Ind AS Implementation to have a Significant and Lasting Impact on Companies in India

On 16th February 2015, the Ministry of Corporate Affairs (MCA) notified 39 Indian Accounting Standards (Ind AS), which are converged with International Financial Reporting Standards (IFRS). As part of this notification, the MCA issued a roadmap for Ind AS implementation by companies in India (other than banking, insurance and non-banking finance companies (NBFCs)). The roadmap, in its first phase, requires companies with a net worth of ₹500 crore or more (along with their holding, subsidiary, joint venture and associate companies) to adopt Ind AS from accounting periods commencing on or after 1st April 2016 and to present comparative Ind AS financial information for the previous year. On 30th March 2016, the MCA notified two additional Ind AS and announced the deferral of Ind AS 115, Revenue from contracts with customers. Accordingly, companies that are required to implement Ind AS in the first phase will have to comply with a total of 40 Ind AS when reporting financial information for the year commencing 1st April 2016. The first interim financial reporting period for some of these companies that are listed will be for the quarter ending 30th June 2016. Read on to know more...

Applicability of the Net worth Criterion

The Ind AS Transition Facilitation Group (ITFG) formed by the Institute of Chartered Accountants of India (ICAI) provided clarification on how the net worth criterion should be applied in determining whether a company falls within the first phase of Ind AS implementation. Based on this, companies with net worth exceeding ₹500 crore in any particular financial year are required to apply Ind AS from the next financial year onwards. Accordingly, even companies that exceeded the net worth threshold as at 31st March 2016 would be required to apply Ind AS for the financial year commencing on 1st April 2016. Additionally their holding, subsidiary, joint venture and associate companies will be required to apply Ind AS from 1st April 2016 onwards.

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Significant Areas of Impact

Ind AS implementation is expected to have a wide ranging impact on Indian companies. While the effect on financial results arising from changes in the accounting framework is an immediate area of impact, there are several others including those relating to organisational structure, stakeholder communication and other regulatory impacts.

Accounting issues and impact on financial results:

There are several differences between the current accounting standards under Indian GAAP and Ind AS. These are expected to give rise to changes in accounting policies that have a significant impact on a company's financial results. Companies that are transitioning to Ind AS will therefore need to carefully evaluate and select their accounting policies as well as the exemptions availed on first time adoption.

A significant difference is the shift in the accounting from the erstwhile historical cost basis to fair value basis; this would apply to several areas such as business combinations, employee stock options, financial instruments, *etc*. This would result in the financial statements reflecting current values for many such items with the impact of fair value changes over financial periods being recorded either in the profit and loss account (e.g., changes in the fair value of derivatives) or in other comprehensive income (OCI) (e.g., revaluation of property, plant and equipment or remeasurement of defined benefit plans).

Ind AS introduces the concept of OCI, which comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as specifically required or permitted by other Ind AS. Companies are required to present their statement of profit and loss in two sections, being the profit or loss section, followed by the other comprehensive section.

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Another component of the financial statements that is required under Ind AS is the statement of changes in equity (SOCIE). This presents the changes in each component of equity arising from profit or loss, OCI, transactions with owners (in their capacity as owners or shareholders) and any other items directly recognised in equity under Ind AS.

Some of the key areas of accounting differences are summarised below.

Revenue recognition:

Ind AS requires revenue to be recognised on sale of goods only on transfer of significant risks and rewards associated with the ownership of goods. This includes consideration of whether effective control over the goods has been transferred. This may give rise to practical differences when applying Ind AS for sales with varying shipment terms. The following are other significant areas of impact relating to the timing or quantum of revenue recognised under Ind AS:

- Ind AS specifically requires contracts with multiple components to be considered for separation based on the relative fair values of the components, whereas there is no specific guidance on this currently. In some cases, this may also result in a portion of the revenue being deferred and being recognised subsequently when the individual components are delivered. Extended credit features within sales contracts are separated by recognising revenue at the present value of future cash inflows. The remaining component is then considered a financing element and related interest income is recognised.
- Transactions that are linked such that the occurrence of one is dependent on the occurrence of the other transaction may be evaluated on a combined basis, considering their commercial substance. This may differ from current practice.
- Ind AS requires revenue to be measured at the fair value of consideration received or receivable after considering any trade discounts, schemes and volume rebates allowed by the seller to the customers. These are, therefore, generally recognised as a reduction from revenue, which may differ from current practice.
- Under Ind AS revenue is recognised gross of excise duties collected and the duty paid to the Government is considered as an expenditure of the company.

Financial instruments:

Accounting for financial instruments under Ind AS is expected to give rise to a substantial impact on profit or loss and net worth for companies that have significant investments in equity instruments, exposures to large volumes or amounts of receivables, transactions in derivative instruments or issuances of quasi-equity, compound or hybrid instruments.

