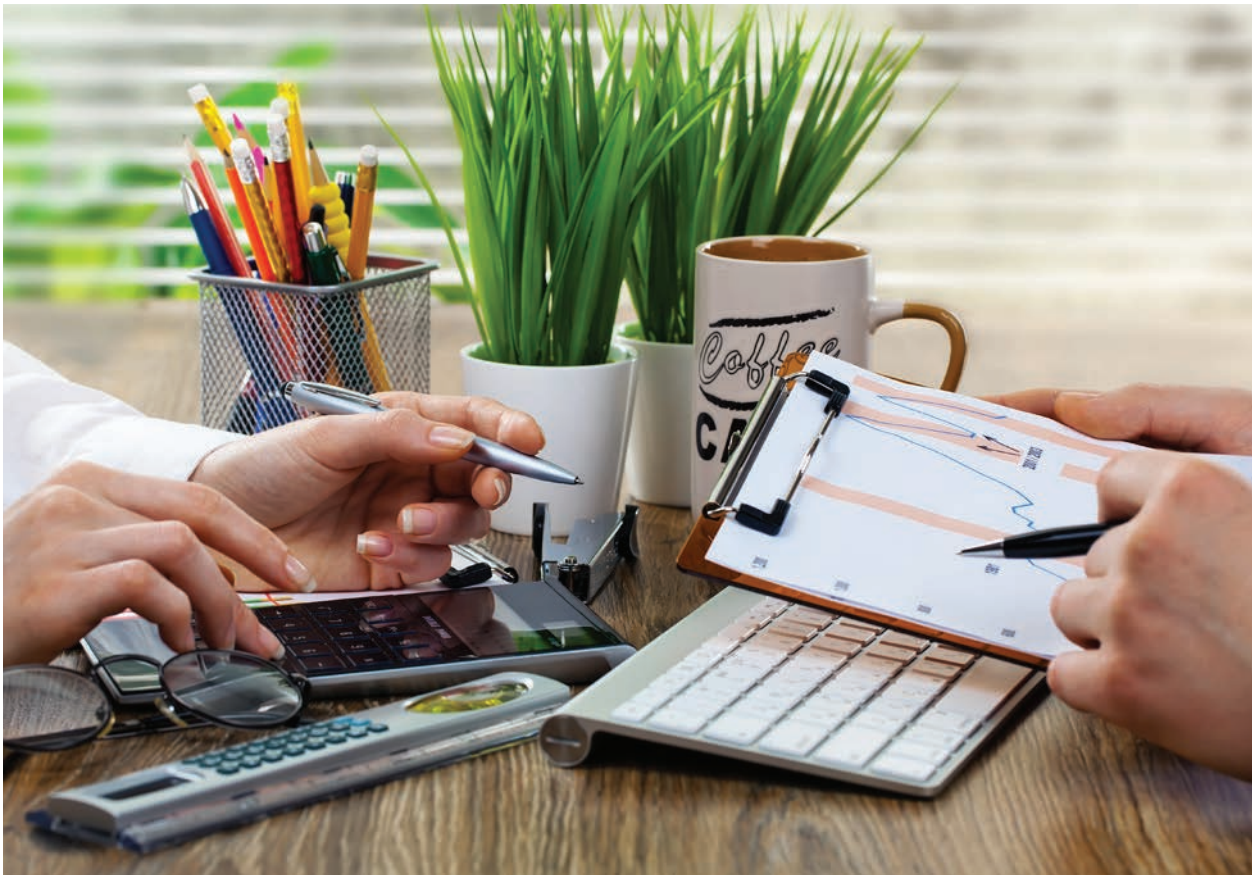
Challenges in Ind AS Implementation



Ind AS accounting comes as a paradigm shift. Fair Value is a new reality. Article explains critical process challenges and technical challenges of Ind AS implementation such as SAP and Ind AS presentation requirements, concept of Materiality in Ind AS Audit, Fair Value Disclosures, contract renovations etc.

Ind AS transition is a joint exercise of consultant, auditee, and auditor. Transition has wide range of impacts on business covenants, tax computation, banker's analysis etc. Complexities present challenges and every challenge is a professional opportunity. Read this article to gain insights into technical views on few critical areas of challenges in Ind AS transition.

