Embedding fair value in financial reporting
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As accounting standards in India are getting aligned to the international standards (IFRS), one of the most important changes facing Indian corporates is the use of fair value as a measurement base for valuing many of the assets and liabilities. This can bring about a lot of volatility and subjectivity to financial statements.

Fair value reporting was applied under the previous GAAP as well, but it was limited to areas such as impairment testing and revaluation of fixed assets. For employee stock option plan (ESOP) accounting, many corporates opted for the intrinsic value method instead of computing the fair value of the option. Under previous GAAP, optionally convertible preference shares were considered part of shareholder’s funds and optionally convertible debentures were considered as borrowings, despite having the features of both equity and debt.

With Indian Accounting Standards (Ind AS), the use of fair valuation estimates has been expanded significantly. The scope of this publication is to highlight some of the key areas where fair valuation will have a significant impact not only on accounting but also for business decisions. The intent is to give a perspective of the possible accounting and business impact as well as to highlight some of the key challenges that corporates could face in embracing fair value in financial reporting. For example, fair valuation of composite financial instruments or contingent consideration, previously held equity interest or non-controlling interest in a business combination could be new concepts for Indian corporates. The comparability of financial performance across companies may also be a challenge in the initial years due to the phased roll-out of Ind AS, exemptions available for first-time adoption and the possibly varying extent of disclosures. However, in the long run, financial reporting will be consistent with international accounting standards, facilitating more informed decisions by global and domestic participants.

Fair value estimation is going to be a significantly challenging aspect of Ind AS adoption. We hope you find this publication helpful in charting your course through the inherently uncertain waters of fair value estimates.
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Fair value – significance under Ind AS
Fair value – significance under Ind AS

Ind AS 113 Fair Value Measurement defines fair value, sets out a single Ind AS a framework for measuring fair value and requires disclosures about fair value measurements.

Under the previous GAAP (i.e., Companies (Accounting Standards) Rules, 2006), there was no separate standard for fair value measurement. Fair value was defined in several standards as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction. This was largely used in the accounting for current investments, fixed assets and amalgamations.

As per Ind AS 113, the definition of fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The measurement premise assumes that the transaction will take place in either the principal market or the most advantageous market, and that market participants will act in their best economic interest. For a non-financial asset, the measurement should take into account the highest and best use that is physically possible, legally permissible and financially feasible.

It is not an entity-specific measurement and should consider the characteristics of assets/liabilities that market participants would take into account, such as conditions, location and restrictions on sale/use.

The valuation techniques should maximize the use of relevant observable inputs and minimize the use of unobservable inputs. The valuation assumptions that can typically be used can be classified as:

- Level 1: Quoted prices in active markets for identical assets or liabilities
- Level 2: Inputs other than quoted prices that are observable, either directly or indirectly
- Level 3: Unobservable inputs
The suggested hierarchy is such that Level 1 inputs are preferred over Level 2 inputs and so on. Hence while valuing equity instruments, the market price method (Level 1) is preferred over the comparable companies multiples method (Level 2), which in turn is preferred over the discounted cash flows method (Level 3).

The premise for annual impairment testing for cash generating units as per Ind AS continues to be recoverable value, which is higher of value-in-use or fair value (net of cost to sell).

An overview of the key principles laid down under the standard is as follows:

- **Highest and best use**: The standard states that if the current use of the asset is sub-optimal, it will have to be disregarded and the possible highest and best use should be considered while making fair value estimates. For example, in valuing factory land that can be also be put for residential use and where such usage would maximize value, the premise of residential use should be considered while arriving at the fair value estimate.

- **Market participant’s view**: As per the previous GAAP, fair value was impliedly entity specific. However, as per Ind AS, fair value considers a typical market participants view, so the intent of the current owner or the acquirer can be disregarded.

- **Inputs consistent with characteristics of assets/liabilities**: Characteristics may result in the application of an adjustment (premium or discount), e.g., control premium, while applying fair value for the controlling stake. However, adjustments that reflect size as a characteristic of the entity’s holding (e.g., blockage factor that adjusts the quoted price because normal daily trading volumes are not sufficient to absorb the quantity held by the entity) are not permitted.

### Key learnings/challenges

The following are some of the key learnings/challenges in fair valuation:

1. **Fair valuation is subjective**

   Fair valuation of balance sheet items brings out the realistic value of those assets and liabilities, enabling stakeholders to better understand the financial position of the entity. This also helps the entity in measuring and managing its performance, including managing liquidity, interest rate, exchange rate and other risks.

   For example, fair valuation of equity instruments under Ind AS 109 would require an entity to account for them at fair value at each reporting date with changes being recognized in the profit and loss account or in other comprehensive income (OCI). However, sometimes the quoted price may be available but there may not be adequate trading volumes in the market. Sometimes, the listed price may not be available and hence the management will have to use Level 2 or Level 3 estimates to arrive at fair valuation. The quoted prices of similar assets may get influenced by asset-specific factors and hence the benchmark may need to be suitably adjusted before being applied for valuation of another asset. The more the use of unobservable inputs, the more subjective the valuation becomes. Hence, companies will have to be watchful with the use of estimates in fair valuation.

2. **Cost of fair valuation**

   Companies at present may not have the depth of expertise in valuation. Hence, they may have to decide between developing an in-house pool of experts or sourcing it externally. Fair valuation may have to be done at each reporting period for various instruments, which may increase the cost of compliance. Hence, to reduce the cost of recurring fair valuations, companies may have to adopt innovative models for engaging valuation experts, for example, by entering into a retainership model with valuation experts or developing fair valuation methodologies for simple and recurring instruments. This will also ensure consistency in the application of fair valuation principles and disclosures.

3. **Disclosure impact of fair valuation**

   Fair valuation impacts not only the accounting of transactions but also the disclosure of those transactions. Ind AS 113 requires extensive disclosures of fair valuation depending upon the use of unobservable inputs for fair valuation. Level 1 fair valuation would require minimum disclosures, while Level 3 fair valuation would require extensive disclosures, including sensitivity analysis of estimates used in fair valuation. Hence, companies will have to be gears up their internal control systems to ensure that adequate fair value disclosures are made in the financial statements.

4. **Planning structure of transactions**

   Some potential transactions may require additional planning and resource allocation. For example, acquirers may want to undertake a pre-purchase price allocation exercise before bidding so that they get an early indication of whether the acquisition could be earnings per share (EPS) accretive from day 1. The issuer of a financial instrument may also want to understand whether it would be presented as a debt or an equity instrument, or whether the transaction may have a Minimum Alternate Tax (MAT) impact due to its fair valuation accounting, etc.
Accounting for business combinations
Ind AS 103 Business Combinations transforms the way companies plan and execute their acquisition strategies. Investors, regulators and the stakeholders will be able to better appreciate the cost of business combinations based on the fair value of assets and liabilities and increased disclosures. The new standard applies to most business combinations, including amalgamations (where the acquiree loses its existence) and acquisitions (where the acquiree continues its existence). More transactions are likely to fall under the definition of business combination and require business combination accounting under Ind AS 103 than amalgamation accounting under previous GAAP AS 14 Accounting for Amalgamations.

The change in accounting for business combinations calls for assets/liabilities acquired in a deal to be measured at fair value and appropriate valuation methods to be applied.

An overview of the accounting principles laid down in Ind AS 103 is as below:

- All business combinations will be accounted for under the purchase method (fair value), excluding business combinations involving entities or businesses under common control, which are to be accounted using the pooling of interest method. Under the acquisition method, an acquirer of a business recognizes the assets acquired and the liabilities assumed at their acquisition-date fair values and discloses information that enables users to evaluate the nature and financial effects of the acquisition.

- Ind AS 103 focuses on the substance of the transaction rather than the legal form. Reverse acquisition is accounted for assuming the legal acquirer is the acquiree.

- Ind AS 103 has changed how contingent consideration is accounted for, such that a liability (or equity) must be recognized at fair value by the acquirer at the date of acquisition. Under previous GAAP, there was no specific guidance on contingent consideration and there were diverse practices being followed.

- Ind AS 103 also provides detailed guidance on the recognition of identifiable intangible assets, which may increase the accounting complexity for many business combinations and therefore increase
Another significant area relates to accounting for business combinations in case of court schemes. Unlike the erstwhile Companies Act, 1956, the Companies Act, 2013 specifically requires accounting treatment prescribed in the amalgamation or demerger schemes to be in accordance with accounting standards. Further, listed entities were earlier required to obtain an auditor’s certificate that the court schemes complied with the provisions of applicable accounting standards. Now, all the companies, listed or unlisted, that apply Ind AS/previous GAAP will need to ensure that schemes filed with the High Court do not propose any accounting treatment that is not in accordance with the principles of Ind AS 103/AS 14.

