India Inc. Performance Impact on Convergence to IND AS!

The fiscal year 2016-17 promises to be a watershed moment for financial reporting by Indian corporates. After much delay and deliberation, India Inc. embraced to a bespoke version of International Financial Reporting Standards ('IFRS') aka Ind AS. The Ind AS were moderated from the IFRS predominantly with the objective of customising it to the Indian context and to ease the pain of First-Time Adoption by Indian companies. In accordance with the applicability waterfall laid down by the Ministry of Corporate Affairs, the big-boys of India Inc. underwent the challenge of first-time adoption and experienced the convergence impact during the first three quarters of 2016-17. In the present article, the authors have endeavoured to holistically evaluate this impact and identify certain trends that may have arisen given such a mammoth conversion exercise. Read on to know more…

The April-June 2016-17 quarter marked the first set of results after the Ind AS came into effect this year. Companies falling in Phase-I of the convergence roadmap converged during this quarter. For this research, we evaluated the results for nine months ending December 2016 (April-December 2016-17) for Phase-I companies that form Nifty-50 companies. The Nifty-50 is a representative group of top 50 companies listed on the National Stock Exchange by market capitalisation. Banks, insurance and financial sector companies were excluded because Ind AS does not apply to them yet. Accordingly, a total of 40 companies were considered in this analysis (***'Coverage Group'***). Consolidated results of these companies, as available, have been given preference in our research.

CA. Gunja Bathiya and CA. Reema Jethwa

(The authors are members of the Institute. They can be reached at gunja.pb@gmail.com.)

In accordance with SEBI requirements, companies under the Coverage Group published results of 9M-FY-2016-17 along with comparatives of 9M-FY-2015-16. These companies also presented a reconciliation of profit as a comparison between published 9M-FY-2015-16 results and the recasted IND AS 9M-FY-2015-16 results (published in 9M-FY-2016-17 disclosure).

It is worthwhile to note that companies were required to provide a reconciliation of material items that impacted the profit\loss of the respective company and accordingly, there could be various other regroupings and reclassifications that may not be covered by such a reconciliation disclosure. Further, owing to SEBI exemption available for the first two quarters many companies have chosen not to provide an equity reconciliation or balance sheet reconciliation. This analysis has been broken up into three sub-parts being,

a. Impact on different components of financial statements
b. Industry sector-wise impact
c. Accounting standard-wise and other impacts.

a. Impact on various components of financial statements:

1. **Impact on Revenue–** The revenue for the companies under Coverage Group 9M-FY-15-16 was higher by INR 42,861 crore under the new norms which represents a 2.58% increase over the earlier published 9M-FY-15-16. 24 out of 40 companies recorded an increase in revenue. Their gains far exceed the losses by 10 companies that recorded the revenue decline. 6 companies reported no change.

Impact on Revenue

Revenue was mainly impacted due to following:

- Change in presentation of excise duty.
- Joint ventures now being accounted as per equity method instead of proportionate consolidation method.
- Accounting for service concession arrangements.
- Revenue recognition for time-bound contract by applying percentage completion method.
- Accounting for linked arrangement (deemed lease contract).
- Impact due to unbundling multiple element contract.

The companies under the Coverage Group have adopted differing stands regarding the disclosure of Excise Duty. Whilst 6 companies chose to present excise duty as a part of Revenue, 25 companies have disclosed the same as a part of expenditure and remaining belong to service sector to whom excise duty did not apply.

2. **Impact on Finance Cost-** Finance cost of Coverage Group was up by INR 405 crore resulted in a 1.10% increase on an overall basis. Out of 40 companies, 28 companies have shown an increase in finance cost, 7 companies have shown decline and 5 companies remain unchanged.

Impact on Finance Cost

Finance Cost was mainly impacted due to following:

- Financial assets and liabilities being classified & measured at Amortised Cost.
- Unwinding of interest because of discounting of long term provision.
- Financial instruments being reclassified into Equity or Liability or Split.

3. **Impact on Employee Benefit Costs–** Employee Benefit Costs for Coverage Group has gone up by INR 10,480 crores as resulted into an increase of 5.23%. Out of 40 companies 10 companies have shown increase in cost whereas 28 companies have shown a decline in Employee Benefit Cost.

Impact on Employee Benefit Costs

Employee Benefit Costs was mainly impacted due to following:

- Reclassification of certain selling & distribution and other expenses to employee benefit cost.
- Re-measurement of employee benefit plans.
- Fair value of ESOP against intrinsic value recorded earlier.
- Actuarial gain or loss which will now form a part of OCI (Other comprehensive income).

4. **Impact on Tax Expense –** Out of 40 companies, 23 companies have reported a decrease in net tax impact and 16 companies have reported an increase in net income tax expense and 1 company remains unchanged. Overall for the Coverage Group there is a decrease in tax expense of INR 630 crore as resulted into a decrease by 1.06%.

