STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank

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To empower the student community...

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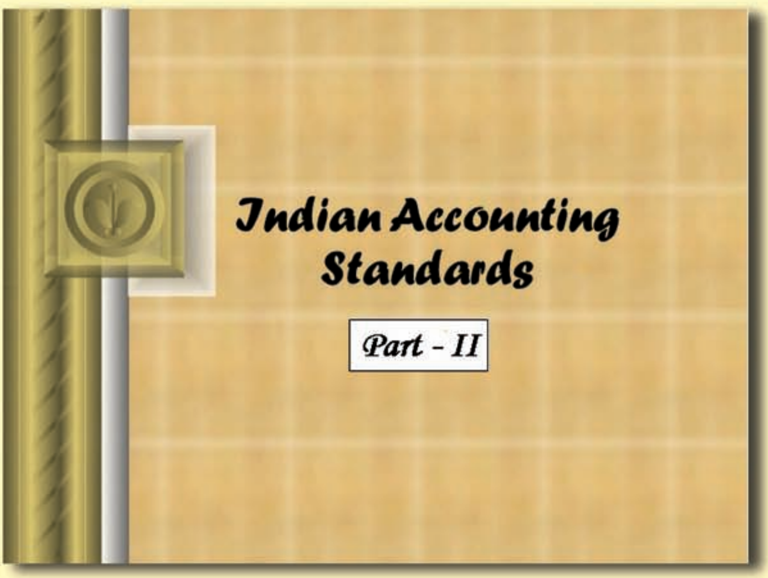

December 2017
Theme 313

"IND AS", PART - II

26th Year of Publication

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SIB STUDENTS' ECONOMIC FORUM

DECEMBER 2017

Theme No: 313: **"Ind AS", Part - II**

A well informed customer will make the policy makers as well as organizations which produce goods and render services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of its products.

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the "Forum". This month the topic for discussion is "Ind AS", Part - II.

Ind AS is based on the principles of "substance over form" and "fair valuation" whereas IGAAP (Indian Generally Accepted Accounting Principle) is focused on "legal form" and "conservatism". There is a significant difference in the presentation of financials under Ind AS with respect to revenue recognition, employee benefits, financial instruments, consolidation, business combination, fixed assets and foreign currency fluctuation.

1. Briefly explain the key areas were the Ind AS impact will be significant?

a) Revenue Recognition

The principles of revenue recognition under IGAAP and Ind AS vary significantly. While IGAAP follows a simplistic approach of transfer of risk and reward for a definitive consideration with certainty of collection, the Ind AS prescribes a more comprehensive approach, which in addition to the above, includes transfer of control, and fair valuation.

Ind AS provides that the related revenues in multiple element contracts like free warranty and service offered on sale of vehicle should be unbundled and recognized separately at the time of actual rendering of service. This is in divergence to the current GAAP practice, where the entire revenue is recognized upfront.

Revenue under Ind AS is to be recognized at gross value of excise duty, considering the excise component as part of expenses under "materials consumed". This will have a material impact on the presentation of revenue and costs of all manufacturing companies.

b) Employee cost

Employee costs under Ind AS vary from IGAAPs primarily on account of share-based payments, and long-term employee benefits.

Employee stock options (ESOPs) will be mandatorily accounted using the "fair value" approach in place of the current options of using intrinsic value.

Ind AS mandates the actuarial gains and losses on post-employment benefit plans and the long-term employment plans to be adjusted through other comprehensive income. This is in variance with the current practice under IGAAPs, where they are charged through the income statement.
This will lead to a reduction in the volatility of employee cost charged to the income statement.

c) Financial Instrument

Ind AS prescribes that financial instrument should be classified in accordance with the substance of the contractual agreement, rather than its legal form. This may lead to reclassification of financial instruments.

Ind AS requires recognition of financial investments at fair value. This is in divergence with the current practice, where investments are classified as current and long term. Fair valuation of investments is likely to boost the net worth of companies and adversely impact return ratios. Investments can be categorized as debt investment or equity investment.

i) Fair valuation of debt instrument
Ind AS requires the fair valuation of debt instrument at the time of preparation of financial statements. The debt instruments are classified into three categories, which will determine the accounting for difference in the fair value since the last measurement:
(a) Solely for the purpose of principal and interest (SPPI) the financial instruments are carried at amortized cost and the gains are recognized in the income statement.
(b) Either SPPI or sale - The instruments are fair valued and MTM (Mark to Market) is recognized through other comprehensive income (OCI). The gains so accumulated are transferred to the P&L on sale/ maturity of the instrument.
(c) Residual - Here, the instruments are fair valued and the MTM is charged through the income statement.