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination, where the value of the acquired identifiable assets and liabilities exceeds the consideration transferred. If that excess remains after applying the requirements of reassessment and review, the acquirer shall recognize the resulting gain (bargain purchase) in OCI on the acquisition date and accumulate it in equity as capital reserve. The gain should be attributed to the acquirer. If there does not exist clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, the acquirer should apply the requirements of reassessment and review. The acquirer needs to assess whether it has correctly identified all of the assets acquired and all of the liabilities assumed, and also to recognize any additional assets or liabilities identified in that review. The excess, if any, after applying the requirements of reassessment and review should be recognized directly in equity as capital reserve.

Ind AS 103 prohibits amortization of goodwill arising on business combinations, and requires it to be tested for impairment annually.

Given below are the key areas that will have a significant impact on companies and will require wider use of fair valuation:

1. Contingent consideration and deferred consideration

Currently, if an element of the purchase price is payable in the future and if certain conditions are met (e.g., performance targets), a liability is recognized when it is probable that an amount will be paid. Ind AS 103 requires that contingent consideration in a business combination be measured at its fair value at the date of acquisition, and that this amount be included in the computation of goodwill. Changes that arise subsequent to that date will generally not impact goodwill, hence getting the right value at the date of the transaction is critical. Subsequent changes in the value of contingent consideration depend on whether they are equity instruments or liabilities. Contingent consideration classified as equity should not be remeasured and its subsequent settlement should be accounted for within equity. Other contingent consideration that is:

- Within the scope of Ind AS 109, i.e., financial instruments, should be measured at fair value at each reporting date and changes in fair value should be recognized in profit or loss in accordance with Ind AS 109.

- Is not within the scope of Ind AS 109 should be measured at fair value at each reporting date and changes in fair value should be recognized in profit or loss.

Often, the terms in any contingent consideration arrangement are unique and complex – e.g., contingent consideration based on entity-specific variables that are not observable in any market, such as the outcome of research projects. Hence, determining fair value is likely to be a time-consuming exercise, and many traditional valuation techniques may not be appropriate.

Measuring the value of a contingent consideration requires an understanding of the expected cash flows from the arrangement, and the probability and assessment of the discount rate for those cash flows. The fair value is to be determined at the end of each reporting period, which may require additional procedures to be incorporated into the year-end and interim close processes, additional information to be collected by information systems, and additional expertise to perform the fair value assessment.

As against contingent consideration, which is dependent upon the occurrence of a future event, there could be cases where consideration is payable under all circumstances (deferred consideration). Such obligation is added to the initial consideration to arrive at the total cost of combination after appropriately making present value adjustment to factor in the time value of money. The unwinding of interest is charged to the statement of profit and loss account. Determining the discount rate to arrive at the present value adjustment may become a challenge in cases where there are no appropriate benchmarks of borrowing rates available.
2. Step acquisitions

In some cases, a controlling ownership interest is gained over a period of time. The acquirer re-measures its previously held equity interest in the acquiree at its acquisition date fair value. The acquirer needs to recognize the resulting gain or loss, if any, in profit or loss or OCI as appropriate. Such gains or losses may have consequential MAT implications when business combinations are accounted for in standalone financial statements. The fair value attributable to the existing investment may be derived from the value determined for the rest of the transaction, but care will be needed to ensure that it does not reflect a control premium.

3. Measuring non-controlling interests (NCI)

NCI represents the equity in a subsidiary that is not attributable directly or indirectly to the parent. Ind AS 103 provides a choice for measuring NCI: at its fair value at the date of gaining control or at its share of the fair value of net assets. By adopting the fair value option for NCI, goodwill will be recognized relating to the business rather than just the parent’s share of the business, which will have a significant impact on the balance sheet. Therefore, it is highly likely that goodwill becomes a higher percentage of the value of the business acquired and may have a consequential impact on future KPI by way of impairment charge to the statement of profit and loss. The fair value attributable to NCI may be derived from the value determined for the rest of the transaction, but care will be needed to ensure that it does not reflect a control premium.

When an entity measures NCIs at their proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, for the purposes of impairment testing, the carrying amount of goodwill allocated to the cash generating unit (CGU) is grossed up to include the goodwill attributable to the NCIs. This adjusted carrying amount is then compared with the recoverable amount of the CGU to determine whether the CGU is impaired.

4. Valuation of intangible assets

Intangible assets, whether or not existing in the financial statements of the acquiree, need to be identified and recorded at fair value. In order for an asset to be recognized as an intangible asset that can be recorded separately, it should satisfy either of the following identification criteria: (a) it should be separable (in isolation or in combination with other assets) or (b) the benefit should be arising out of legal or contractual rights.

The new intangible assets could be customer relationships, customer contracts, brand, domain names, non-competition agreements etc. This may increase the accounting complexity for some business combinations. It will therefore increase time and cost, and will result in higher post-combination amortization charges being recognized. At the same time, it will reduce the amount of goodwill being recognized.

There may be multiple methods available for valuing a particular asset. For example, brand/trademark could be valued using, among others methods, the royalty relief method or the premium profit method. While customer contract/related relationships are generally valued using the multi-period excess earnings method, it requires one to (a) identify inter-dependency and hierarchy among assets, (b) split future revenues into those arising from existing customers and new customers and (c) value other assets that contribute to same cash flows and estimate their individual return expectations based on the characteristics of those assets. Intangibles such as licenses, which serve as an entry barrier, may sometimes get valued using the greenfield method to estimate the possible value for a new player. Assets such as non-compete would require multiple scenarios of a business plan, as they get valued as the difference of outcome between the “with” and the “without” scenario. An overall sense check is required by computing the weighted average return of assets (WARA) and comparing it with the weighted average cost of capital (WACC), and also with the internal rate of return (IRR) on the deal.

5. Valuation of options

Some business combinations involve options over some or all of the outstanding shares. For example, the acquirer might have a call option, i.e., a right to acquire the outstanding shares at a future date for a particular price. Alternatively, the acquirer might have granted a put option to the other shareholders whereby they have the right to sell their shares to the acquirer at a future date for a particular price. In some cases, there may be a combination of such call and put options, the terms of which may be equivalent or may be different. The accounting for call and put options written in favor of NCI can be complex and can have a significant impact on the financial statements. This would require a careful analysis of facts and circumstances, including the specific contractual terms related to the transaction. In case of transactions that require valuation of non-controlling interest, one should also check if there is pre-agreed formula for transfer of shares inter-se shareholders. For example, if the acquirer has an option to buy the non-controlling stake at a particular price, the initial consideration may
include the value of the call option. This would also impact the value of the non-controlling interest, if the starting point used is the consideration paid for the controlling stake. A critical evaluation would be required to be made for all the call and put options as they would result in volatility in the financial statements. Such options could have a significant impact on accounting for business acquisitions.

6. Valuation of contingent liabilities and indemnification assets

Certain contingent liabilities that are present obligations arising from past events may become actual liabilities in the financials of the acquirer even if they were off-balance sheet items for the acquiree. They are considered based on scenario analysis, which considers the probability of devolvement appropriately. There must be a present obligation arising from a past event that can be reliably measured. Such a liability is recognized at fair value. The determination of whether a past event has occurred is a matter of judgment, particularly in cases of litigation claims, and it is likely to require greater time and effort to identify.

The acquiree’s selling shareholders might provide an indemnification to the acquirer for uncertainties about the settlement amount of the acquired assets or liabilities assumed by the acquirer (e.g., uncertain tax positions, environmental liabilities or other legal matters), which often require the acquiree’s selling shareholders to reimburse the acquirer for some or all of the cost incurred in connection with an assumed pre-acquisition contingency. When the indemnified item is measured at fair value at the date of acquisition, the indemnity asset is also measured at fair value (and reflects uncertainty relating to the collectability of the asset). When the indemnified item is one that is not measured at fair value (as the item is an exception to the general principle), or it is not recognized (as it cannot be reliably measured), the indemnity asset is recognized and measured using the assumptions consistent with those used to measure the indemnified item, subject to the management’s assessment of the collectability of the indemnification asset and any contractual limitations on the indemnified amount.

Consequently, if the related liability is not recognized at the date of acquisition, an indemnification asset is also not recognized. This effectively results in eliminating a mismatch that arises when applying Ind AS 103.

