Corporate India's Report Card on the New GAAP

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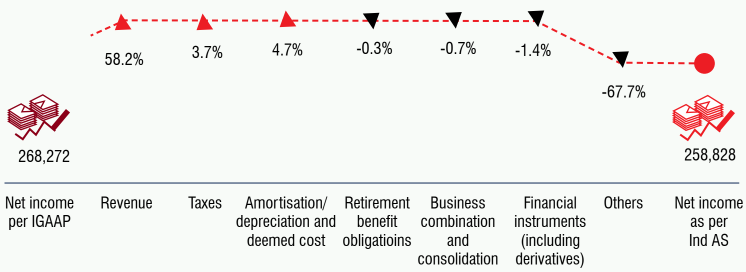
The IFRS standards, now globally accepted, are intended to improve the quality, transparency and international comparability of financial information. The overriding aim is to assist investors and other market participants in making informed decisions, thereby contributing to economic efficiency. Close to 126 jurisdictions the world over now requires IFRS for their publicly-accountable entities. India has followed suit by adopting the Indian Accounting Standards (Ind AS), which are substantially converged with IFRS. The transition to Ind AS has had a multi-dimensional effect that went beyond accounting, impacting IT systems, controls, processes, HR policies, contractual and funding arrangements, and taxes.

A report card on Ind AS transition

For over two years, managers, regulators, Boards and accounting professionals have been actively preparing for this accounting shift, and the March-quarter results of phase I companies is a testament to corporate India's readiness to embrace such a significant change in reporting. Below, we present a 'report card' on how Ind AS has impacted business earnings.

As the March-quarter results indicate, the impact of Ind AS adoption has been all-pervasive, and not restricted to any industry sectors. The main impact has come from a fundamental change in the financial reporting framework; a general shift from the historical-cost convention to the use of fair value; and an increased focus on the substance, rather than the legal form, of the underlying transaction. Overall, the transition has resulted in a decrease of 3.5 per cent in

3.5% decrease in reported net income for the year ended 31 March 2016



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The details of the impacted areas are as follows:

Revenue

The average increase in revenue as a percentage of net income was 58.2 per cent, while overall revenue increased by 4.6 per cent. It is important to note that with the implementation of the GST from July 1, 2017, companies will again see a reduction in their top line, because GST replaces the existing excise-duty tax, which is based on production, and would therefore gross-up the revenue figures. (The excise-duty adjustment is about 7.1 per cent.) Excluding the impact of excise duty, revenues declined mainly due to:

- **Linked arrangements, comprising of a sale and a subsequent repurchase transactions.** Ind AS requires accounting to reflect the economic substance of transactions, and not merely their legal form. An example of this is where an entity sells goods but at the same time enters into an agreement to later repurchase the goods, thus negating the effect of the original sale. In such a situation, the two transactions are dealt together as a single transaction, and when the seller has retained the risks and rewards of ownership, even though the legal title has been transferred, the transaction is accounted like a financing arrangement, thus not giving rise to revenue. This results in deferral of revenue, with the inventory continuing to be recognised on the balance sheet.
- **Determination of principal versus agent relationship.** In agency relationships, the net fees rather than the gross billing are recognised as revenue. Unlike the previous Indian GAAP, Ind AS requires the evaluation of factors such as credit risk, pricing risk and primary obligor.
- **Delayed revenue recognition, resulting in deferral of revenue where revenue recognition criteria have not been met under Ind AS.** This might include, for example, service arrangements, maintenance contracts, upfront fees, and so on.
- **Discounting contract consideration to its fair value in case of long-term construction contracts/extended payment terms, including adjustments related to retention money.** This effectively separates the financing element of the transaction from the true revenue component.
- **Consideration paid to customers in the form of awards, incentives, cash discounts, among others.** These are presented net of revenue under Ind AS.

Taxes

Reported net income increased by around 3.7 per cent on account of taxes. Additionally, the greater use of fair value has tax consequences on MAT liabilities and transfer pricing. Under Ind AS, deferred taxes are recorded on the basis of temporary differences, as opposed to the timing differences model under the previous Indian GAAP. The Ind AS model is broader, resulting in deferred taxes on more items. The main reason for the increase is the lower threshold for recognition of deferred tax asset under Ind AS on carried forward business and long-term capital losses vis-à-vis the stricter Indian GAAP model. Other tax-related adjustments include:

- Recognition of deferred tax liability on undistributed earnings from subsidiaries and joint ventures

- Impact of deferred taxes on unrealised profits on intra-group transactions
- Income tax effects of group share-based payment arrangements.