Generally, most financial instruments (other than debt instruments including receivables) will be measured at fair value with changes in fair value being recognised either in the profit or loss account or in other comprehensive income based on the Ind AS guidance as well as accounting policy choices made by the company. For trade receivables, companies will be required to measure impairment based on the expected loss model which may give rise to accounting differences.

The issuance of quasi-equity, compound or hybrid instruments by companies, such as redeemable or convertible preference shares shall also have a significant impact since these would be separated into their debt, derivative or equity components with corresponding distributions being recognised as interest expense or dividends respectively.

Employee stock options:

Currently, most companies in India account for share based payment transactions (e.g. employee stock options) using the intrinsic value method. This requires no compensation cost to be recognised if the exercise price for the option is not less than the market price of the underlying shares on the date of grant. However, Ind AS generally requires all share based payment transactions to be recognised using the fair value approach. This would result in additional compensation cost being recognised, based on the fair value (at grant date) of the stock options granted.

Where a parent entity makes a grant to employees of a subsidiary, Ind AS generally requires the subsidiary to recognise the cost relating to the share based payment and a corresponding equity contribution from the parent entity.

Taxes:

Ind AS requires deferred taxes to be recognised using the balance sheet approach, based on the temporary differences between the carrying amount of an asset or liability and its tax base. This is unlike the income statement approach that is currently followed by Indian companies. Therefore, additional deferred taxes may need to be recognised for temporary differences that do not affect the computation of income, such as on revaluation of assets or fair value changes for securities that are recognised in other comprehensive income, and so on.

Business combinations and consolidation:

Ind AS requires a company to mandatorily prepare consolidated financial statements, if it has entities that it controls. It requires the consideration of all facts and circumstances when assessing whether control exists, and not merely ownership or control over a majority of voting power. This includes factors such as power arising from contractual arrangements (such as shareholder agreements), substantive rights held by other parties and exposure to variable returns.

Unlike the current accounting principles for mergers and amalgamations, Ind AS provides guidance for all types of business combination transactions. It requires application of the acquisition method of accounting wherein the net assets of the acquiree are recognised at their fair values in the books of the acquiring company. This may also result in recognition of certain identifiable intangible assets (and contingent liabilities) which were not recorded in the books of the company being acquired (e.g., specific customer contracts or customer lists, customer relationships through loyalty programmes, in-process research and development expenditure, *etc.*). Consideration paid is also measured at fair value and any excess of the consideration over the fair value of the net assets acquired is recognised as goodwill. Ind AS also provides specific guidance on accounting for minority interest, known as 'non-controlling interests' and permits their measurement on a fair value basis. These requirements are expected to have a significant impact on financial results of companies.

Enhanced disclosure requirements:

Ind AS also requires extensive disclosures to be made in the financial statements or in the notes. Specifically, disclosures relating to operating segments (Ind AS requires segments to be determined based on how components are reviewed by the 'chief operating decision maker' of an entity), related party transactions and financial instruments are very detailed as compared to current requirements. Compilation of information

The Minimum Alternate Tax (MAT) – Ind AS Committee (the Committee) formed by the Central Board of Direct Taxes (CBDT) has issued a report with its recommendations for computation of book-profits by Ind AS compliant companies, for levy of MAT. While this report does not propose any further adjustments to book profits (other than those currently specified in the Income-tax Act, 1961), it proposes that some Ind AS adjustments that are recorded in reserves should be included in book profits at an appropriate point in time.

and preparation of these disclosures is expected to require significant investment of time and efforts by companies adopting Ind AS.

Stakeholder communication:

Adoption of Ind AS for preparation of financial information is expected to have a substantial impact on the financial results of such companies, as mentioned above. Given the extent of impact, it will be imperative for companies to proactively initiate communication with various stakeholders in order to effectively manage stakeholder expectations. This may include enhanced communication with key shareholders, other market participants and analysts prior to as well as after financial results have been published. Such communication will be critical during the first year of adoption as the impact of Ind AS on financial results will need to be explained. Communication with bankers and other lenders is also crucial as Ind AS will likely have an impact on key financial ratios used to monitor compliance with debt covenants.

Business implications:

Ind AS requires companies to assess the substance of contracts and transactions based on the guidance in the standards and account for them accordingly. This may involve complex analysis and could result in a completely different accounting treatment for certain transactions. For example, some supply contracts may include characteristics of a lease and, therefore, may be accounted wholly or partly as leases under Ind AS. Another example is sales contracts with multiple deliverable elements, which are generally separated and each element is recognised based on its relative fair value; or sales contracts with significant volume rebates or discounts which are recognised on a net basis.

These scenarios may prompt companies to assess if any changes may be required to their contracting terms or arrangements in order to avoid unintended or undesirable accounting consequences.