Key learnings/challenges

The changes brought in by Ind AS 103 are likely to impact all stages of the acquisition process – from planning to the presentation of the post-deal results. The following are some areas that will be affected:

1. Deal structures may change

Accounting considerations should not drive acquisition decisions, but accounting can have a real impact on deal structures, on the planning and process that surround deals and on communications with the marketplace. Ind AS 103 is more prescriptive in nature when it comes to accounting requirements. The mandatory requirement of purchase method of accounting (except common control transactions) has reduced alternatives and may also have other consequential impacts, including reduced tax leakages. It would require new policies and procedures to monitor and determine the fair value of some assets and liabilities pursuant to business combination, need early input of accountants and lawyers, and expand the call for valuation expertise.

2. Challenges in purchase price allocations (PPAs)

The new standards have made PPA more rigorous. Despite the comprehensive guidance under Ind AS 103, there are still numerous challenges relating to PPA. Therefore, the PPA should be an integrated part of an acquisition process as it is a time consuming process and may take a period of six to twelve months. Many intangible assets that would previously have been subsumed within goodwill must now be separately identified and valued. The valuation of such assets is a complex process and may require specialist skills. The PPA process can be divided into the following steps:

- Defining the PPA strategy
- Determining the total consideration, including contingent consideration
- Fair-valuing the existing assets and liabilities
- Identifying new intangible assets
- Valuing newly identified intangible assets
- Calculating goodwill
- Benchmarking the results

An appropriate and well-defined PPA strategy gives guidance for the whole PPA process and makes the process efficient. The identification of additional intangible assets that are separable from goodwill as well as the valuation of these assets pose a challenge for companies and are based on various subjective assessments. This is primarily due to
the lack of sufficiently reliable and observable data. Intangible assets that are particularly challenging to measure are customer relationships, non-compete arrangements and intangible assets in the “early stage” of development (e.g., in-process research and development assets). The value of the newly identified assets has a direct impact on the resulting goodwill and, due to the amortization of the additionally recognized intangible assets with definite useful life, on the future earnings of a company. Goodwill is tested for impairment annually as required under Ind AS 36, Impairment of Assets. It is vitally important for acquirers to clearly communicate to the market the value of the assets acquired and liabilities assumed as part of an acquisition.

Fair valuation of tangible assets and working capital items such as debtors, inventories and derivatives will have its own set of challenges. For some further detailed discussion, refer chapters on “financial instruments” and “property, plant and equipment.”

Ernst & Young conducted a global survey of PPA practices in February 2009, gathering an extensive sample of transactions: 709 transactions disclosed in annual reports from 2007 (mostly using IFRS and US GAAP). For the 709 transactions analyzed, the number of different types of intangible assets recognized was up to five per transaction. For 60% of the transactions, only one or two separate types of intangible assets were disclosed, with different types of intangible assets perhaps sometimes being grouped together. Goodwill represented 47% of the total enterprise value and recognized intangible assets represented 23%.

As a result, one-third of the combined intangible value was allocated to specific intangible assets, whereas two-third was allocated to goodwill. As a consequence, PPAs have significant implications to the profit and loss account due to potential future amortizations and impairments.

3. Identifying earn-outs that are remuneration or consideration

For a number of industries, such as insurance brokers, financial planners, recruitment, medical research and advertising, the key driver of the business is the customer relationships held by key employees, or the specific skills of key employees. Retaining such key employees is critical to the continued success of the business. Invariably, this is achieved through substantial additional payments in the future, which are often linked to continued employment.

While payments relating to contingent considerations included as part of purchase consideration may be negotiated as part of gaining control of another entity, the accounting may not necessarily always reflect this – particularly if these payments are made to those who remain as employees of the business after it is acquired. In such cases, depending on the exact terms of the arrangement, the payment made may be accounted for as remuneration expenses for services provided subsequent to the acquisition rather than as part of the consideration paid for the business, thereby resulting in a significantly different reported effect of the transaction than might otherwise be expected. In other cases, the additional payment will be accounted for as contingent consideration.

4. Greater transparency – increased disclosures

The new standard will influence the “how, when and what” of stakeholder communications. The financial statements will be longer than before and even more detailed. Significant new disclosures are required regarding the cost of acquisition, values of the main classes of assets and liabilities, fair value for contingent liabilities acquired and the justification for the amount allocated to goodwill. Details of the actual costs of an acquisition (including professional fees paid to investment banks, lawyers and accountants) are also required.

Ind AS 103 requires that factors that give rise to goodwill be disclosed in annual reports – companies often only disclosed a brief comment on synergies and other components of the purchase price. Disclosures are intended to allow users to assess the reasonableness of the management’s decisions and assessments. Analysts, shareholders and other users of the financials will have more information about the nature and consequences of management decisions on acquisitions than they have ever had before. A bigger challenge for companies could be to provide adequate disclosure at the end of the financial year.

Post-acquisition disclosures include annualized revenue and profit as if deals had been completed at the start of the financial year, analysis of acquired receivables’ gross contractual amounts and fair values and estimates of the range of outcomes on contingent consideration.
Accounting for financial instruments
Ind AS 32 Financial Instruments: Presentation, Ind AS 109 Financial Instruments and Ind AS 107 Financial Instruments: Disclosures deal with the comprehensive presentation, recognition, measurement and disclosure aspects of financial instruments.

These standards make greater use of fair values than the previous GAAP. All financial assets and liabilities are initially recognized (in the balance sheet) at fair value adjusted for the transaction cost. Further, in the case of fair value through profit or loss (FVTPL) and fair value through other comprehensive income (FVOCI) instruments, subsequent measurement is also at fair value. Additionally, fair value disclosures would be required for financial instruments even if they are measured at amortized cost. The use of fair values sometimes causes volatility in the income statement or equity. Currently, Indian entities have limited experience of utilizing valuation tools or experts for fair valuation of such instruments. Further, India has implemented Ind AS 109 (IFRS 9 equivalent) earlier than the mandatory adoption date of International Accounting Standards Board (IASB) issued IFRS 9, i.e., 1 January 2018. Hence, Indian companies would not have the benefit of global experience of implementation of IFRS 9.

The following are the key aspects of these standards:

- Ind AS 32 requires the issuer of a financial instrument to classify the instrument as a liability or equity on initial recognition, in accordance with substance of its terms and the definitions of these terms. The application of this principle requires certain instruments that have the form of equity to be classified as liability. For example, under Ind AS 32, mandatorily redeemable preference shares on which a fixed dividend is payable are treated as liability.

- Ind AS 32 requires compound financial instruments, such as convertible bonds meeting specified criteria, to be split into liability and equity components, and each component to be recorded separately.

- Under Ind AS 109, all financial liabilities are classified into two categories, namely, FVTPL and other financial liabilities. Initial measurement of all financial liabilities is at fair value.
Subsequent to initial recognition, FVTPL liabilities are measured at fair values, with gain or loss (other than gain or loss attributable to “own credit risk”) being recognized in the income statement. Gain or loss attributable to “own credit risk” for FVTPL liabilities is recognized in equity. Other financial liabilities are measured at amortized cost using the effective interest rate at each reporting date.

- Ind AS 109 contains three principal classification categories for financial assets, namely, measured at amortized cost, FVOCI and FVTPL. A financial asset that is a debt instrument is subsequently measured at amortized cost if it is held within a business model whose objective is to collect contractual cash flows and the contractual terms of the financial asset give rise to cash flows that are solely the payments of principal and interest (SPPI). A financial asset that is a debt instrument is subsequently measured at FVOCI if it meets the SPPI criterion and is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. All other financial assets, including equity instruments, are classified as being subsequently measured at FVTPL. At initial recognition of an equity investment that is not held for trading, an entity may irrevocably elect to present in OCI the subsequent changes in fair value.

- Ind AS 109 has introduced a new “expected credit loss model” for the impairment of financial assets. It applies to financial assets that are debt instruments but are not measured at FVTPL, including loans, lease and trade receivables, debt securities, and specified financial guarantees and loan commitments issued. It does not apply to equity instruments. The model uses a dual measurement approach, under which the loss allowance is measured as either 12-month expected credit losses or lifetime expected credit losses.

- As per Ind AS 109, all derivatives, except those used for hedge purposes, are measured at fair value, and any gains/losses are recognized in profit or loss.

- Ind AS 109 deals with various aspects of hedge accounting in a comprehensive manner. It defines three types of hedging relationships, namely, fair value hedges, cash flow hedges and hedges of net investments in a foreign operation. It also lays down prerequisite conditions to apply hedge accounting.

- Ind AS 107 requires entities to provide comprehensive disclosures in their financial statements with respect to the financial instruments.

Given below are the key areas that will have a significant impact on companies and will require wider use of fair valuation:

1. **Interest free loans/deposits**

   Ind AS 109 requires all financial assets and liabilities to be fair valued on the transaction date. When an entity grants interest free loans to its subsidiaries, its fair value would be the present value of the future cash flows at the current market rate of interest. The difference between the gross amount of loans given and their present value would be classified as investment in subsidiary. The recipient subsidiary, on the other hand, would present the difference as contribution received from parent under Equity. Similarly, interest-free loans given to employees would also be fair valued and the difference may be treated as employee cost.

