Impact of IFRS on Reported Results of Companies – A Sectoral Analysis

Transition to IFRS will have an impact on reported revenues, profits, net worth, earnings per share and other performance matrices for all companies. This article seeks to highlight the significant IFRS impact areas in respect of some of the key sectors in our economy. For example, for the real estate sector, the key impact will be deferral in timing of revenue recognition. For companies in the infrastructure sector who enter into service concession arrangements, IFRS prescribes a different accounting model in which revenue is recognised for each deliverable, i.e., construction and operation and maintenance of underlying asset separately. This accounting is also dependent on how is the consideration discharged by the grantor, either as a fixed annuity or as a right to charge end users. Companies in the IT & BPO sector may be impacted by the accounting for share-based payments and revenue recognition for bundled contracts with multiple deliverables. For banks, accounting for upfront fees, provision for doubtful loans and advances and securitisation transactions may be areas which may have a significant impact on transition to IFRS. For other manufacturing and consumer goods companies, revenue recognition including accounting for customer incentives and estimation of useful lives and accounting for depreciation may be some of the areas to be evaluated at the time of transition. Read on to know more…

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Notwithstanding the deferral of the implementation of IFRS in India, companies are tracking the events that unfold on the roadmap for IFRS transition in India, including recent developments to Indian GAAP like Revised Schedule VI, financial reporting changes due to the revised Companies Bill, which gradually aligns Indian GAAP with IFRS.

Over the past decade, Indian companies in the Infrastructure sector have increasingly participated in public-private partnership projects involving Central and State governments. The ICAI has released an exposure draft on such arrangements, which seeks to converge Indian GAAP with IFRS. Some infrastructure companies in India have already adopted the principles of this exposure draft in preparing their financial statements. extent.

Transition to IFRS will have an impact on reported revenues, profits, net worth, earnings per share and other performance matrices for all companies. The impact of IFRS convergence across industry sectors is varied, with some sectors being significantly impacted and some may have a low or moderate impact.

This article seeks to highlight the significant IFRS impact areas in respect of some of the key sectors in our economy.

(a) Real Estate

Sale of properties under construction

Currently under Indian GAAP, pursuant to guidance note issued by Institute of Chartered Accountants of India (ICAI), real estate companies follow the percentage completion method to recognise revenues and costs from sale of properties/apartments. IFRS principles treat sale of apartment and properties as a sale of a product which is arguably also the underlying substance of such transactions, as against contracts for provision of construction services. This conclusion is based on the fact that:

1) Customers do not have any right to make fundamental changes to the structure or design of the apartment during the construction period; and
2) Customers do not have the right to take over incomplete property under construction, in the case of default by the developer or otherwise.

Under this approach, 'Agreement to sell' entered by developers for an under construction property is akin to a transferable forward contract to sell the property in the future at an agreed price; and this by itself does not transfer the risks and rewards of ownership to the customer until transfer of possession of the property thereby postponing revenue recognition till such transfer.

However, the aforesaid may not impact real estate developers in India as the India converged IFRS standard (Ind AS) will permit companies to recognise revenue on a percentage completion method over the construction period. This however would not be in compliance with IFRS, due to which the financial results of Indian real estate developers will not be comparable with their global peers.

Structured financing arrangements

Structured financing arrangements for special purpose vehicles (SPV) floated by real estate companies for projects, would need to be closely evaluated to identify the substance of the transaction, and accounting will have to reflect this underlying substance. For example, instruments issued by the SPV for which the SPV has an obligation to pay cash would need to be classified as debt and the underlying committed returns or fluctuations in the value of such instruments would have to be recorded in the income statement. This would also increase the volatility of the reported earnings and reduce reported profits.

Investment properties

Land and building held for earning rentals and capital appreciation would be classified as investment property. An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement. Subsequently, investment property can be measured using the cost or the fair value model. However, as a minimum, companies that subsequently measure the investment property at cost will need to disclose the fair value of these properties in order to reflect their true worth to the users of financial statements.

(b) Infrastructure

Public-private partnership in infrastructure

Over the past decade, Indian companies in the infrastructure sector have increasingly participated in public-private partnership projects involving Central and State governments. These arrangements are often described as a 'build-operate-transfer' (BOT), 'rehabilitate-operate-transfer','public-to-private/ public-private-partnership' or 'service concession arrangements'. The infrastructure assets can take many forms e.g., roads, bridges, tunnels, ports, hospitals, water distribution networks and electricity supply plants.