Introduction

In 1494, Luca Pacioli described double-entry bookkeeping in his work 'Summa di Arithmetica,' printed in Venice and accounting has rumbled on ever since. Corporates had to move onto new GST regime alongside New accounting–Ind AS and continued compliance with new Companies Act, 2013. On the one hand, rotation of auditors built new relationships with new clients, but on the other hand, new relations demanded additional efforts to learn the businesses of new clients. The pace of change has suddenly overburdened chartered accounts. Nevertheless, Indian CAs served entities and passed through something that looked impossible. Undoubtedly, Ind AS transition, one of

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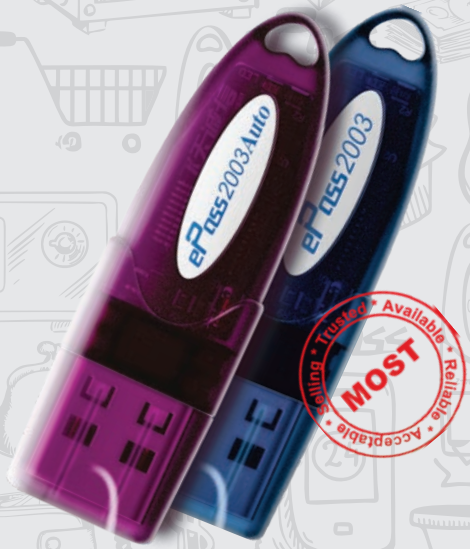

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the compliance challenge, was a difficult task, and CAs have certainly helped businesses move closer to achieve a better presentation. Ind AS can be described as better accounting for better markets. Amid, transition exercise, accountants faced two types of challenges–1. Process challenges and 2. Technical Challenges.

Process Challenges

Process challenge includes–scale/volume of the work; time frame; project management; communication between the consultant, auditor, and auditee; tax auditors' inability to understand Ind AS financials; existing financial reporting structure, etc. In this article, we will primarily focus on technical challenges after we discuss a solution to SAP and Presentation challenge.

SAP & Presentation Requirement

Ind AS compliant schedule III requires classification of various assets and liabilities into a financial and a non-financial category. ERPs in line with previous GAAP presentation requirement now need substantial modification to bring them in compliance with Ind AS for example:

General Ledger Balance	Previous GAAP SAP Group	Ind AS SAP Group
Building	Fixed Asset	1. Non-Current Asset (Main Group) Property, Plant, & Equipment (Sub-Group) Or 2. Non-Current Asset (Main Group) Investment Property (Sub-Group)
Prepaid Expense	Current Asset	3. Current Asset (Main Group) – Non-Financial Asset (Sub-Group) - Other Current Asset (sub-sub-group)
Redeemable Preference Share Capital	Equity	4. Non-Current Liability (Main Group)

Potential Way forward to build Ind AS Compliant SAP mechanism:

1. Create a new financial version
2. The new version will allow you to modify the way you want to create new presentation requirement.
3. Create Main Group–Current Asset, Non-current Asset, Current Liabilities, and Non-Current Liabilities, Equity, Revenue, Other Income, Expenses, Exceptional Items
4. Create Sub-Grouping–Eg. Create PPE as a sub-group under Non-Current Asset
5. Assign GL to each of sub-groups–Eg. Assign Building to PPE.

Modified New Version of SAP will help entities to create Ind AS compliant Balance Sheet and Statement of Profit and Loss (Profit or Loss portion). However, entities cannot avoid investing efforts in segregating Other Comprehensive Income and creating Statement of Changes in Equity. Above way is very handy and cost-effective solution for all entities that are transiting into Ind AS.

Critical Technical Challenges

We have identified few critical technical areas that challenged many entities in their transition exercise.

1. Net-worth and applicability of Ind AS
2. The concept of Materiality in Ind AS Audit
3. Offsetting
4. Other Comprehensive Income
5. Fair Value Disclosures
6. Income Tax Reconciliation
7. Consolidation of Employee Benefit Plans and CSR Trusts
8. Contract Renovation
9. New Revenue Standard–Ind AS 115

Net-worth and Applicability of Ind AS

Ind AS applies to all listed entities and to all entities whose net-worth is ₹250 crore or more. Net-worth is defined in Section 2(57) of Companies Act, 2013 as the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.'