Financial Instruments

There was an overall decrease in net income of around 1.4 per cent owing to changes in the classification and measurement of financial instruments such as redeemable or convertible preference share capital, which can have a significant impact on leverage ratios, net worth and net income. The key Ind AS adjustments include:

- **Recognition of impairment losses under the expected credit losses (ECL)**, as compared to the 'incurred loss' model under Indian GAAP. Overall, this results in higher provisioning, since now, the expected life-time losses are to be recognised.
- **The appropriate liability/equity classification is now based on the substance of the contractual arrangement.** As an overriding principle, a financial instrument is classified as a liability if the issuer is required to settle the obligation in cash or as a financial asset. For example, redeemable preference shares, which have historically been shown as capital, are reported as a liability under Ind AS. The dividend and distribution tax on such capital also get recorded as an expense using the effective interest method.
- **Certain compound instruments, such as optionally convertible debentures/ preference shares are to be separated into their liability and equity components.** This results in lower net income under Ind AS.
- **Long-term financial assets such as interest-free deposits, long term receivables, and employee loans are also recorded at fair value,** with a corresponding adjustment to income.
- **Under Indian GAAP, investments were carried at lower of cost and fair value or at cost less impairment.** Ind AS significantly changes this by recording all but certain, specific debt instruments and financial assets at fair value.
- **Finally, all derivatives must now be recorded at fair value with recognition of both gains and losses,** whereas under Indian GAAP, fair value losses were recognised, but gains (except when hedge accounting was applied) were not.

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Retirement Benefit Obligations

Reported net income decreased by 0.3 per cent in this area due mainly to actuarial gains and losses being reclassified to OCI, as opposed to the P&L account under Indian GAAP.

Business Combination and Consolidation

There was an overall decrease in reported net income of around 0.7 percent because of business combination and consolidation. This was due mainly to:

- **Consolidation or de-consolidation of certain entities classified as subsidiaries.** This includes the consolidation of ESOP trusts and on the de-consolidation of associates and joint ventures.
- **Retrospective application of business combination principles.** This increases the value of tangible/intangible assets due to fair valuation, and consequently, impacts the subsequent depreciation/amortisation.
- **Recognition of acquisition-related costs in the income statement vis-à-vis the cost of investment/goodwill asset under Indian GAAP.**

> Under the previous GAAP, foreign exchange differences arising on longterm loans other than those taken for purchase of a depreciable asset were recognised in the foreign currency monetary translation reserve and amortised over the term of the loan

Amortisation and Depreciation

The reported net income increased by around 4.7 per cent because of adjustments resulting from amortisation and depreciation. The key reason for this was the reversal of amortisation of indefinitely-lived intangible assets. Companies that fair-valued their property, plant and equipment at the date of transition saw an increase in their net worth.

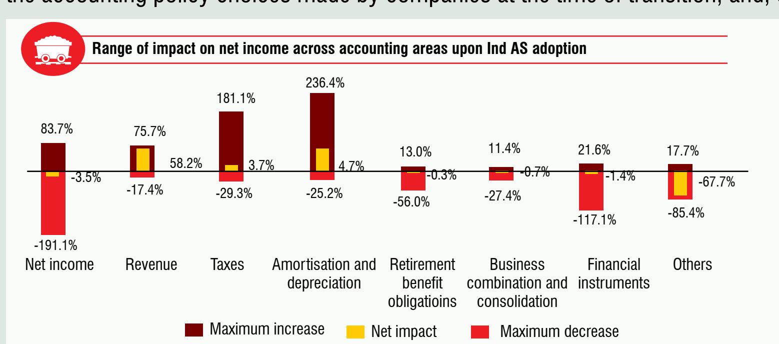
Other Adjustments

There include:

- **Recognition of government grants on a deferred income basis.** Under Indian GAAP, certain grants could have been directly recognised in reserves, which is not permissible under Ind AS, under which grants are to be accounted as capital or income grants.
- **Under the previous GAAP, foreign exchange differences arising on long-term loans other than those taken for purchase of a depreciable asset were recognised in the foreign currency monetary translation reserve and amortised over the term of the loan.** Under Ind AS, some companies have adopted a policy of recognising such exchange difference in profit and loss.
- **Accounting for provisions related to constructive obligations under Ind AS,** which, under Indian GAAP, were generally accounted for on the basis of past legal obligation.
- **Under the previous GAAP, employee compensation costs for share-based arrangements were based on the intrinsic value method,** but under Ind AS, they are recognised using the fair value method. This includes recognising cost in a group scenario where the parent grants share-based grants to the employees of other group companies.
- **Accounting of arrangements that may not have been legally termed as leases, but which are in substance the right to use underlying assets as embedded leases.**

Summary

The transition to Ind AS by the phase I companies provides some interesting insights. Although the reported net income shows an average decline of 3.5 per cent, as is evident from the chart below, the impact varies across companies. This, in turn, is the result of the varied nature/complexity of underlying business transactions, the accounting policy choices made by companies at the time of transition, and, of



course, the nature of their industry.

With the phase-I transition now substantially complete, it is for the phase-II companies, including financial services companies, to make this important journey. ■