Ratings

CRISIL
An S&P Global Company

Ind AS impact

Financial statements to undergo changes, but no major rating or criteria changes foreseen since fundamentals remain the same

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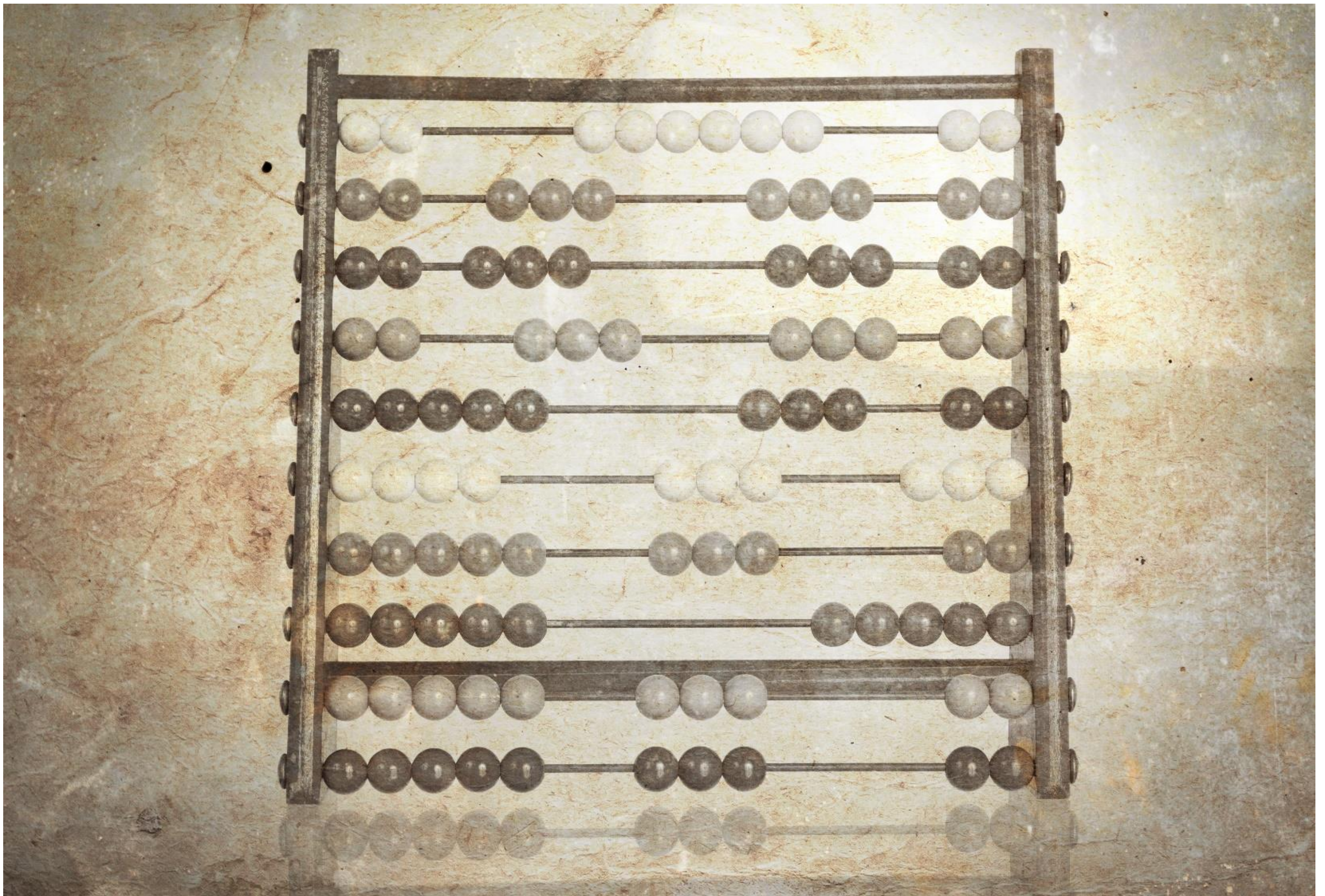

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Executive summary

On Feb 15, 2015, the Ministry of Corporate Affairs, in consultation with the National Advisory Committee on Accounting Standards, notified the Companies (Indian Accounting Standards) Rules, 2015, laying down the roadmap for the implementation of Indian Accounting Standards.