Impact on Tax Expenses

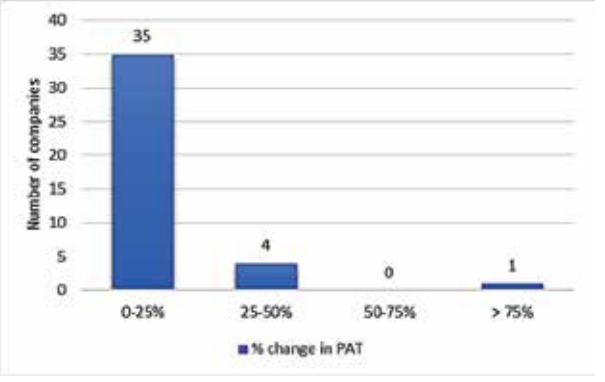
Tax Expenses was mainly impacted due to following:

- Change in the method of calculation of DTA/DTL from profit & loss to balance sheet approach.
- Change in criteria of recognising deferred tax assets (DTA). DTA on losses is now recognised on a probability test against virtual certainty test.
- Creation of deferred taxes on unrealised profit and on undistributed profit.

5. **Impact on Profit after Tax–** Overall, companies forming a part of the Coverage Group witnessed an increase in reported profit after tax by INR 7,175 crore as resulted into 4.60% increase. Out of 40 companies, 14 reported decline in profit, 26 have reported increase in profit. The net impact has been a mixed bag, however with an increase in overall impact.

Impact on Profit after Tax

Based on the 9 months ended results disclosed by companies, more than 70% of the companies experienced less than a 10% impact on their net profit. Evidently this large percentage indicates the impact of Ind AS being minimal in many cases, however, this impression may not be completely correct as much of the impact would have been moderated by the various exemptions availed by the companies for first-time adoption. It is worthwhile to note that Ind AS provide for various additional first-time exemptions as compared to pure-breed IFRS. In many cases, the net profit impact though not significant, there could be meaningful impact on individual accounting line-items. For example, netting of sales promotional items with revenue may have no impact on net profit but will have a significant impact on revenue. A large majority of companies have not disclosed such reclassification adjustment, though we expect the annual reports to carry such a detailed disclosure.



Another measure of operational profitability EBITDA (Earnings Before Interest Tax Depreciation and Amortisation) was down by INR 8,780 crore which on an average accounts for 2.45% decrease. EBITDA has been calculated after other income.

Impact on EBITDA

b. Sectoral Impact:

In our analysis, we evaluated the sector-wise impact on key industry sectors on account of Ind AS conversion. Below is the summary of the impact:

1. **Impact on Pharmaceutical and healthcare sector**

   Overall, companies belonging to the pharmaceutical and healthcare sector have reported increase in revenues. However, these companies have reported reduction in tax liability. In aggregate, companies in this segment have reported a positive impact on overall Profit After Tax by 3.56%.

   Impacts–

   - Impact on account of Business Combinations is a focus area on account of purchase price consideration allocation method adopted. Apart from goodwill and other intangibles, acquired in-process research and development needed to be evaluated for capitalisation.

- Creation of deferred tax assets on business losses and on unrealised profit.
- Out-licensing agreements lead to deferment of revenue in line with corresponding obligations. Other regular sales agreements like multi party agreements where component of sales to be unbundled and recognised separately at the time of performance.
- Revenue also gets affected by related sales promotion and incentives as well as potential returns, all of which is required to be estimated and reduced from sales.
- Contract manufacturing agreements needed evaluation to determine if these are in-substance lease of those facilities.

2. **Impact on Technology, media and telecommunication sector**

Majority of the companies belonging to this sector have reported a negative impact on revenue unlike Pharmaceutical and Healthcare sector. These companies have reported an increase in net profit by 0.06% on an overall basis. It is worthwhile to note that a few companies under this sector were also converged to IFRS for international reporting purposes and accordingly the overall impact is muted.

Impacts–

- The sector evidences fair amount of inorganic growth and therefore acquisition related accounting has been impacted. Acquired intangibles will be accounted at fair value and, unlike goodwill, are generally amortised and will impact. Further, goodwill from past acquisitions, which may represent finite life intangibles, may have a potential impairment cost.
- Employee stock options and other stock based structures are affected Net Profit. Customer contracts, especially when there are multiple elements also impacted revenue.
- Deferred tax on undistributed earnings of subsidiaries has also a visible impact on companies under this sector.

3. **Impact on Engineering & Infrastructure sector**

Majority of the companies belonging to this sector have reported positive impact, cumulating to impact on EBITDA of 0.76%, also a positive impact has been reported on net sales and there is an increase in net profit by 2.57% due to lower charge of finance cost by 12.40%.

