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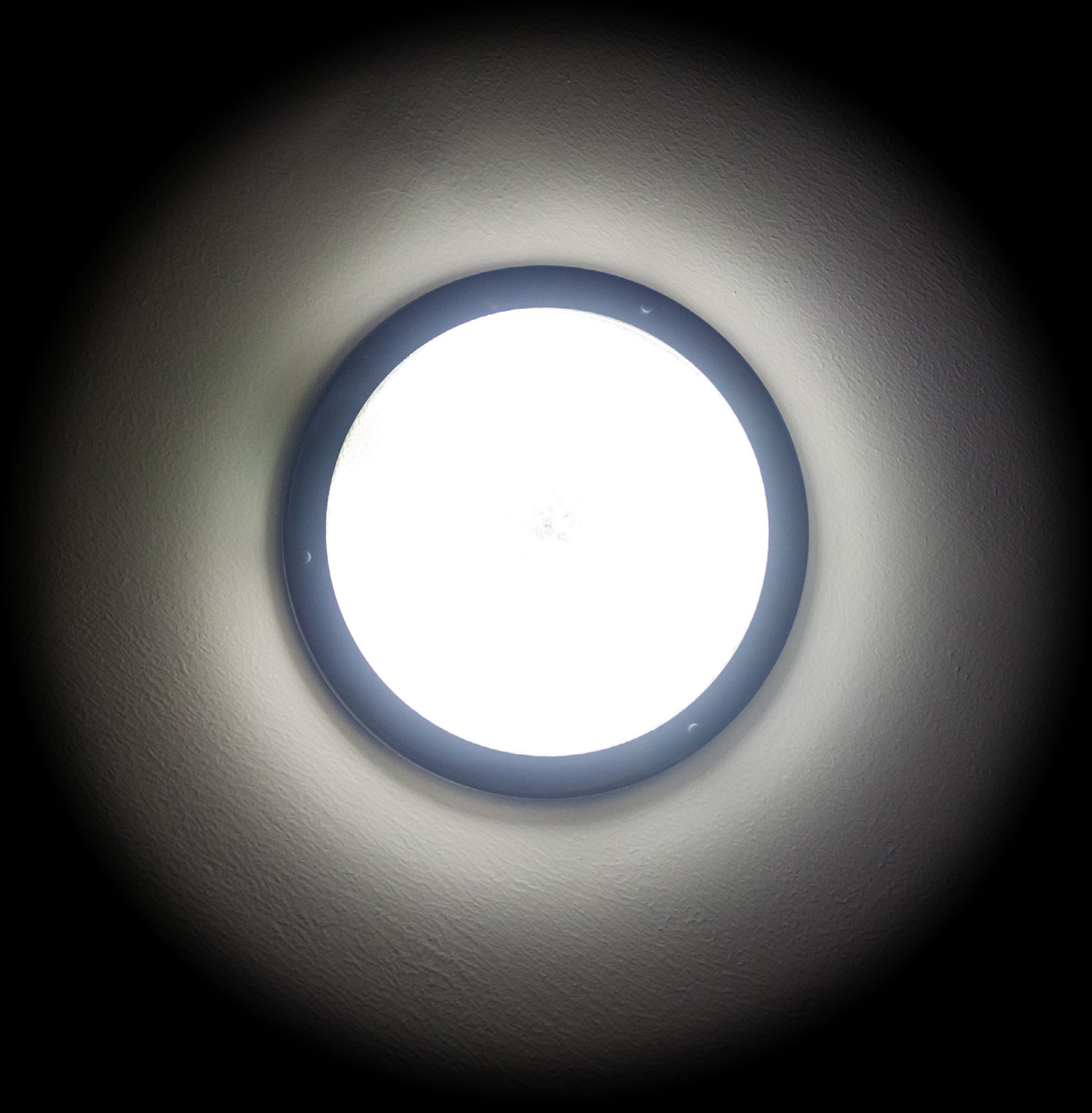

Ind AS

Industry insights | Consumer Business

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Content

Foreword

Ind AS is at par with global reporting standards and accordingly, the accounting principles adopted and the disclosures accompanying financial statements become even more important to investors, as they provide information about the decisions made regarding various accounting judgements made by the management in preparing financial statements. Needless to say, the impact of any fundamental change to an accounting framework has a much wider ramification on the company. Any transaction, from a routine sales transaction to corporate restructuring, needs to be represented in an accounting language. Hence, when that changes, the impact is pervasive.