IFRS provides specific guidance on accounting for such arrangements in which the public sector controls or regulates the services provided with the infrastructure and their prices, and controls any significant residual

interest in the infrastructure. The ICAI has released an exposure draft on such arrangements, which seeks to converge Indian GAAP with IFRS. Some infrastructure companies in India have already adopted the principles of this exposure draft in preparing their financial statements.

Under IFRS, the accounting of such arrangements is split up into the initial construction phase and the subsequent operations phase. The operator will have to allocate the total consideration to each phase based on their relative fair values. The operator will have to recognise the compensation receivable for the construction phase as either: (a) a financial asset to the extent that it has an unconditional right to receive cash irrespective of usage of the infrastructure (for example, where the operator receives a pre-determined payment from the government irrespective of the actual usage); or (b) an intangible asset, to the extent that consideration is dependent on usage of the infrastructure (for example, where operator has a right to charge the user based on usage of the infrastructure for a defined term). In certain arrangements, both a financial asset and an intangible asset may need to be recognised. All such assets are recorded based on their fair values. In the construction phase, the operator will have to recognise revenue as per IAS 11 on construction contracts to the extent of the value of the services performed (i.e. cost of constructing the infrastructure asset with a reasonable margin). During the operations phase, the accounting will be determined by the type of arrangement with the grantor. In the case of a financial asset model, the operator will recognise an interest income over the life of the arrangement and a service income towards any additional services like for operations and maintenance. In the case of an intangible asset model, the operator will recognise the amounts collected from users of the infrastructure assets as income.

Companies across sectors, including infrastructure sector may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use a specific asset (e.g., an item of property, plant or equipment) in return for a payment or series of payments. IFRS provides specific guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with standard on leases.

The intangible asset will be amortised in accordance with the principles laid down in IAS 38 on intangible assets. Further, contractual obligations to maintain or restore infrastructure are recognised and measured in accordance with IAS 37 on provisions, contingent liabilities and contingent assets; irrespective of the model followed. Currently, under Indian GAAP, operators generally recognise and depreciate infrastructure assets as their own property, plant and equipment. Amounts received from the government and user charges are generally recorded as income over the period of the arrangement. No separate income is generally recognised during the construction period.

Adoption of IFRS will affect operators' revenue recognition and profit pattern during the period of the arrangement. The change in the profit profile could also impact the timing or ability to pay dividends in certain years during the term of the project. Additionally, the operators' balance sheet composition will also change, as assets previously classified as fixed assets will now be separately classified as financial assets or intangible assets.

Leases

Companies across sectors, including infrastructure sector may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use a specific asset (e.g., an item of property, plant or equipment) in return for a payment or series of payments. Examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services, include arrangements in the power sector, in which power generators enter into contracts to provide power companies with rights to capacity.

IFRS provides specific guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with standard on leases. Generally, current practice under Indian GAAP is to record such arrangements as normal supply arrangements (and not lease contracts) unless the agreement is specifically designated as a lease.

Convergence with IFRS would require both the supplier and purchaser to determine whether the arrangement is in substance a lease. This would require an evaluation of whether the fulfillment of the arrangement is dependent on the use of a specific asset or assets, whether the purchaser has the ability

or right to operate or direct the operation of the asset, and whether the purchaser has the ability or right to control physical access to the underlying asset. If the evaluation indicates that the arrangement contains a lease, a further assessment is required on whether the lease constitutes a finance lease or an operating lease. Consistent with the general standard on lease accounting, finance leases would result in de-recognition of the underlying asset and recognition of a lease receivable by the supplier, and recognition of the asset and a lease liability by the purchaser. This could significantly affect the balance sheet of both the suppliers and the purchasers. Complexities may also arise in relation to separation of the lease portion of the arrangement from the non-lease portion of the arrangement. For example, it is possible that the arrangement may include a lease of specific assets (based on the factors discussed above) and provision of subsequent services to operate the asset on behalf of the purchaser. In such a case, the total value of the arrangement would need to be segregated between the lease and the non-lease elements on a rational basis.

Foreign exchange differences

The current accounting framework in India allows companies to defer the foreign exchange differences arising from translation of long-term monetary items being accounted in profit and loss by parking such differences in a Foreign Currency Monetary Translation Difference Account or capitalising the same. IFRS requires accounting for all exchange differences in the profit and loss account. This will have a significant impact on the reported earnings and net worth of many companies in India across sectors particularly the Infrastructure sector which is highly leveraged.