Impacts–

- One company has reported ₹215.68 crore as a provision for expected credit loss, it has also reported decrease in employee benefit cost on account of constructive obligation.
- Fair valuation of financial instruments is also an additional impact visible.

4. **Impact on Oil & Gas sector**

Companies belonging to this sector have reported an increase in the revenue, an increase in finance cost and an overall increase in net profit of 3.99%.

Impacts–

- Change in the method of recognising revenue from completion method to percentage of completion method. Accounting for exploration assets has also impacted these companies.
- Effect on discounting of decommissioning liabilities and unwinding of such liability especially in relation to exploration and production assets.
- Fair value impact of financial assets & liabilities.
- Certain companies have opted for fair valuation of certain assets and accordingly the net worth and depreciation have been impacted.

5. **Impact on Power & Utilities sector**

Companies under this sector have reported decrease in revenue, finance cost, tax expenses and thus increase in net profit of 4.25%.

Impacts–

- Companies under this segment usually undertake projects on a BOT, BOLT and other similar models. Accordingly accounting for service concession arrangement has impacted companies representing this segment.
- Tax and deferred tax impacts that affected the other sectors has also impacted

companies in the power and utilities segment.

- Adjustment to value of Property, Plant and Equipment and related impact on depreciation has been an impacting area.
- Fair value of derivatives and other hedging instruments has impacted companies in this sector.
- A company in this segment has recognised Embedded lease under one of its contracts.

c. Standard-wise and other observation:

As expected the Ind AS standards of Financial Instruments and Income Taxes affected more than 80% of the companies covered by the Coverage Group. Other standards which affected companies under the Coverage Group are detailed below:

Standard	% of companies affected
Income Taxes	93%
Financial Instruments	80%
PPE, Intangibles and Impairment	45%
Revenue	25%
Operating Segment	23%
Business Combination	18%

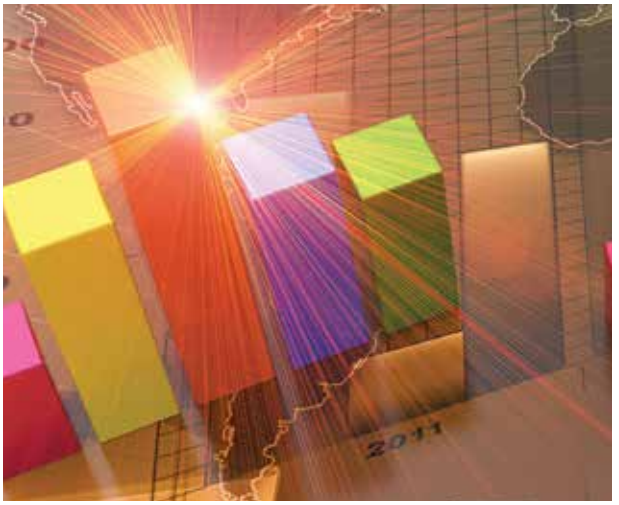
*For Q1 16-17

1. **Presentation of Excise Duty–**
   25 companies have reported Excise duty separately as an expenditure (Gross of Revenue). As a clarification NSE/BSE issued a notification which clarifies that Excise Duty is to be shown as an Expense.

2. **Equity Reconciliation as on transition date–**
   Only 6 companies have provided their Equity Reconciliation as on 1st April, 2015. As per SEBI requirements only a profit reconciliation was mandatory and not an equity reconciliation.

3. **Notes provided for Reconciliation of Profit–**
   10 companies have provided an explanation for their profit reconciliation and items arising thereon. These explanations provide certain insights into the impacts that arise during the convergence process.

4. **Exemption/Relaxation Given by SEBI–**
   Based on discussion with trade representative bodies, professional bodies and impacting companies, with a view to ease the pain of first-time adoption, SEBI has granted various exemptions to companies. Below is a summary of the exemptions that have been availed by the companies:



30 days extended period in reporting the quarterly numbers	Relaxation to not disclose March 2016 quarterly Ind AS results	Relaxation to not audit/ limited review comparative period results
11 companies availed of this exemption	21 companies availed of this exemption	25 companies have availed of this exemption

The above SEBI exemptions are available for companies under the Phase-II and subsequently as well. Accordingly, it is expected that larger number of Phase-II companies will opt for the exemptions provided by SEBI.

Summary Conclusion

The first shoots seem to suggest that India Inc. has been able to absorb the IND AS impact atleast on the P&L front. Though there would be exceptions, the broad performance of India Inc. has not been significantly affected by the adoption to IND AS. The extent of impact has been largely influenced by the first-time adoption policies and exemptions chosen. It may be bit early to comment on the overall impact as not many companies have disclosed the networth and balance sheet impacts which are expected to be significant. The year-end disclosures will also provide a much better perspective on impact on financial position of the companies and detailed reasoning into the impact that affected the companies. ■