Net-worth shall be calculated as at 31st March 2014 or the first audited financial statements for accounting period which ends after that date.

Entities that were created out of amalgamation or demerger through court order may have created reserves on such amalgamation or demerger. Reserves created out of amalgamation shall be excluded from the net-worth calculations. On the contrary, reserves on demergers may form a part of net-worth as they are not explicitly excluded.

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The concept of Materiality for Ind AS Audit

Auditors must set their materiality level before beginning audit under Ind AS regime. Ind AS, principle-based standards, will often use present valuation, fair values, and accounting with substance over form. Transition exercise, hence, is complex and certain rules are ignored considering immaterial impact on Financial Statement. Accordingly, auditors must be cautious in analysing materiality of non-compliance with Ind AS in certain areas which are found to be immaterial.

Material Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make from the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor. Schedule III states Financial Statements shall disclose all 'material' items, i.e., the items if they could, individually or collectively, influence the economic decisions that users make from the financial statements. Materiality depends on the size or nature of the item or a combination of both, to be judged in the particular circumstances. For Statement of Profit and Loss, materiality is identified explicitly as-any item of income or expenditure which exceeds one percent of the revenue from operations or ₹10,00,000, whichever is higher.

Offsetting

Offsetting assets and liabilities or incomes and expenses may have a drastic impact on financial statement analysis. For example, if current assets are 3 and current liabilities are 2 then the current ratio is 1.5. However, if current liabilities worth 1 are offset against current assets, then current assets would be 2 and current liabilities would be 1. The new current ratio of 2 (which looks better than old ratio–1.5) is more from wishful thinking than from legal position on offsetting and hence manipulative. Thus, auditors shall carry substantive procedures to identify correct offsetting provisions. Per Para 42 of Ind AS 32, financial assets and financial liabilities can be offset only when –

a) Currently has a legally enforceable right to set off the recognised amounts; and
b) Intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Frequently, we observe multiple debates on offsetting following combinations:

1. Debit balances of Creditors and Credit Balances of Debtors: Should not be offset with Payables (i.e., Creditors) and Receivables (i.e., Debtors) respectively
2. Income Tax Provision of One Year and Advance Tax/TDS of the same year: Can offset with one another
3. Income Tax Provision of One Year and Advance Tax/TDS of another year: Cannot offset with one another
4. Deferred Tax Asset of one entity and Deferred Tax Liability of another entity to be reported in Consolidated Financial Statements: Cannot offset in Consolidated Financial Statements
5. Government Grant related to Capital Goods and related to Revenue Items/Expenses: Government grants related to capital goods must be recorded as deferred income. Government grants related to revenue items/expenses may be presented as a deduction from the related expense.

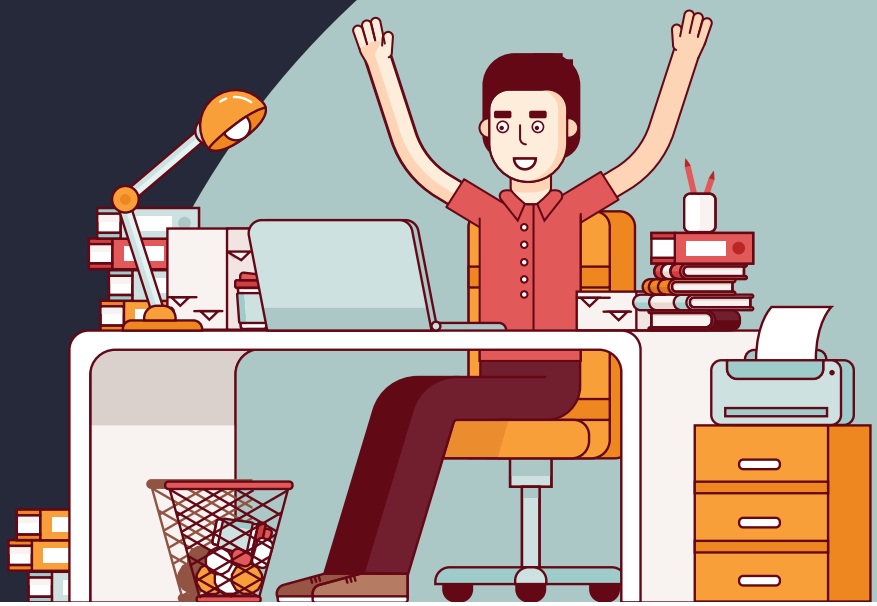
Other Comprehensive Income (OCI)