   For example, Entity P (the parent entity) gives an interest-free loan of INR100 million to Entity S (the subsidiary entity) for a period of 5 years. At an assumed market rate of 12%, the present value of the loan would be INR57 million. Hence, Entity P would account for a loan given of INR57 million and an investment of INR43 million (100-57). Correspondingly, Entity S would account for borrowing of INR57 million and equity (contribution received) of INR43 million.

   Further, similar considerations apply when an entity gives security deposits for lease of assets, supply contracts, service contracts etc. These security deposits would be discounted and the difference would be accounted for as prepaid rent, advance for goods/services etc.

2. **Equity instruments/convertible debts**

   Ind AS 109 requires all investments in equity instruments (except investment in subsidiary, associate and joint ventures) to be fair valued at each reporting date. Ind AS 27 Separate Financial Statements requires an entity to choose from carrying investments in a subsidiary, associate and joint venture at cost or measuring it as per Ind AS 109, i.e., at fair value. As per Ind AS 109, equity instruments are instruments that are in substance equity irrespective of the form of the instrument, e.g., preference shares, bonds and debentures that are mandatorily convertible into fixed number of equity shares may be required to be classified as investment in equity instruments. These equity instruments would be fair valued at each reporting date irrespective of whether they are listed or not. Further,
investments in optionally convertible instruments will also be fair valued at each reporting date.

3. Compound financial instruments

A compound financial instrument is a non-derivative financial instrument that contains both a liability and an equity component. The issuer entity recognizes separately the components of a financial instrument that (a) creates a financial liability of the entity (a contractual arrangement to deliver cash or another financial asset) and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity). For example, a bond that is optionally convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument.

Ind AS 32 requires an issuer of a compound financial instrument to split the instrument into the debt component and the equity component. While the debt component is determined using fair valuation, the equity component is the residual value. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component or recognized separately as a derivative based on the terms of the instrument.

4. Mutual funds

Most mutual fund investments would not meet the Solely Payments of Principal and Interest (SPPI) test required by Ind AS 109. Hence, they would be classified as FVTPL, requiring fair valuation at each reporting date and the changes reported in the income statement.

5. Financial guarantee

A financial guarantee contract is defined by Ind AS 109 as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

The guarantor is required to recognize the financial guarantee contract liability initially at its fair value. Subsequently, this guarantee (unless designated as FVTPL) is to be measured at the higher of (a) the amount determined after considering the impact of impairment and (b) the amount initially recognized less the cumulative amount of income recognized as per Ind AS 18 Revenue.

6. Derivatives/hedge accounting

Derivatives such as call and put options, future contracts, forward contracts and swaps are commonly used by entities. These are accounted for at FVTPL at each reporting date. Further, an entity may choose to apply hedge accounting, for which there are specific accounting principles mentioned in Ind AS 109.

According to a recent study by EY titled “Ind AS transition - Journey of Indian Corporates” carried out to analyze and evaluate the first-time Ind AS results of BSE top 100 companies:

- **INR55,000 crore** increase in net worth of 47 companies due to fair value of financial instruments
- **INR4,000 crore** decrease in net worth of 13 companies due to ECL
- **INR3,300 crore** decrease in net worth of 9 companies due to fair value of financial instruments
Key learnings/challenges

The changes brought in by Ind AS 109 are likely to impact not only the accounting for financial instruments but also the business decisions, especially due to extensive use of fair valuations. Few of them are summarized as below:

1. Unintended revelation of value of unlisted strategic investments (equity/preference/bonds)

Ind AS requires investment in securities that are classified as equity and those debt securities that do not fulfil certain cash flow characteristic tests to be fair valued at each reporting date. Hence, investment in equity shares, preference shares etc. would now have to be accounted for at fair value. Fair valuation of listed securities, if fairly traded, is its observed price on the stock exchange. However, valuing unlisted securities involves a high level of management estimates and judgment. In case there are no directly comparable companies with similar businesses whose valuation benchmarks are publicly available, one would have to rely on valuation techniques such as discounted cash flows method (which is Level 3 input based). Fair valuation of convertible securities would be even more complicated, as they contain derivatives.

2. Fair valuation of derivatives

Ind AS 109 requires all derivatives to be fair valued even if accounted for as hedging instruments. Forward contracts entered into with banks are valued using assumptions shared by the bank with the entity. However, other contracts such as swaps, convertible instruments and call/put options are generally valued using valuation models.

Further, Ind AS 113 requires that fair value be measured based on market participants’ assumptions, which would consider counterparty credit risk in derivative valuations. Furthermore, the standard is explicit that the fair value of a liability should reflect the effect of non-performance risk, including, but not limited to, an entity’s own credit risk. As a result, IFRS 13 requires entities to consider the effects of credit risk when determining a fair value measurement, e.g., by calculating a debit valuation adjustment (DVA) or a credit valuation adjustment (CVA) on their derivatives.

As no specific method is prescribed in the accounting literature, various approaches are used in practice by derivatives dealers and end users to estimate the effect of credit risk on the fair value of OTC derivatives.

3. Struggle with debt-equity ratio/loan covenants

Many structured instruments that were previously classified as equity under previous GAAP would now be classified as debt under Ind AS or vice versa by the issuer. Further, many of these securities would be accounted for at fair values by the investor. Hence, companies will have to consider accounting for these instruments while issuing/investing in structured instruments. A few accounting concerns for such instruments have been listed below:

a. Perpetual debt

“Perpetual debt” instruments are those that provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. However, this does not mean that “perpetual debt” is to be classified as equity, as the issue proceeds will typically represent the net present value of the liability for interest payments.

For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8% applied to a stated par or principal amount of INR1 million. Assuming 8% to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of INR1 million. Thus, perpetual debt gives rise to a financial liability for the issuer.

b. Preference shares

Investment in a financial instrument, to be subsequently measured at amortized cost, must fulfil the cash flow characteristic test, i.e., whether the instrument would provide only principal and interest. In many cases, investment in preference shares with discretionary dividends or conversion option would generally fail the test. Hence, investment in preference shares, which have been classified as debt, would generally be measured at fair value.

4. Unintended MAT impact on debt restructuring

It is common for an entity, particularly but not necessarily when in financial difficulties, to approach its major creditors for a restructuring of its debt commitments – for example, an agreement to postpone the repayment of principal in exchange for higher interest payments in the meantime, or to roll up interest into a single “bullet” payment of interest and principal at the end of the term. This may result in the new terms being classified as “substantially different” from the existing ones and consequently the
gains and losses being recognized in the income statement as per Ind AS 109. This may give rise to a significant income to companies, which would be considered for MAT calculations.

5. Effect on performance assessment

Fair valuation of certain transactions affects the profit/loss of an entity, thereby affecting the measures used to assess performance. Companies may have to devise new standards to assess the performance of employees. Some of the transactions that affect income statement are as mentioned below:

a. Financial guarantee

The requirement to measure financial instruments at fair value on initial recognition also applies to issued financial guarantee contracts that are within the scope of Ind AS 109. When issued to an unrelated party in a standalone arm's length transaction, the fair value of a financial guarantee contract at inception is likely to be equal to the premium received, unless there is evidence to the contrary. However, when a parent provides financial guarantee to a bank in respect of its subsidiary’s borrowings and charges no fee, it will have to be fair valued. Its fair value is generally considered to be equal to the savings in the interest cost by the subsidiary. The value so derived would be amortized over the period of the loan to which the guarantee relates.

For example, a subsidiary would be able to raise loans from banks at a 14% rate of interest. However, if the parent provides financial guarantee to bank, the subsidiary would receive loan at 13% interest. This saving of 1% would be used to fair value the financial guarantee contract. Hence, entities would have to determine the interest rate that would be levied for loans borrowed by subsidiaries had the financial guarantee not been given by the parent.

b. Discounting

Fair valuation of certain instruments includes impact due to discounting. This discounting is then unwound over the tenure of the instrument.

An entity is required to use a discount rate based on the assumptions that market participants would use to determine the interest rate to be charged on a similar instrument with similar terms, risks etc. Though entities will be able to benchmark the financial liabilities with other borrowings to determine the discount rates, the discount rates for financial assets may pose a challenge.

6. Extensive disclosures

Ind AS 107 requires an entity to disclose the following:

a. 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.

b. An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

c. An entity shall disclose an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Fair value considerations

Valuation of financial instruments is complex. It requires the valuer to understand the contractual terms of the instrument in detail and thereafter choose the right method and build the appropriate model.