Beyond the issue of rules versus principles, Ind AS also can pose particular technical accounting challenges to companies in the consumer business industry. While Ind AS prescribes rules for accounting, Income Computation and Disclosure Standards ("ICDS") have been notified by the Government to be applicable from financial year 16-17 onwards for computing taxable income. ICDS have been notified by the Government as per powers granted under section 145(2) of the Income-tax Act, 1961 ("Act"). The notified ICDS shall supersede the existing accounting standards notified by the CBDT on 25 January 1996 relating to disclosure of accounting policies and disclosure of prior period and extraordinary items and changes in accounting policies.

This document aims at throwing light one some of the implications on the consumer business sector.

The bottom line

Ind AS is more principle-based than Indian Generally Accepted Accounting Principles (Indian GAAP). This represents a fundamental shift that will force many CFOs to play a larger role in setting standards for their organizations. Reporting under Ind AS will enhance the presentation of financial performance and balance sheet to investors and capital providers.

Abhijit Damle

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Impact of Ind AS

Below, we highlight the key impacts resulting from the new Standards that will be of particular interest to stakeholders in the consumer business sectors

1. Definition of Revenue

Under the existing Indian GAAP, revenue is defined as gross inflow of cash, receivable or other consideration arising in course of the ordinary activities of sale of goods, rendering of services and use by others of enterprise resources yielding interest, royalties and dividends.
Following presentation is made by some of the large FMCG manufacturing companies under the existing Indian GAAP:

Turnover (Gross)
Less: Excise duty
Turnover (Net)

Ind AS defines revenue as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity.

As per Division – II of Schedule III to the Companies Act, 2013 (i.e. Ind AS based Schedule III) revenue from sale of products shall be presented including excise duty.

FMCG manufacturers need to make a careful assessment for determining whether excise duty should be netted off against the turnover under Ind AS since it is levied on the production of goods. The Institute of Chartered Accountants of India has provided a clarification through its Ind AS Transition Facilitation Group (ITFG) clarification bulletin that considering the above facts excise duty should be reflected as an expense.
This radical change in accounting for revenue would lead to re-evaluation of tax treatment of the transactions especially for companies paying taxes under MAT.

While, gross inflow of "economic benefits" are considered as revenue under Ind AS, the gross inflow of "cash, receivables or other consideration" is considered as revenue under ICDS for tax purposes. Hence, in the event, the company is obligated to pay tax under Minimum Alternate Tax (MAT) provisions, it would be required to pay taxes on book profits calculated as per Ind AS. Due to the different principles for recognizing revenue under Ind AS and ICDS, there could be inconsistencies in intended tax principles.

2. Sales promotion expenses

Revenue is measured at the fair value of the consideration received (or receivable) taking into account the amount of any trade discount and volume rebate allowed by the entity. The sales incentives, discounts and rebates given to customers were considered as sales promotion expenses by some of the leading FMCG companies.

For the purpose of determining the fair value of the revenue, companies should make an assessment as to whether the sales incentive, discount and rebate needs to be considered as a reduction in the selling price and hence accounted as reduction in revenue.

Further, as mentioned under para 2 above, considering that, under ICDS, revenue is defined as gross inflow of cash, recognition of revenue as per Ind AS and ICDS could differ resulting into an impact on companies who are paying tax under MAT regime.

Under the current indirect tax laws, VAT on sale of goods is levied on the net income i.e. after considering the discounts and rebates given to customers and hence there should not be any impact on levy of indirect taxes based on the change in the accounting treatment.

3. Customer loyalty award points

Retailers and Hotels use customer loyalty programmes which grant customers award credits (often described as points) at the time of sale of products. The customer can redeem the points for free or discounted goods or services.

The issue that arises in the above scenario is how the entity's obligation to provide free or discounted goods or services ('awards') in the future should be recognized and measured.

The recognition principles of the revenue standard are generally applied to each transaction. However, in certain circumstances, it is necessary to apply the recognition principles to the separately identifiable component of a single transaction to reflect the substance of the transaction.

The award credits are separately identifiable components of the sale transactions and the fair value of sale transaction is allocated between award credits and the other components of the sale. The consideration allocated to the award credits shall be measured by reference to their fair value i.e. the amount for which the award credits could be sold separately.