ii) Non-convertible preference shares (NCPS) to be classified as debt and the corresponding cost to be recognized as finance cost. This will lead to decline in the earnings of companies having preferential shares, since the preferential dividend paid as an appropriation of profit will now be classified as finance cost, and increase in the debt-equity.

iii) Perpetual debentures / compulsorily convertible debentures to be classified as equity with finance cost accounted in statement of equity.

d) Proposed dividend
It is shown as an appropriation of profits for the year in which it is declared under

IGAAP. In Ind AS the proposed dividend is shown as an appropriation of profit post getting declared and it continues to remain as part of reserves unless it is approved.

e) **Foreign exchange fluctuation**
Under the erstwhile Accounting Standard, companies have to capitalize foreign exchange differences on long-term monetary items or to accumulate them in reserves and subsequently amortize them into the statement of profit and loss over the remaining tenure of the related monetary item. Under Ind AS, the exchange fluctuation on translation or settlement of the foreign currency monetary items to be recognized in the income statement.

f) **Deferred taxes**
Under Ind AS, determination of deferred taxes is tabulated with reference to a balance sheet approach compared to the income statement approach as required under earlier Accounting Standard.

2. Briefly explain the impact of Ind AS on the various sectors of the economy?

a) Banking

i) Fee income on loans extended - No specific guidelines with respect to recognition of fee income on loan extended. Generally fee recognized on receipt. Under Ind AS income is recognized over the life of the loan / period of service.

ii) NPA recognition – Presently NPA is recognized as per RBI guidelines which are more on lines with the incurred loss model. In Ind AS, NPA recognition is as per Expected Credit Loss (ECL) method. Hence the NPA recognition will be early. The ECL model contains a ‘three stage’ approach based on the change in credit quality of financial assets since initial recognition:
Stage 1: Includes financial instruments that have not had significant increase in credit risk since initial recognition or those having low credit risk on the reporting date. For these assets, 12-month expected credit losses (resulting from default events possible within 12 months) are recognized and interest revenue is calculated on the gross carrying amount of the asset.
Stage 2: Includes financial instruments that have had a significant increase in credit risk since initial recognition but where there is no objective evidence of impairment. For these assets, lifetime ECLs are recognized, but interest revenue is still calculated on the gross carrying amount of the asset. Expected credit losses are the weighted average credit losses with the probability of default (PD) as the weight.
Stage 3: Includes financial assets where there is objective evidence of impairment on the reporting date. For these assets, lifetime ECLs are recognized and interest revenue is calculated on the net carrying amount (that is, net of credit allowance). Further, for trade receivables, Ind-AS mandates the use of lifetime ECL model.

b) Telecom

i) Revenue Recognition - No specific requirement on unbundling of services as per IGAAP. Composite sale of handsets, sim-card, packages, etc to be unbundled and recognized separately in Ind AS.

ii) Consolidation of Joint ventures - Consolidated as per equity method in Ind AS. In the erstwhile method it's based on proportionate basis.

iii) Capitalization of exchange fluctuation - To be charged to income statement as per Ind AS whereas capitalized to value of asset under IGAAP.

c) Media

i) Revenue Recognition - Entire revenues are recognized on initial broadcast. No separate revenues booked for bonus / free slots under IGAAP. In Ind AS revenue to be apportioned between initial and bonus / free slots and recognized separately on broadcast.

ii) Redeemable preference shares - Forms part of share holders' funds in the erstwhile accounting standard. In Ind AS it's classified as debt. Dividend on preference shares is treated as a finance cost.

d) Automobiles

i) Assets given to auto ancillaries - No guidance available and hence not accounted under IGAAP but it is considered as a deemed sale under Ind AS which will reduce the asset base, operating expenses will increase on fair valuing goods purchased which will be offset by recognizing revenues from lease rentals.

e) Consumer

i) Discounts / Incentives Expensed in P&L account as per IGAAP. Under Ind AS, revenues recognized net of incentives / discounts which reduces the revenue and increases the operating margins.

f) Power

Under Ind AS, certain BOT (Build Operate Transfer) projects awarded can qualify for accounting under service concession arrangements if they meet the conditions. Under the service concession arrangements, revenue and profitability on the construction of the asset will be recognized upfront during the construction phase, which will be compensated by lower profitability during the operation and maintenance phase.

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