Hybrid financial instruments could have redemption rights, conversion rights, voting rights, dividend rights, protective covenants etc.

Optionally convertible preference shares would require splitting the instrument value into debt and equity using option pricing models such as Black Scholes, binomial and sometimes Monte Carlo simulation by the issuer of the instrument. If conversion terms are such that there are floors and caps, there is effectively more than one embedded derivative.

Most seed, early stage and growth funding by venture capitalists/private equity investors have special rights attached to the instruments used for funding, e.g., liquidation preference, anti-dilution and/or down round protection rights. The contractual waterfall among investors needs to be built in the option pricing model to arrive at the differential value of each instrument and correct equity share value for ESOP accounting. Further, down-round protection rights provided to investors could result in the need to classify certain instruments that would otherwise be classified as equity, as liability.

The key assumptions that impact the derivative value, apart from the exercise price and the spot price, would be volatility, period of conversion or liquidation event, dividend yield and currency choice for determining risk free rate.

Given the complexities in the accounting and valuation of financial instruments, it is recommended to seek expert advice.
Accounting for employee share-based payments
Share-based payment awards are common features of employee remuneration for directors, senior executives and other employees. The objective of such awards is to incentivize employees and non-employees to encourage them to contribute to the overall growth of the company. The introduction of Ind AS 102 Share-based Payment brings about a significant change in the recognition and measurement principles for share-based payment transactions entered into by corporates. An overview of the significant aspects of Ind AS 102 is as below:

- The accounting treatment prescribed under Ind AS 102 is based on the fair value of the underlying instruments. Therefore, the option of using the intrinsic value method in the Guidance Note on Accounting for Employee Share-based Payments (Guidance Note) will no longer be available except in extremely rare cases wherein the entity may be unable to estimate reliably the fair value of the equity instruments granted at the measurement date.

- Under previous GAAP, a subsidiary normally did not account for ESOPs issued to its employees by its parent entity since it did not have any settlement obligation. However, in view of lack of specific guidance, diverse accounting practices were being followed. Under Ind AS 102, such ESOPs will have to be accounted for as per principles laid down in Ind AS 102, i.e., either as equity-settled or as cash-settled plans, depending on the specific criteria. As per Ind AS 102, a receiving entity whose employees are being provided ESOP benefits by a parent will have to account for the charge. This will reflect the true compensation cost of receiving employee benefits.

- Ind AS 102 provides accounting principles for new equity instruments granted as replacement equity instruments for the cancelled equity instruments. Further, acquirers in a business combination often exchange share-based payment awards (i.e., replacement awards) for awards held by employees of the acquired business. These exchanges frequently occur because the acquirer wants to avoid having non-controlling interests
in the acquiree and/or to motivate former employees of the acquiree to contribute to the overall results of the combined, post-acquisition business.

Under Ind AS 102, costs with respect to awards granted with graded vesting will have to be recognized on an accelerated basis, which could have been recognized on a straight-line basis under previous GAAP. If the stock options are supposed to vest in a graded manner over the terms of the option, then the company may end up recording higher costs in the initial years, which will decline over the years in a progressive manner.

Given below are the key areas that will have a significant impact on companies and will require wider use of fair valuation:

1. **Fair value considerations**

   The adoption of Ind AS 102, while providing a fair measure of employee share awards, leads to an increase in the cost for the company at the time of recognition, as the fair value, which incorporates the value of the optionality for the holder, is almost always likely to be higher than the intrinsic value. For instance, an ESOP issued by a company at its current share price would be cost-free to the company as per the intrinsic value method (as the vesting price would equal the current price); however, under option pricing methods such as Black Scholes or Binomial, the fair value of these ESOPs would be more than the intrinsic value, and the company would have to recognize the costs.

   The intrinsic value method, as permitted under previous GAAP, does not factor in option and time value when determining compensation cost. Fair valuation will increase the charges for ESOPs for many companies, and will have a significant impact on key indicators such as earnings per share.

2. **Share-based payments to non-employees**

   Corporates often enter into partnership agreements with their suppliers to provide them with opportunities of sharing profits of a particular venture by offering them share-based payments. This mode of payment is considered as an incentive tool intended to encourage improved efficiency and quality of work from vendors. For example, if an external supplier of goods or services is paid in shares, share options or cash based on the price (or value) of shares or other equity instruments of the entity, Ind AS 102 must be applied.

   Under Ind AS 102, an entity will have to account for such benefits under the fair value method. Under previous GAAP, there was no specific guidance for such benefits to non-employees and there was diversity in practices being followed by different entities. The specific guidance in Ind AS 102 will ensure consistency and also result in a mandatory charge to the statement of profit and loss.

3. **Group share-based payment plans**

   It is common practice for a group to operate a single share scheme covering several subsidiaries. A parent might decide to grant equity-settled awards to employees of its subsidiary. The subsidiary must account for the services received from its employees as an equity-settled award in its own financial statements. A subsidiary might grant its employees rights to equity instruments of the parent. The subsidiary accounts for the transaction with its employees as cash-settled. This applies irrespective of how a subsidiary obtains the equity instruments to satisfy its obligation to its employees. Ind AS 102 considers arrangements in which the parent has an obligation to make cash payments to the employees of a subsidiary that are linked to the price of either the subsidiary’s equity instruments or its own equity instruments. In both cases, the subsidiary has no obligation to settle the transaction. Therefore, the subsidiary accounts for the transaction as equity-settled, recognizing a corresponding credit in equity as a contribution from its parent. Such accounting will reflect the true compensation cost of receiving employee benefits. Exchanges of share-based payment awards issued in a business combination

   Ind AS 103 addresses the accounting treatment required in a business combination in which an acquirer either replaces acquiree awards mandatorily or voluntarily, even if the acquiree awards would not expire as a consequence of the business combination, or does not replace acquiree awards.

   If the acquirer is obliged to issue replacement awards in exchange for acquiree share-based payment awards held by employees of the acquiree, then all or a portion of the market-based measure of the acquirer’s replacement awards are treated as part of the consideration transferred by the acquirer. The effect will be to increase goodwill and recognize a corresponding amount in equity. The acquirer is considered to have an obligation if the employees or the acquiree can enforce replacement. Such an obligation may arise from the terms of the acquisition agreement, the terms of the acquiree’s award scheme or legislation.

4. **Extensive disclosures**

   Ind AS 102 requires detailed disclosures for stock option plans. The key disclosures include:
Embedding fair value in financial reporting

Key challenges/learnings

The changes brought in by Ind AS 102 are likely to have a significant impact on the financial statements of the companies adopting Ind AS and will require wider use of fair valuation. Some of the challenges are summarized as below:

1. Valuation of options

Ind AS 102 essentially requires the determination of the fair value of the options (as against the share in the intrinsic value method) and recording of such costs over the vesting period of such options with the employees. This method inherently assumes that every option has a value and its fair value should be accounted for through the statement of profit and loss. A key challenge in the adoption of Ind AS 102 is fair valuation of the share options – intrinsic value is no longer permitted. It may be noted that Ind AS 102 uses the term “fair value” in a way that differs in some respects from the definition of fair value in Ind AS 113 Fair Value Measurement. Therefore, when applying Ind AS 102, an entity measures fair value in accordance with Ind AS 102 and not Ind AS 113.

The valuation of ESOPs for unlisted companies, including private companies, is much more subjective than for listed companies. In case of listed companies, the market price of the share and the volatility of the share are objectively measurable. However, for unlisted companies, these are subjective inputs and need to be estimated. Companies will require the assistance of valuation experts to arrive at the correct valuation at the grant date and for subsequent measurement.

If the stock option award scheme is linked to multiple variables (e.g., continuity of service, achievement of targets and future stock price), then determining the fair value of such options may require the use of complex valuation models. This will further necessitate the use of valuation experts.

There are various well-established valuation models available to estimate the fair value of share options. Appendix B to Ind AS 102 refers to the Black-Scholes-Merton and binomial models as two acceptable methods that entities might use when estimating the fair value of employee share options. Entities should also consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply. In the process of estimating the fair value of a share option, despite the valuation model adopted, a minimum of six inputs (expected life, current share value, exercise price, expected volatility, expected dividend yield and risk-free interest rate) have to be taken into consideration.

The growing complexity of share option awards calls for more advanced valuation models and techniques. Besides the Black-Scholes-Merton and binomial tree models, valuation specialists have also adopted other models such the trinomial tree model, finite difference method and Monte Carlo simulation method for heavily structured share options.