If the fair value of the award credits cannot be determined as mentioned above, the same shall be estimated by reference to the fair value of the awards for which they could be redeemed. The fair value of the award credits takes into account: (a) the amount of the discounts or incentives that would otherwise be offered to customers who have not earned award credits from an initial sale; and (b) the proportion of award credits that are not expected to be redeemed by customers.

The revenue in respect of the consideration allocated to award credits shall be recognized when award credits are redeemed and the Company fulfils its obligations to supply awards. The amount of revenue recognized shall be based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

However, under ICDS, the revenue cannot be deferred as ICDS IV defines revenue as "gross inflow of cash", which could give rise to creation of deferred tax asset. Further, whether a corresponding provision can be made against gross revenue (i.e. including award credits) will play important role in analyzing the tax impact.

4. Warranties

At times, retailers sell products along with the extended warranty which is in addition to the scope of coverage of the original warranty and the same is sold as part of a package.

In this scenario, appropriate assessment is required to be made to determine whether the sale of product including extended warranty has two separately identifiable components i.e. sale of the product with the original warranty and with the extended warranty. If more than one separately identifiable component is identified, Ind AS 18 requires the fair value of the total consideration received (or receivable) for the agreement to be allocated to each component and the recognition criteria of Ind AS 18 is then applied to each component.

Revenue in respect of the sale of the product is recognized when the entity transfers significant risks and rewards while the revenue for the extended warranty is recognized over the period of extended warranty.

Considering the different principles for recognizing revenue under ICDS and Ind AS, there could be a timing difference for recognition of revenue, which would result in creation of a deferred tax asset in respect of the revenue recognized over the period of extended warranty. However, creating a provision for extended warranty on scientific basis similar to that created for normal warranty may be considered.

5. Principal vs Agent – Online retailers

One of the important considerations in revenue recognition is whether the entity is acting as a principal or if it is in an agency arrangement. Generally, if an entity is primarily obligated in a transaction, i.e., it is exposed to the inventory risks, customer's credit risks and latitude in establishing prices, the revenue is recorded at the gross sales price. In other cases, the entity recognises the net amounts (i.e., gross sale less related costs) as commission or agency fees earned. This evaluation is relevant for the online retailers that are substantially growing over the last decade in India and which provide a market place for various retail shops without sometimes carrying the inventory risk.

6. Barter arrangements

Entities normally transact for cash or right to receive cash. Sometimes transactions are undertaken, which involves exchange of goods or services. A typical example in the hospitality industry is when hotels may provide a free stay as a consideration for an advertisement campaign. The accounting standard does not permit recognition of revenue in exchange transaction of similar goods or services; however, revenue is recognized in case of exchange of dissimilar goods or services.

The important question is measurement of the value or consideration of the transaction. The guidance available in this regard clarifies that revenue is measured based on the fair value of the goods or services received adjusted for cash or cash equivalent received or paid. If the fair value of the goods or services received cannot be reasonable determined, the revenue is measured at the fair value of the goods or services given up, adjusted for cash or cash equivalent received or paid.

7. Leases

Entities in retail industry have significant operating leases for premises which generally have a lock-in period with escalation built within the lock in period and also at intervals of renewal options. Accounting for leases every year requires consideration of such escalations.

As per the accounting policy followed by large companies in the retail industry, lease payments under an operating lease are generally recognized as an expense on a straight-line basis over the lease term. Ind AS 17, however, specifically requires that the expense is not adjusted if the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases.

Further, entities makes payment of interest free lease deposits in respect of the premises obtained on lease which are generally carried at cost. Under Ind AS, there lease deposits are to be measured at amortized costs. Accordingly, the amount of deposit will have to be fair valued by attributing time value of money at a rate which should represent the fair rate of return earned by the enterprise. The resultant asset will have to be amortized over the tenure of the lease agreement as incremental rent and interest income on the balance amount will have to be accrued over the tenure in a way that on maturity / end of lease tenure, the carrying value of the deposit is equal to the original amount.

This could trigger a controversy from an income tax perspective as to whether the withholding tax provisions would be applicable on the incremental rent expense. Non-deduction of tax at source has various consequences such as dis-allowance of expense while computing tax profits, interest, penalty, etc.

This could result in tax authorities seeking to tax the interest income while disallowing the rent expense leading to undue litigation. Further, separate tracking could be required for actual and notional rent entries.