OCI is the second leg of Statement of Profit and Loss. Over a period, accountants have understood this new presentation requirement but have failed to apply it with clarity. For example, let us take two scenarios:

1. Revaluation Surplus is reduced on impairment
2. Derecognition of Cash Flow Hedge and Cash Flow Hedge Reserve accounted through OCI

Accountants must note that any change in revaluation surplus is never reclassified to profit or loss. However, that does not mean such change is not reflected in OCI. OCI shall be presented with the negative amount of any reduction with revaluation surplus with a simultaneous reduction in Revaluation Surplus column in Statement of Changes in Equity.

Derecognition of Cash Flow Hedge requires Cash Flow Hedge reserve to be reclassified into profit or loss. Presuming credit balance of such reserve, on derecognition, OCI shall be presented with negative balance along with similar negative balance in Cash Flow Hedge Reserve Column in SOCIE and a simultaneous positive amount in



other income in profit or loss (i.e., reclassification adjustment).

Overdrafts repayable on demand

Overdrafts repayable on demand are financial liabilities and to be presented as a current financial liability on the face of the balance sheet (and not as cash & cash equivalent). However, in a statement of cash flows, the balance of overdraft repayable on demand must be adjusted both in the opening and the closing cash and cash equivalent balances (and change between to two shall not be presented as financing activity).

Fair Value Disclosures

For each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount. However, such disclosure is not required when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables. Following 3 disclosures are new and vital:

(a) Fair Value of Financial Assets and Financial Liabilities measured at Amortised Cost
(b) Fair Value hierarchy of financial assets and financial liabilities measured at fair value and
(c) Details of significant unobservable inputs used in Level 3 fair value measurements and sensitivity of fair value measurement to changes in unobservable inputs

Often accountants are confused in the classification of 'trade receivables' and 'cash.' We observe the industry-wide practice of classifying such assets as at 'amortised cost.' Consequently, the fair value of such amortised assets is to be disclosed. However, the carrying amounts of trade receivables (and trade payables) and cash and cash equivalents are considered to be the same as their fair values due to their short-term nature. Similarly, the carrying amounts of long-term loans given (and loans taken) with floating rate of interest are considered to be close to the fair value.

Another area of confusion is disclosing fair value inputs either as Level 1, Level 2, or Level 3. Level 1 prices are quoted prices in active market for an identical asset. Level 2 prices are unquoted prices in active market for an identical asset. Level 3 inputs are unobservable inputs.

Examples of Valuations of various investments using different levels of inputs:

Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
1. Equity Investments (other than Subsidiary, Associate or Joint Venture) in the listed entity 2. Mutual Funds 3. Quoted Bonds 4. Government Securities/ Bonds	1. Unquoted Preference Shares in an active market (Future cash flows are discounted using G-sec rates as at reporting date) 2. Derivative Instruments (Present value technique using forward exchange rates at the end of reporting period)	1. Unquoted Equity Investments (other than Subsidiary, Associate or Joint Venture)

Level 3 inputs valuations further need disclosure of significant unobservable inputs (for example Capitalisation rate) and sensitivity analysis (for instance 25bps change in Capitalisation rate would result in +/- 'amount' crore.)

