieving the set objectives by:

- Monitoring/controlling unexpected variances by assessing the possibility of future events and its impact on business.
- Building confidence of investors and stakeholders.
- Improving governance structure.
- Effectively responding in the dynamic business and economic environment.

- Enhancing the inherent capability of managing risks.
- Increasing risk awareness within the organisation.

### Responsibility of ERM

Since involvement in creating a strategy is required, the responsibility must initially flow from the top management and then to the middle management and division managers. Apart from this, the chief risk officer/risk management committees appointed in an organisation would also support the implementation of an ERM.

### Establishment of ERM

The management, while establishing an ERM within an organisation, can take support from the internal audit team. Three key activities where the internal audit department can support this process are given below:

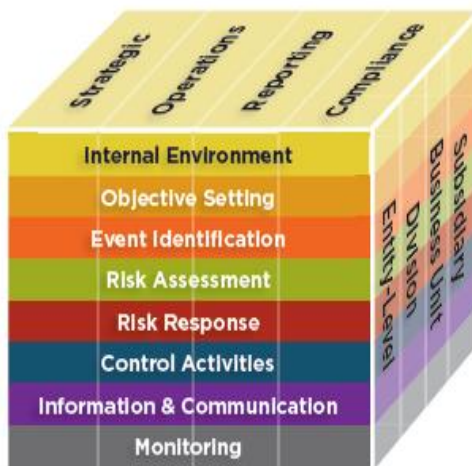
- 1) Encouraging leadership from the top;
- 2) Assisting in the development of a business case for ERM; and
- 3) Suggesting an ERM organisation structure.

The Board and senior management set the tone for the organisation's risk culture; hence, with ERM implementation, they will be in a position to confidently assure investors that they are managing risks effectively that would be affecting the organisation objectives. Therefore, the *'tone at the top'* is of utmost importance and is the first step towards the establishment of ERM within an organisation.

### Achievement of organisation objectives

The ERM process must be viewed as an ongoing activity. The initial risk assessment process requires periodic updating and the organisation must be adjusted to the

need of recognising new and emerging risks. In this context, the COSO ERM framework assists the organisation in achieving the broad-level objectives as it is presented in the form of a matrix which consists of four categories (strategic, operations, reporting and compliance) across the top and eight integrated components of ERM. The relationship between the objectives and the components is depicted in a three-dimensional matrix, in the form of a cube. The management evaluates the appropriate ERM infrastructure and develops the process to choose risk management vision, goals and objective.



The ERM framework required to achieve the entity's objectives are given below:

- Strategic: High level goals, aligned with and supporting the objectives
- Operations: Efficient and effective use of resources
- Reporting: Reliability of the report
- Compliance: Regulatory compliance with the applicable rules and regulations

The eight integrated components of ERM are:

**Internal environment** – The internal environment would comprise of the tone at the top, risk management, approach and appetite of risk in the organisation.

**Objective setting** – The management should set objectives which are aligned with its mission and risk appetite.

**Event identification** – Internal and external events affecting the organisation's achievement of objectives must be identified and distinguished into risks and opportunities.

**Risk assessment** - The management designs the procedure for creation of ERM, whereas internal audit assists the management by leveraging their experience in developing risk management. There is no standard procedure followed for risk assessment.

However, there are attributes of a good risk assessment which are:

- Conciseness
- Consistency of terminology
- Formal structure in the risk rating system
- General clarity of message

**Risk response** – The management selects risk responses (accepting, avoiding, reducing and sharing risks) that are aligned with the risk appetite of the organisation.

**Control activities** – Policies and procedures are framed and followed to ensure risk responses are carried out effectively.

**Information and communication** – Relevant information is identified, captured and communicated across the organisation to enable employees to carry out their responsibilities effectively.

**Monitoring** – Monitoring of the entire ERM is accomplished through ongoing management activities, separate evaluations or both.

## Steps to implement ERM

The following steps should be followed by an organisation in the implementation of ERM:

### 1) Seek Board and senior management leadership, involvement and oversight

The Board and senior management should give their assent on initial objectives and state the benefits and their expectations from ERM. There should be clear agreement and alignment of the Board and senior management's expectations, timing and expected results.

### 2) Select a strong leader to drive the ERM initiative

Management should identify a leader with the right qualities to head the ERM effort. They do not need to head ERM for an extended time period but must take the first initiative.

### 3) Establish a management risk committee or working group

An organisation should consider creating a senior-level Risk Management Committee or Working Group as the support through which the designated leader can implement the ERM initiative.

### 4) Conduct the initial enterprise wide risk assessment and development an action plan

A top-down assessment is carried out for risks that could be most significant to the organisation and its ability to achieve its business objectives by assigning a risk ranking.



**5) Inventory the existing risk management practice**

At this stage, an assessment of current risk is carried out where the areas of strength and weakness are identified.

**6) Develop initial risk reporting**

Despite what specific reporting format is considered, the report must clearly reflect the relative importance or significance of each identified risk. Hence, organisations use simplified lists, colours, graphics, etc.

**7) Develop the next phase of action plans and ongoing communication**

Once the initial ERM action plan has been concluded, the risk leader should focus on a series of action plans for the next stage of implementation.

The Board of Directors and senior management are inevitably responsible for ensuring enterprise-wide risks are managed in the organisation. They should also play a significant role in the establishment and maintenance of ERM and can rely upon internal audit to enhance value in the implementation process. The internal audit division should also apply its standards of independence and educate the management on the types and nature of risks and risk-based assessments for ERM to be implemented successfully.





## Companies Act, 2013: Key updates

### **The Companies (Share Capital and Debentures) Amendment Rules, 2016**

The Ministry of Corporate Affairs (MCA) has issued the Companies (Share Capital and Debentures) Amendment Rules, 2016. These rules shall amend the Companies (Share Capital and Debentures) Rules, 2014. In rule 17, sub-rule (1), clause (n), after sub-clause (iii), a proviso has been inserted. The proviso states that:

“Provided that where the audited accounts are more than six months old, the calculations with reference to buy-back shall be on the basis of un-audited accounts not older than six months from the date of the offer document which are subject to a limited review by the auditors of the company.”

[Source: The Companies \(Share Capital and Debentures\) Amendment Rules, 2016](#)

### **The Companies (Incorporation) Second Amendment Rules, 2016**

The MCA has issued the Companies (Incorporation) Second Amendment Rules, 2016. These rules shall amend the Companies (Incorporation) Rules, 2014. Form number INC-11 (Certificate of Incorporation) has been substituted in these rules.

[Source: The Companies \(Incorporation\) Second Amendment Rules, 2016](#)

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

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SKP is a long established and rapidly growing professional services group located in seven 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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