8. Contract manufacturing arrangements

Contract manufacturing arrangements entered into by some of the FMCG companies needs to be assessed to determine whether it includes any leasing arrangement.

Such determination should be based on the substance of the arrangement and requires an assessment of whether:

01. Fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset) and
02. The arrangement conveys a right to use the asset.

There may be situations that although a specific asset is explicitly identified in an arrangement but the fulfillment of the arrangement is not dependent on the use of the specific asset.

Further, an arrangement conveys the right to use if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset which can be demonstrated if any of the following condition is met:

01. The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
02. iThe purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
03. Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

The above may also have an impact from the perspective of indirect tax laws. Consideration, if any, charged for the use of the assets should be liable to VAT if the arrangement results in transfer of right to use assets.

9. Other conceptual matters

Substance over form	Ind AS being principled based standards focus on substance over form.
Time value of money	• Ind AS considers time value of money while measuring assets as well as liabilities. However, there is no such adjustment permitted under ICDS for computing taxable income. • Amortized cost method using Effective Interest Rate is used for interest recognition. However, under ICDS, interest shall accrue on time basis and hence interest will be taxed in the hands of the debt securities holder before maturity.
Fair value	• Ind AS considers/ allows use of fair values • Ind AS 113 deals with determination of fair value. However, ICDS prescribes historical cost subject to provision for loss • Under Ind As, income statement includes notional items which could be taxable in Ind AS scenario under MAT provisions
Restatement	The general principle in IAS 8 is that an entity must correct all material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by: • restating the comparative amounts for the prior period(s) presented in which the error occurred; or • if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.
Other comprehensive income (OCI)	• changes in revaluation surplus (Property plant and equipment) • actuarial gains and losses on defined employee benefit plans recognized • gains and losses arising from translating the financial statements of a foreign operation • gain or loss on financial asset classified as FVOCI • the effective portion of gains and losses on hedging instruments in a cash flow hedge

10. Other significant tax considerations

Transitionary provisions from Indian GAAP to Ind AS	The differences in valuation of assets and liabilities will be routed through opening Other Comprehensive Income ("OCI") or opening retained earnings. Accordingly, the treatment of P&L entries (which later form part of retained earnings) made during previous financial year for comparative figures would need to be evaluated for MAT purpose.
Lohia committee report – Efforts to reconcile MAT to Ind AS	Central Board of Direct Taxes (CBDT) formed a committee (Lohia Committee) to suggest a framework for computation of book profit for MAT purpose for companies adopting Ind AS. In March and July 2016, the Lohia committee released its report (Lohia report) giving recommendations on the treatment of Ind AS transactions in MAT scenario. The above reports were placed before the public for comments. However, these reports have not been finalized yet. Further, there will be adjustments made to profit & loss account (P&L) or other comprehensive income (OCI) during year ended 31 March 2016 also, to reconcile the opening P&L balance as on 1 April 2016, which are not commented on by the Lohia committee. Hence, this could have an impact on advance tax obligation.
Requirement to maintain separate books	On account of the difference in treatment of revenue and expenditure as per Ind AS and ICDS, there could be a requirement to maintain separate books of accounts.

Way forward

The management of consumer business companies will need to exercise significant judgment in applying certain aspects of this new GAAP, including those related to the revenue recognition and the fair value considerations. Given the involvement of substantial judgment, documentation with regard to basis of conclusions / views taken will be crucial. Taxation will be one of the key challenges and documentation again could prove to be immensely helpful in addressing concerns on that front.

Although converting to Ind AS will present challenges, we believe it will be worth the effort. It will help businesses revamp their accounting policies and better align themselves with the business realities, fair value being the pivotal concept in Ind AS. The new standards shall be effective in harmonising the accounting and financial reporting process, bring Indian financial reporting substantially at par with the more mature economies which shall provide an impetus to the capital markets and potentially make access to the overseas capital markets seamless. It shall also provide a fundamental pillar of trust and facilitate inbound and outbound international investments.

Given the peculiar nature of the consumer sector, where volume of transactions could be very large, companies will have to gear and adapt their systems to the new accounting and tax principles. There is an increased emphasis on processing the requisite information in the desired manner using various automated techniques and data analytics tools.

Contacts

For further information, please contact us at:
inconsumerbusiness@deloitte.com