However, it is to be noted that Ind AS allows an accounting policy choice to defer exchange differences on long-term foreign currency assets and liabilities, and recognise such differences over the period of the underlying asset/liability, which can significantly dilute the impact on conversion.

Consolidation

Under IFRS, consolidation is based on the control (both direct and indirect) over the entity rather than ownership. This may result in consolidation of some entities and de-consolidation of certain entities based on contractual arrangements.

In India across sectors including the infrastructure sector, there are alliances between Indian and foreign companies/Private Equity (PE) investors, where the Indian company may hold a majority stake but has shared control with the foreign company/PE investor, for example, veto power with the foreign partner/ PE investor for approval of annual budgets and operating plans etc., due to which the Indian company cannot demonstrate unilateral control over the investee.

Based on the guidance under IAS 27, the investee may get classified as a jointly controlled entity and the Indian company would not be able to report the entire revenue of the investee in its consolidated financial statements.

(c) IT & BPO

Revenue recognition

IT companies often enter into composite contracts for software licenses, implementation services, software development services and ongoing maintenance services. Further, in many cases, IT product companies provide free upgrades and other free add-on software. Under IFRS, the substance of the transaction should be considered to determine whether the various components should be treated as a single contract or accounted for separately. The general revenue recognition criteria are then applied to each component of a software contract, as follows:

- For software products, the revenue recognition criteria for sale of goods are applied
- For services related to the software sold, the related revenue is deferred and recognised when the services are provided, either on a straight-line or percentage of completion basis
- For customised software (where the license cannot be used without significant customisation and modification), revenue is recognised by reference to the stage of completion of development in a similar manner to services and construction contracts. In such cases, upfront recognition of revenue from license of software products would not be appropriate.

Under IFRS, it may be necessary to segment a single contract into its components, with different revenue allocations for each component. Generally, if separate components have standalone value to a customer, allocation of overall revenues to individual components (elements) would be required irrespective of whether all elements are documented in one single contract or in separate concurrent contracts. Thus, the substance of the arrangement is evaluated to determine whether multiple elements are involved.

Outsourcing contracts

Increasingly, Indian IT and BPO companies are entering into total outsourcing contracts that include end-to-end outsourcing of IT systems. Some of these contracts may also include upfront transfer of existing assets, employees and systems of the customer to the vendor.

In order to determine the proper accounting, IFRS requires evaluation of the substance of contracts:

- Where outsourcing contracts include specific assets (for example, an IT platform or other IT hardware), it needs to be evaluated whether the arrangement contains a lease and then the asset should be accounted for in accordance with standard on leases. This may result in certain IT assets used by the vendor to be derecognised as a sale-type finance lease to the customer, with upfront sale recognition
- Where a contract includes multiple elements, then identification and recognition of those separate elements may be required.

Currently, Indian GAAP provides limited guidance on the above areas and most companies account for these arrangements based on the legal form of the arrangement (such contracts are not accounted for as leases, unless they are structured in that manner).

Share-based payments

Several IT and BPO companies use share options to attract and retain employees. Guidance in Indian GAAP on share-based payments to employees (for example, employee stock options) provides entities with a choice to either adopt the intrinsic value method or the fair value method. Substantially all Indian IT and BPO companies have currently opted to adopt the intrinsic value method under which no compensation cost is recognised for options that have an exercise price equal to the market price of the share on the date of the grant. Under IFRS, goods or services received in a share-based payment transaction are measured at fair value. The fair value of the options is determined using an option pricing model such as the Binomial lattice model or Black-Scholes model. This would usually result in recognition of compensation cost even if the options are at-the-money on the grant date.

For awards that vest in a graded manner (for example, 25% vesting each year over a 4-year period), IFRS only permits the accelerated method of amortisation whereas Indian GAAP permits the straight-line method of amortisation for such awards. Resultantly, compensation charge will be significantly higher in the initial period of option grants.

Indian companies would need to re-evaluate their compensation strategies (including the cash-option mix) to determine the optimal use of share-based payment arrangements.

(d) Banks and NBFCs

Fee income recognition

Fee income is earned when banks disburse loans and is generally directly linked to the lending operations. Currently under Indian GAAP, entities can recognise fee income when due/realised. Under IFRS, income on loans (including loan processing fees) should be recorded on an effective interest rate (EIR) basis, implying that the fee income would be spread over the tenure of the loan based on a constant yield.