2. Voluminous disclosures

There are extensive disclosure requirements under Ind AS 102, including the valuation method used to estimate the fair value of the awards including the following:

- The type and scope of agreements existing during the reporting period
- Descriptions of each type of arrangement, including general terms and conditions of the arrangement (e.g., settlement methods and vesting conditions)
- The number and weighted-average exercise price of share options (outstanding at the beginning of the reporting period and at the end of the reporting period, granted, vested, exercised, expired and forfeited during the period)
- The valuation method used to estimate the fair value of the awards (model and input values etc.)

All companies using share-based arrangements will be required to carefully analyze and evaluate the terms of its arrangement with its employees and its non-employees on its financial statements as well as related disclosures.
First-time adoption considerations
Ind AS 101 First-time Adoption of Indian Accounting Standards prescribes the accounting principles for first-time adoption of Ind AS. It lays down various “transition requirements for when a company adopts Ind AS for the first time, i.e., a move from Accounting Standards (previous GAAP) to Ind AS. Conceptually, the accounting under Ind AS should be applied retrospectively at the time of transition to Ind AS. To ease the process of transition, Ind AS 101 provides certain solutions in overcoming practical difficulties in applying Ind AS for the first time. Ind AS 101 provides the basis on which an entity will convert its previous financial statements to Ind AS. It prescribes ground rules and accounting policies to be followed in an entity’s first set of Ind AS financial statements, and in preparation of its opening Ind AS balance sheet. The key features of Ind AS 101 are as follows:

- Ind AS 101 defines the previous GAAP as the basis of accounting that a first-time adopter used for its reporting requirements in India immediately before adopting Ind AS.
- Ind AS 101 establishes exceptions and exemptions from retrospective application of Ind AS. The exceptions are mandatory in nature (i.e., cases where the company is not allowed to apply Ind AS retrospectively) and exemptions are voluntary in nature (i.e., the company may elect not to apply certain requirements of Ind AS retrospectively). Entities must evaluate which exemptions (voluntary) are relevant and may lead to the best outcome for the company.
- Ind AS 101 is very much a rule-based standard. The exceptions given and exceptions provided are applicable only to the specific items and cannot be applied by analogy to any other item.
- Ind AS 101 also prescribes presentation and disclosure requirements to explain the transition to the users of financial statements, including explanation on how the transition from previous GAAP to Ind AS affected the company’s financial position, financial performance and cash flows. Ind AS 101 does not provide any exemption from the disclosure requirements in other Ind AS.
- An entity that presents its first Ind AS financial statements is a first-
time adopter and should apply Ind AS 101 in preparing those financial statements. It should also apply Ind AS 101 in each interim financial report that it presents in accordance with Ind AS 34 Interim Financial Reporting for a part of the period covered by its first Ind AS financial statements.

An overview of the key first-time adoption considerations prescribed under Ind AS 101 that permit fair valuation is as below:

1. Deemed cost

To deal with practical issues in the retrospective restatement, Ind AS 101 permits a first-time adopter to measure items of PPE at deemed cost at the date of transition to Ind AS, which could be either of the following:

- Use of fair valuation or revaluation as deemed cost
  Under this approach, a company may choose to fair value land or any other item of PPE having a higher fair value, which could result in increased net worth or assets having a lower fair value to reduce potential impairment charge. However, it would also have a consequential impact on the earnings by way of higher amortization or impairment charge.
  In case of non-depreciable assets such as land, there will be no impact on future profits/losses by way of amortization but there can be possible impairment charge (as in the case of other depreciable assets).
- Event-driven fair value measurement as deemed cost:
  A first-time adopter may have established a deemed cost in accordance with previous GAAP for some or all of its assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatization or initial public offering. Such date could be at or before the date of transition to Ind AS or after the date of transition to Ind AS. This approach/exemption may be applied selectively to some or all assets and liabilities of a first-time adopter.
  Previous GAAP carrying value as deemed cost: A first-time adopter may opt to continue with the carrying value for all of its PPE as recognized in its previous GAAP financial statements and use that as its deemed cost at the transition date subject to compliance with specified conditions.

2. Business combination

Another significant exemption in Ind AS 101 is exemption to a first-time adopter from restating business combinations prior to its date of transition to Ind AS. Retrospective application of Ind AS 103 to past business combinations may not be practical in all cases. Consider a situation wherein a company acquired a subsidiary almost 10 years back. Under previous GAAP, the company recognized the assets and liabilities of the subsidiary at book value. To apply Ind AS 103 retrospectively, the parent company will need to go back in the history and determine the acquisition date fair values of assets and liabilities of the subsidiary. Considering the long period of time, this may be impractical.
  If a company elects the exemption to apply Ind AS 103 Business Combinations prospectively, there are clearly significantly less efforts involved because the entity will not be required to get retrospective fair valuation done for identifiable assets acquired and liabilities assumed and can largely continue with accounting done under the previous GAAP. However, consider that an entity has made a substantial business combination in the recent past years, which resulted in considerable goodwill because it was required to recognize assets and liabilities acquired at book value under the previous GAAP. In this case, retrospective application of Ind AS 103 will give the entity an opportunity to present the true worth of the acquisition and reduce the amount of goodwill. Retaining goodwill at a substantial amount can cause significant volatility in the statement of profit and loss because of impairment.
  Business combinations occurring after the date of transition, if any, must be accounted for under Ind AS 103, i.e., any business combinations during the comparative periods need to be restated in accordance with Ind AS. However, if an entity opts for retrospective fair valuation for a particular past acquisition, it would have to restate all combinations after that acquisition.

3. Financial instruments

Ind AS accounting for financial instruments is complex and requires exercise of significant judgements/estimate. In most case, companies may not have collected necessary information to apply Ind AS accounting retrospectively. To ease the transition, Ind AS 101 specifies voluntary exemptions and mandatory exceptions related to financial instruments accounting. Voluntary exemptions include:

- Ind AS 101 exempts a first-time adopter from separating compound financial instruments into liability and equity as required by Ind AS 32 Financial Instruments: Presentation if the liability component is no longer outstanding at the date of transition to Ind AS.
- Designation of financial asset as at fair value through profit or loss: An entity may designate a financial asset measured at fair value
through profit or loss in accordance with Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind AS. An entity exercising this exemption needs to make certain additional disclosures, i.e., fair value of financial assets so designated at the date of transition and their classification and carrying amount in the previous financial statements.

Designation of investment in equity instruments at fair value through OCI: An entity may make an irrevocable election to designate an investment in an equity instrument at fair value through OCI in accordance with Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind AS. It requires such election to be made on initial recognition and it cannot be changed subsequently. Mandatory exceptions include the following:

- A first-time adopter should apply the derecognition requirements in Ind AS 109 Financial Instruments prospectively for transactions occurring on or after the date of transition to Ind AS. However, an entity may apply the derecognition requirements in Ind AS 109 retrospectively from a date of the entity’s choosing, provided that the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognized as a result of past transactions was obtained at the time of initially accounting for those transactions.
- As regards hedge accounting, an entity should not reflect in its opening Ind AS balance sheet a hedging relationship of a type that does not qualify for hedge accounting in accordance with Ind AS 109. If an entity had designated a transaction as a hedge before the date of transition to Ind AS but the hedge does not meet the conditions for hedge accounting in Ind AS 109, the entity should discontinue hedge accounting. Transactions entered into before the date of transition to Ind AS should not be retrospectively designated as hedges.
- Entities are required to assess whether a financial asset meets the conditions for classifying a financial asset as measured at amortized cost or at fair value through OCI on the basis of the facts and circumstances that exist at the date of transition to Ind AS.
- The impairment requirements of Ind AS 109 are required to be applied retrospectively.

- Ind AS 109 does not permit embedded derivatives to be separated from host contracts that are financial assets. Rather, an entity applies Ind AS 109 classification requirements to the entire hybrid contract. However, Ind AS 101 requires a first-time adopter to assess whether an embedded derivative should be separated from the host contract (which is not a financial asset) and accounted for as a derivative based on conditions that existed at the later of the date it first became a party to the contract or the date a reassessment is required by Ind AS 109.
- A first-time adopter should not recognize the corresponding benefit of the government loan at a below-market rate of interest as a government grant. However, if the information needed to retrospectively apply Ind AS 109 and Ind AS 20 to this transaction had been obtained at the time of initially accounting for that loan, then an entity is allowed to retrospectively apply the requirements in Ind AS 109 and Ind AS 20 to any government loan originated before the date of transition to Ind AS.