Organisational changes:

The Ind AS implementation process is expected to have an impact on the entire organisational set-up for some companies since it will require significant re-allocation of resources as well as training and skills enhancement for personnel in affected business units. This process is likely to have an organisation-wide impact since it involves not just accounting changes but also affect information and communication systems, hiring of skilled resources, contracting by business units, product development and structuring as well as any future business re-organisations (such as acquisitions, restructuring or divestments).

This indicates that almost all aspects of the business will need to build awareness and the necessary level of knowledge around Ind AS to manage this change.

Regulatory impact including taxation:

The Minimum Alternate Tax (MAT) – Ind AS Committee (the Committee) formed by the Central Board of Direct Taxes (CBDT) has issued a report with its recommendations for computation of book-profits by Ind AS compliant companies, for levy of MAT. While this report does not propose any further adjustments to book profits (other than those currently specified in the Income-tax Act, 1961), it proposes that some Ind AS adjustments that are recorded in reserves should be included in book profits at an appropriate point in time.

In addition, the Committee has recommended that certain adjustments relating to first time adoption of Ind AS, that are recorded directly in reserves/retained earnings, and would never be reclassified to the statement of profit and loss, should be included in book profits in the year of first-time adoption. Therefore, companies that are transitioning to Ind AS may experience a significant impact on their book profits for levy of MAT and would likely have to consider the MAT implications when selecting their Ind AS accounting policies and first-time adoption exemptions.

Companies that fall within the Ind AS roadmap and are proposing to file their offer document with the Securities and Exchange Board of India (SEBI)

after 1st April 2017, are required comply with the circular issued by SEBI on this matter. Such companies are requires to prepare and disclose financial information for some of the preceding financial years under the Ind AS framework, depending on the date of filing the offer document. This may involve additional efforts and pose some challenges for these companies.

Future Impact and Benefits of Ind AS Adoption

The experience of other countries, for example Korea, that have adopted IFRS indicates that while there have been several challenges during the implementation process, adoption of IFRS has also yielded some long-term benefits for companies. One of the key challenges, which may also be relevant for Indian companies, is that IFRS or Ind AS are principles-based standards which require transactions to be accounted for based on their economic substance. This requires the exercise of judgement, often by senior management, and may also lead to increased diversity in practice. Another ongoing challenge may be the increased use of fair value as a measurement basis when accounting for several types of transactions. This means that external or market driven factors will affect a company's financial results. Also, reliable measurement of fair value may be a significant challenge due to lack of depth in certain segments of the financial markets.

However, these challenges can be mitigated, as the Korean experience has shown, by establishing suitable mechanisms, such as enhancing the training and availability of accounting and valuation experts. Another important mechanism that has already been established by the ICAI is the Ind AS Transition Facilitation Group (ITFG) to address complex interpretational issues relating to Ind AS and provide clarification to companies.

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Despite the challenges, companies that adopt Ind AS are likely to experience lasting benefits. Companies that have listed their securities in overseas markets will benefit from reduced cost and effort as Ind AS are largely converged with IFRS. Ind AS adoption will also improve the transparency in financial reporting by Indian companies, making them more comparable to their international peers due to the enhanced stature of the reporting framework adopted.

The ITFG has issued four bulletins so far with its responses on a range of accounting and reporting issues under Ind AS. Besides, in view of a number of issues constantly being faced by the Small and Medium Practitioners (SMPs) and companies in the implementation of Ind AS, the ICAI has also launched a "Support-desk for Implementation of Ind AS" which can be accessed through ICAI website homepage on the link: https://docs.google.com/forms/d/1_KTFV6gIAFsBSXpyalyb2P2XkOdvGX4Nhc52z8lWhwg/viewform?edit_requested=true. Alternatively, one may also send views by e-mail at indas@icai.in.

Despite the challenges, companies that adopt Ind AS are likely to experience lasting benefits. Companies that have listed their securities in overseas markets will benefit from reduced cost and effort as Ind AS are largely converged with IFRS. However, differences arising from certain 'carve-outs' provided under Ind AS will still need to be factored, as these result in the Ind AS accounts not being fully IFRS compliant. Ind AS adoption will also improve the transparency in financial reporting by Indian companies, making them more comparable to their international peers due to the enhanced stature of the reporting framework adopted. Another key benefit is the increased involvement of senior management in accounting and financial reporting in order to appropriately reflect the economic substance of transactions in the financial statements.

Ultimately, for Ind AS to succeed in the long term, Indian companies need to embrace the principles underlying the Ind AS framework and contribute actively to the standards development process, not just in India but internationally. This will enable increased representation of their interests in the development of new or amended IFRS and enable Indian companies to stay ahead of the curve by being fully involved in emerging accounting concepts. ■

What lies behind us and what lies before us are tiny matters compared to what lies within us. - Ralph Waldo Emerson