Provision for doubtful loans and advances

Currently, the criteria for non-performing asset (NPA) recognition and related provisioning are regulated by the Reserve Bank of India (RBI). The accounting policy followed by banks in India on NPA recognition and provisioning is as per the prudential norms formulated by the RBI. The central bank has prescribed particular percentages to be provided for standard, sub-standard and non performing assets.

The current IFRS accounting guidance in IAS 39 states that a loan is impaired when there is objective evidence that events since the loan was granted have affected expected cash flows from the loan. The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows at the loan's original effective interest rate. Impairment assessment is carried out on a case-by-case basis or on a group basis for portfolios of loans that have similar risk characteristics. IFRS also does not permit general provisioning as such.

Securitisation transactions

At present, RBI guidelines on securitisation permit de-recognition of securitised financial assets if the true sale criteria (as prescribed) is met. The gain on de-recognition, if any, is amortised over the life of the securities issued by the special purpose entity established for the securitisation, although the assets are no longer recognised in banks' financial statements.

IFRS guidelines are more stringent on securitisation compared to current Indian GAAP. The securitised assets will continue to be recognised on balance sheet if the reporting entity retains control over the assets securitised or if risks and rewards have not been transferred.

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As per the IFRS guidelines, a transaction will qualify as a securitisation if the originator has not retained 'substantially' all the risks and rewards of the assets. By providing some form of credit enhancement or recourse, the originator will continue to have exposure to risks and rewards and, consequently, the de-recognition criteria would not be met and the loans securitised would have to be recognised on balance sheet. The consideration received would be presented as borrowings.

(e) Manufacturing sector and FMCG

Timing of recognition of revenue

Currently under Indian GAAP, many companies recognise revenues on dispatch of the product from the production unit, which coincides with transfer of legal title of goods. However, as per IFRS, revenue can be recognised only when significant risk and rewards are transferred to the buyer and the seller does not retain managerial involvement or effective control over the goods sold.

For example, for domestic sales, if the company bears the risk of damage/loss to goods before it reaches the dealer/customer, then revenue recognition may need to be deferred till delivery.

Customer incentives and discounts

Companies offer a range of dealer discounts and incentives (including free gifts to ultimate customers) to boost their sales. Under Indian GAAP, the majority of such discounts and incentives are recognised as sales promotion expenses, while the sales are reported gross of such incentives. Under IFRS, all forms of discounts and incentives to the dealers are recognised as a reduction of revenue. Though such IFRS adjustment may not have an impact on the profits for the year, they do impact the revenues and key ratios related to revenue (for example, gross profit margins).

Further, supermarkets, retailers, airlines, hotels etc., roll out various customer loyalty programmes, comprising 'loyalty points' or 'award credits'. Award credits may be linked to individual purchases or groups of purchases over a specified period. The customer can redeem the award credits for free or discounted goods or services. Under IFRS, the award credits (i.e. air miles, shopping card points etc.,) under customer loyalty programmes are not recognised as sales promotion or any other expense. Instead, they are recognised as a separate component within a multiple element revenue arrangement. As such, the revenue under the sales arrangement is allocated to one or more elements, including the award credit. At the inception of the arrangement, the revenue attributable to the award credit is deferred and is recognised as and when the award credits are redeemed by the customer. The revenue attributed to the award credits takes into account the expected levels of redemption.

Useful life and component approach for depreciation

Currently, many companies apply schedule XIV rates for providing depreciation on assets. As such, the entire depreciable amount (i.e. cost less residual value) is depreciated over the useful life estimated under Schedule XIV to the Companies Act, 1956. Any replacement of significant component is generally charged to profits as repairs cost.

Under IFRS, companies would be required to depreciate an asset over its useful life, which will be different from Schedule XIV. Further, if the asset includes a component, that can be readily identifiable; is of significant value in relation to the asset; and has a significantly different useful life; IFRS requires to treat such components as akin to separate assets. Such components are depreciated over the component's useful life and the replacement of such component is treated as akin to replacement of an asset (i.e. disposal and fresh purchase). These principles are also included in the new Companies Bill.

The above are some important differences under IFRS which will need to be addressed by Indian companies on conversion to IFRS. Besides the impact on the financial results of companies across key sectors as covered above, one will also need to assess the impact of these on regulatory reporting (for example, capital adequacy ratio etc), debt covenants from financial institutions, impact on dividend payout and impact on taxes as well. ■