According to a recent study by EY titled “Ind AS transition - Journey of Indian Corporates” carried out to analyze and evaluate the first-time Ind AS results of BSE top 100 companies:

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<th>INR43,900 crore</th>
<th>INR68,600 crore</th>
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<td>increase in net worth of 3 companies due to fair value of PPE</td>
<td>increase in net worth of 2 companies due to fair value of investments in group companies</td>
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<th>INR26,600 crore</th>
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<td>decrease in net worth of 4 companies due to fair value of PPE</td>
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<th>INR630 crore</th>
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<tr>
<td>decrease in net worth of 1 company due to fair value of investment in group companies</td>
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</table>
Key learnings/challenges till date

The exemptions/exceptions specified in Ind AS 101 are likely to impact most of the company in different ways and will require wider use of fair valuation. The key consideration that could be evaluated by the entity could be any or all of the following:

1. Selection of accounting policies

Under Ind AS, it is necessary to make certain accounting policy choices, and the choices can have a significant impact on an entity’s financial results and the processes that support financial reporting. For example, is it more appropriate to recognize property, plant and equipment (PPE) at cost or at fair value? How to obtain the fair value as defined in Ind AS 113 Fair Value Measurements?

2. Deemed cost exemption –

Retrospective application of Ind AS 16 and Ind AS 38

Full retrospective application of Ind AS 16 Property, Plant and Equipment and Ind AS 38 Intangible assets to the items of PPE and intangible assets could be quite onerous as these items are long-lived asset, which means that accounting records for the period of acquisition may not be available anymore. If a company want to choose fair valuation or revaluation as the deemed cost, it would require careful evaluation as to which assets should be measured at fair value (e.g., non-depreciable assets like land) or whether it be appropriate to use previous GAAP carrying amount for all the PPE under the deemed cost exemption. With regard to deemed cost, Ind AS 101 provides an option to continue with the carrying value for all of its PPE measured as per previous GAAP and use that as the deemed cost on the date of transition.

Typically, there is a significant upside in land when fair valued if it was acquired long ago. Also, this is without any impact on future depreciation (unless it is a leasehold land). Hence choosing the fair value option for freehold land could increase the net worth without impact on future earnings per share (EPS). The key impacts of upward valuation of land are as below:

- Higher depreciation in future periods except for freehold land
- Recognition of deferred tax liability
- Potential impairment losses in future period

Not opting for upward fair valuation may lead to higher profit on disposal of assets in the future (particularly in case of leasehold land). In case of buildings and plant and machinery in conventional sectors that are not majorly sensitive to technological change, the fair values would typically be higher than book values but with a corresponding impact on future depreciation. In technology-sensitive sectors, fair value of plant and machinery typically gives a downward adjustment. The downward valuation may result in:

- Lower depreciation in future periods
- Lower risk of future impairment
- Recognition of deferred tax assets

Companies should consider alternative uses of an asset in their determination of fair value. A company’s current or intended use of a non-financial asset might not be the highest and best use of the asset, and thus does not determine its premise of value. Instead, the highest and best use of the asset (or asset group) should be determined based on how market participants would maximize the asset’s value. For example, market participants may maximize the value of land, currently used as a site for a manufacturing facility, by using it for residential housing instead. However, companies should have evidence to support an assumption that market participants would use the asset in this manner.

3. Business combinations

Fair value measurement of assets acquired and liabilities assumed is complex. An entity should set up processes and systems to capture data for business combinations. It would require a detailed evaluation as to whether retrospective application of Ind AS 103 will give the entity an opportunity to present the true net worth of the acquisition. For detailed discussion, refer the chapter on “business combinations.”

4. Investments in subsidiaries, jointly controlled entities and associates in separate financial statements

In the preparation of separate financial statements, Ind AS 27 Separate Financial Statements requires an entity to account for its investments in subsidiaries, jointly controlled entities and associates either (a) at cost or (b) in accordance with Ind AS 109.

If a first-time adopter measures such an investment at cost, it can measure that investment at one of the following amounts in its separate opening Ind AS balance sheet:

- Cost determined in accordance with Ind AS 27
- Deemed cost defined as either fair value determined in accordance with Ind AS 113 at the date of transition to Ind AS or previous GAAP carrying amount at the transition date
Therefore, a first-time adopter may choose to use either of these bases to measure investment in each subsidiary, jointly controlled entities or associate where it elects to use a deemed cost.

The choice of fair value can give an upside in case of investments that have been performing well. In case the management believes that there could be potential indicators of impairment in the future and the previous GAAP values could themselves be at risk, it may opt for the fair value option. This could have a downward impact on the net worth directly but may insulate EPS from any adverse impact in the future. However, consultation with auditors beforehand is important to ascertain if it is not inconsistent with positions taken in the past under previous GAAP.

5. Fair valuation of a liability

In most instances, a quoted price for the liability being measured will not be available as liabilities are generally not transferred. In the absence of a quoted price for an identical or similar liability, the fair value of the liability should be measured from the perspective of a market participant that holds the identical instrument as an asset at the measurement date. This approach applies even when the identical item held as an asset is not traded. As with all fair value measurements, inputs used to determine the fair value of a liability from the perspective of a market participant that holds the identical instrument as an asset must be prioritized in accordance with the fair value hierarchy. When a quoted price for the transfer of an identical or a similar liability or entity’s own equity instrument is not available and the identical item is not held by another party as an asset, an entity should measure the fair value of the liability or equity instrument using a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity.

As per Ind AS 113, an entity should use valuation techniques that are appropriate in the circumstances and for which sufficient data is available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. Three widely used valuation techniques are the market approach, the cost approach and the income approach.
PPE, investment property, intangible assets, impairment and leases
Under Ind AS, there are various standards that prescribe accounting for assets. Some of the important ones include Ind AS 16 Property, Plant and Equipment, which deals with accounting for tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and are expected to be used during more than one period; Ind AS 38 Intangible Assets, which is applied in accounting for intangible assets; Ind AS 40 Investment Property, which is applied in the recognition, measurement and disclosure of investment property; Ind AS 36 Impairment of Assets, which prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount; and Ind AS 17 Leases, which prescribes accounting for agreements that transfer the right to use assets.

While Ind AS 16 and 38 give an option to account the PPE and intangible assets at fair value at periodic intervals, Ind AS 40 mandates fair value of investment property only for disclosures, Ind AS 17 mandates fair value at initial recognition of finance leases and Ind AS 36 considers fair value for testing assets for impairment.

The following are the key aspects of these standards:

- Ind AS 16 permits the revaluation model for subsequent measurement. If an asset is revalued, Ind AS 16 mandates revaluation to be done for the entire class of PPE to which that asset belongs and the revaluation to be updated periodically. Ind AS 38 is on similar lines, except that the revaluation model is allowed for an intangible asset provided an active market exists.

- Ind AS 16 mandates component accounting, which involves identifying components of assets that have a significant cost in comparison to the cost of the main/mother assets and also have materially different useful lives from the main asset or other major components. Identification of the significant part is a matter of judgment and needs to be decided on a case-to-case basis. Further, major repairs and overhaul expenditure are capitalized as replacement costs if...
they satisfy the recognition criteria.

- Ind AS 40 mandates disclosure of fair value of all investment properties.

- Ind AS 36 requires impairment to be tested based on the higher of fair value less cost to sell and value in use. For estimating the fair value, a market participant’s ability to generate economic benefits by using the asset in its highest and best use must be taken into account. The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible. Also, a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market for the asset or liability, or in the absence of a principal market, in the most advantageous market for the asset or liability. Many a times, it is difficult to find the principal market for assets.

- Ind AS 17 requires lessees to recognize finance leases as assets and liabilities in their balance sheets at lower of the fair value of the leased property or the present value of the minimum lease payments.

- Ind AS 17 explicitly requires that the land and buildings elements of leases be considered separately for the purpose of lease classification. Each part must be classified as an operating or finance lease in the same way as leases of other assets. If either or both parts of the lease comprise a finance lease, the minimum lease payments need to be allocated between the land and buildings elements in proportion to the respective fair values of the leasehold interest in the land and buildings elements at the inception of the lease. If it is difficult to allocate the payments between the two elements, then the entire lease may be classified as a finance lease unless it is obvious that both the land and buildings elements are operating leases.

**Key learnings/challenges**

The key learnings/challenges arising from the change in the accounting principles are summarized below:

1. **Revaluation model**
   a. **Class of PPE**

   Ind AS 16 allows an entity to choose either the cost model or the revaluation model as its accounting policy. The said accounting policy is required to be applied to an entire class of PPE, i.e., if an item of PPE is revalued, the entire class of PPE to which that asset belongs will have to be revalued. A class of PPE is a grouping of assets of a similar nature and use in an entity’s operations. Examples of separate classes include land, buildings, machinery, ships, aircraft, motor vehicles, furniture and fixtures, office equipment, bearer plants, data processing equipment, computers and software.