Income Tax Reconciliation

Para 81 (c) of Ind AS 12 requires disclosure of an explanation of the relationship between tax expense (income) and accounting profit. Accounting profit means profit before tax. The entity may use its income computation sheet as a foundation to build the reconciliation. Income computation under income tax act also begins with accounting profit, i.e., profit before tax. All disallowances or deductions are either temporary or permanent (please note Ind AS does not categorise any difference to be permanent). However, these are the only reasons for the difference between tax profit and accounting profit. The entity then must apply tax rate on each of these items to reconcile income tax and tax on accounting profit. The effective tax rate is income tax over accounting profit.

The difference between profit before tax and profit under income tax computation is mainly because of following reasons:

1. Income Exempt from Tax–Eg. Dividend Income, Interest on tax-free bonds, etc.
2. Expenses Disallowed related to Income Exempt from Tax
3. Expenses that are not deductible–Tax on employee perquisites borne by the company, CSR expenses
4. Weighted deduction on R&D and deduction under Section 80IA
5. Impairment losses etc.

Consolidation of Employee Benefit Plans and CSR Trusts

Ind AS 110 Consolidated Financial Statements excludes explicitly from consolidation the post-employment benefit plans or other long-term employee benefit plans to which Ind AS19, Employee Benefits, applies. However, Ind AS 110 has not specifically excluded CSR Trusts. Thus, entities are required to maintain the document stating the CSR activity and costs incurred are primary in a capacity of a trustee and not in a position of the controlling stakeholder of the trust. Trustee relationship will help entities to escape from the consolidation of CSR Trusts.

Contract Renovation

Employee bonuses or commissions are often linked to the performance of the entity. Performances are now evaluated on Ind AS audited financial statements. The entity must clarify the base to evaluate such performance. For example, if employee bonus is dependent upon growth in profit of the company, the entity must explain whether such profit is profit after tax (i.e., from profit or loss section) or is it total comprehensive income (i.e., a total of profit or loss and other comprehensive income). Similarly, when performance-linked payments are agreed, financial statements primarily excluded fair value impact except for impairment. Hence, under a new regime, an entity must also specify whether profits for performance evaluation are after fair value accounting.

Imagine a situation where bank requires its borrower to maintain debt-equity ratio below 3. An entity with preference share capital previously has achieved a debt-equity ratio of 2.7 (preference share capital was accounted as equity) and hence was within the covenants. However, post Ind AS, there is twofold impact–equity is reduced, and debt component is increased. This also results in a breach of covenant. Hence, entities should renovate the contract either to interpret preference share capital to be equity or to increase the base ratio of debt-equity as a performance evaluator.

New Revenue Recognition Standard – Ind AS 115

Ind AS 115 Revenue from Contracts with customer is effective for a period beginning from 1st April 2018. The standard prescribes the revenue recognition as a 5 step model. The fundamental change that has been brought in by this standard is to recognise revenue by transfer of control rather than by transfer of substantial risks and rewards. This standard states that revenue can be recognised at a point in time or over time. Performance can be evaluated using output or input method. CIF or FOB are the payment terms and by themselves may not substantiate the timing of revenue recognition. Hence, entities shall make a new assessment of revenue recognition under new accounting standard.

Standard also requires extensive disclosures of disaggregation of total revenue, information about performance obligation, changes in contract asset and contract liability balances between periods and key judgements and estimates. The standard permits the use of either retrospective or cumulative effect transition method.

Few more Technical Challenges

This article could have been continued to address few more technical challenges in Ind AS implementation such as identification and segregation of embedded derivatives, calculation of Expected Credit Losses, derecognition of financial assets in case of recourse factoring, restructuring of loans and modification of contracts, analysing investment as a joint venture or a subsidiary, appointed date of high court order and acquisition date under Ind AS, MAT on Ind AS Book Profit etc. However, we will prefer to take a pause and analyse the characteristics of challenges. All challenges mentioned above, point towards judgements. Hence, drawing judgements that are reasonable is key to successful transition.

Conclusion

Change is universal and fair value is now an accounting truth. One side of the existing accounting system reflects-the challenge and another side-a professional opportunity. Ind AS is a reality and fair value is no more imagination. Entities will continue to hire experts in areas such as valuations, purchase price allocations, income tax and accounting profit reconciliations, etc. Indian CAs must cease the opportunity to become expert in Ind AS which in turn opens the door for global/IFRS accounting hub. ■