   These are very broad categories of PPE, and it is possible for them to be classified further into sub-group of assets of a similar nature and use. Office buildings and factories or hotels and fitness centers could be separate classes of asset. If the entity used the same type of asset in different geographical locations, e.g., clothing manufacturing facilities for similar products or products with similar markets in Sri Lanka and Guatemala, it is likely that these would be seen as part of the same class of asset. However, if the entity manufactured pharmaceuticals and clothing, both in European facilities, then few would argue that these could be assets with a sufficiently different nature and use to be a separate class. Ultimately, it must be a matter of judgement in the context of the specific operations of individual entities.

   Hence, companies cannot apply the revaluation model selectively to assets. Assets installed at different geographical locations but of a similar nature and use must also follow the same accounting policy. This is an issue especially in case of consolidated financial statements. All entities within a group have to follow uniform accounting policies. Hence, all assets with similar nature and use, irrespective of the legal entity they are controlled by, must follow same accounting policy in the consolidated financial statements.

   b. **Frequency of valuation**

   It is believed that the value of land may change frequently. However, the value of other assets may not change as frequently unless there is some change in technology or external environmental circumstances that may have an impact on values. Ind AS 16 requires revaluations to be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. Hence, entities may have to decide...
Embedding fair value in financial reporting

1. Frequency of revaluation for class of assets
   The frequency of revaluation for class of assets, which may differ from one class of asset to another.

2. Fair value of investment property
   Ind AS 40 mandates disclosure of the fair value of an investment property. Generally, it is difficult to determine the fair value of an investment property based on current prices in an active market. Accordingly, it may have to be estimated using other valuation techniques, such as discounted cash flow projections. If fair value is estimated using discounted cash flow projections, care is needed to ensure that the projections reflect the asset's highest and best use, i.e., commercial, residential, agricultural etc. Also, generally it is assumed that the current use of the property is the best use. For example, if an entity rents out a property, it is the best use of the property. However, companies will have to identify the highest and best use of a property whose future use is undetermined.

   Sometimes, an item may need to be grouped with others for the purpose of measuring fair value, i.e., the valuation premise may differ from the unit of account. For example, an entity may own an investment property that is attached to land and contains other assets, such as fixtures and fittings. The unit of account for the investment property would likely be the standalone asset in accordance with Ind AS 40. However, the value of this asset on a standalone basis may have little meaning as it is physically attached to the land and derives its benefit in combination with the fixtures and fittings in the building. Therefore, when determining fair value, the valuation premise would likely reflect its use in combination with other assets.

3. Active market for intangible assets
   An entity can apply the revaluation model for an intangible asset only if the fair value can be determined by reference to an active market. An active market is defined in IFRS 13 as one in which transactions for the item take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

   Few intangible assets will be eligible for revaluation, and indeed the standard concedes that such an active market would be uncommon. Nevertheless, in some jurisdictions, an active market may exist for freely transferable taxi licenses, fishing licenses or production quotas. However, by their very nature, most intangible assets are unique or entity-specific. The standard lists brands, newspaper mastheads, music and film publishing rights, patents and trademarks as items that are ineligible for revaluation because each such asset is unique. The existence of a previous sale and purchase transaction is not sufficient evidence for the market to be regarded as active because each such asset is unique. The standard notes that where contracts are negotiated between individual buyers and sellers or when transactions are relatively infrequent, the price of a previous transaction for one intangible asset may not provide sufficient evidence of the fair value of another. In addition, if prices are not available to the public, this is taken as evidence that an active market does not exist.

4. Fair value of land
   Land is considered to be an asset whose value increases over time. Hence, companies in India revalue their land to bring the current value in the books. Generally, the value of land is determined by using the transaction prices/asking prices of comparable land parcels in the surrounding area, adjusted for factors such as location, accessibility, frontage, size and developed/undeveloped land condition around the measurement date. Government stamp duty reckoner rates may also be considered as one of the inputs to determine the fair value of land in some cases. However, there are various factors that an entity must consider in valuing its land parcels, some of which are mentioned below:

   ▶ Legal use

   The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible. To be legally permissible, the standard indicates that the use of a non-financial asset need not be legal (or have legal approval) at the measurement date, but it must not be legally prohibited in the jurisdiction. For example, if the Government has prohibited building on or developing certain land (i.e., the land is a protected area), for an entity to develop the land, a change of law would be required. As the development of this land would be illegal, it cannot
be the highest and best use of the land. Alternatively, if a land has been zoned for commercial use but nearby areas have recently been developed for residential use, and therefore market participants would consider residential development as a potential use of the land, this alternative use could be deemed to be legally permissible as re-zoning the land for residential development would only require approval from an authority and that approval is usually given.

- Restriction on use

Ind AS 113 indicates that the effect on fair value of a restriction on the sale or use of an asset will differ depending on whether the restriction is deemed to be a characteristic of the asset or the entity holding the asset. A restriction that would transfer with the asset in an assumed sale would generally be deemed a characteristic of the asset and therefore would likely be considered by market participants in pricing the asset. Conversely, a restriction that is specific to the entity holding the asset would not transfer with the asset in an assumed sale and therefore would not be considered when measuring fair value. Determining whether a restriction is a characteristic of the asset or of the entity holding the asset may be contractual in some cases. In other cases, this determination may require judgement based on the specific facts and circumstances.

- Significant upside in value with no impact on depreciation

Real estate in India has been generally witnessing a strong inflation over the past few decades, with the value increasing in multiples over this period. This led to a significant upside in the revaluation of real estate in India, except for the past few years where the prices have somewhat stabilized in a few locations. The recent compensation rules for acquisition of large land parcels as per the Land Acquisition Act 2013 have only added to the inflationary trend of land prices, especially in rural areas. Thus, the revaluation of land in any part of India generally yields a significantly higher land value as compared to the book values of older land parcels. This helps in recording the land assets at a higher value of land, which is marked to the market with no consequent impact on depreciation for freehold land parcels. However, in case of leasehold land parcels, the higher value of land can lead to higher amortization charge on a yearly basis.
Way forward
Adoption of Ind AS would involve extensive use of fair valuation. As discussed earlier in this publication, it would not only affect the financial reporting, but also have an impact on the business decisions. Hence, companies will have to plan the implementation of fair valuation well in order to avoid unintended consequences. Below are a few steps that may assist companies in smooth implementation of fair valuation:

1. **Accessing fair valuation experts**
   
   Adoption of Ind AS may change the way contracts are structured and negotiated. Managing the impact of this change and the consequences to the business requires advance planning and potentially involves a variety of experts such as accountants, lawyers and valuation professionals. Most companies may not have the depth of expertise in valuation and may need to consider whether the expertise can be developed in-house or whether it will need to be sourced externally. Further, different valuation experts may be required for different assets such as property, financial instruments, plant and machinery, and furniture and fixtures.

2. **Developing fair value methodology**
   
   Listed price may not be available for all assets and liabilities. Hence, fair valuation will have to be done considering various internal and external factors related to functional and economic aspects such as physical characteristics, highest and best use, technological changes and market condition. Fair valuation may get complicated for certain items given the specific challenges around limited availability of relevant and reliable market data in the Indian market, varying legal norms and disparities in actual transacted market rates across cities and states. Given these complexities and challenges, it is critical to develop a methodology for fair valuation of various assets and liabilities, and follow it consistently.

3. **Creating strong internal controls**
   
   Fair valuation may be subjective at times and hence may be subject to misuse. Though Ind AS 113 Fair Value Measurement requires extensive disclosures when management estimates are used, entities may have
their own internal controls to check on such estimates. Any significant changes in estimates may make the income statement volatile and may also have an effect on the confidence of investors and other stakeholders. Hence, it is important for entities to have strong internal controls for measuring fair values of assets and liabilities.

4. Planning fair valuation

Some potential transactions may require additional planning and resource allocation, especially in the case of a business combination. It is always better if potential acquirers undertake a pre-purchase price allocation exercise before bidding so that they get an early indication of whether the acquisition could be EPS accretive from day 1. Similarly, companies may also be required to relook at their investment agreements and the terms and conditions of instruments such as preference shares and debentures to avoid the undesirable impact of accounting for these instruments. Further, there would be income tax (MAT) impacts that entities would like to consider based on whether the fair valuation is accounted for in the OCI or in the statement of profit and loss.

5. Managing disclosures

Ind AS 113 requires extensive fair valuation disclosures, which increase with increase in the use of unobservable inputs for fair valuation. Further, there are other standards such as Ind AS 40 Investment Property that require entities to disclose the fair value but not account for it. These disclosures would have to be consistent year-on-year and hence entities may want to develop manuals to manage them.
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