Apart from better disclosures, revised accounting standards will bring financial statements closer to economic reality. It will also ensure comparability between financial statements in line with global standards, and improve the ability of Indian companies to access funds abroad.

The reported financials of CRISIL rated companies migrating to revised accounting standards are likely to undergo significant changes and make comparability with financial statements under Indian GAAP difficult.

Most of the changes occurring in the financial statements of companies rated by CRISIL will be on account of changes in reported net worth (because of fair valuation of assets), liabilities and financial instruments, deferred taxes and employee stock options.

The reported profitability number would be more volatile because of changes in fair valuation of derivatives and financial instruments (including equity, debt and foreign currency loan obligations), amortisation of goodwill, and reclassification of actuarial gains/losses.

Companies in sectors such as capital goods, infrastructure, retail, IT services and auto ancillaries are more likely to be impacted than others on account of revised accounting standards.

The revised accounting standards are unlikely to have a material impact on the business fundamentals and hence the underlying cash flows and economic risks of these companies remain unaffected.

CRISIL's rating criteria focuses on the cash flow generating ability of companies so as to assess their ability to fulfil repayment obligations. As part of its analytical approach, rather than relying on audited financial statements, CRISIL has always made adequate analytical adjustments to reflect accurate financial position. Hence no major changes are envisaged in the outstanding ratings or the existing criteria framework on account of the revision in accounting standards.

Background

As per the guidelines issued by the Ministry of Corporate Affairs, the migration to Indian Accounting Standards shall be done in a phased manner. Under Phase I, all companies (listed and unlisted) having a standalone net worth greater than, or equal to, Rs 500 crore as on March 31, 2014, will have to adopt the revised accounting standards. For these companies, 2016-17 will be the first year of adoption and the financials of 2015-16 will be published as a comparative under the revised accounting standards.

Under Phase II, the implementation of revised accounting standards will be applicable to all listed entities irrespective of their net worth. These guidelines are also applicable to unlisted companies having a standalone net worth greater than, or equal to, Rs 250 crore as on March 31, 2014. For companies under Phase II of Ind AS migration, 2017-18 will be the first year of adoption. Banks, NBFCs and insurance companies will also migrate to the new standards from 2018-19 in a phased manner.

Phase-wise implementation of Ind AS

<table>
<tr><th>Particulars</th><th>Phase I</th><th>Phase II</th><th>Voluntary adoption</th></tr>
<tr><td>Year of adoption</td><td>2016-17</td><td>2017-18</td><td>2015-16 or thereafter</td></tr>
<tr><td>Comparative year</td><td>2015-16</td><td>2016-17</td><td>2014-15 or thereafter</td></tr>
<tr><td>Covered companies</td><td></td><td></td><td></td></tr>
<tr><td>a) Listed companies</td><td>All companies with net worth equal to, or more than,
Rs 500 crore</td><td>All listed companies, and those in the process of getting listed</td><td rowspan="2">Any company could voluntarily adopt Ind AS</td></tr>
<tr><td>b) Unlisted companies</td><td>All companies with net worth equal to, or more than, Rs 500 crore</td><td>Companies having a net worth equal to, or more than Rs 250 crore</td></tr>
<tr><td>c) Group companies</td><td colspan="3">Applicable to holding, subsidiaries, joint ventures, or associates of companies covered in (a) & (b) above</td></tr>
</table>

CRISIL has outstanding ratings on 327 companies that have reported net worth of Rs 500 crore or more as on March 31, 2014. These companies will come under the Phase I implementation plan of revised accounting standards. Of these 327 entities, there are 141 listed entities that will report their first-quarter financials as per Ind AS.

Revised standards will improve the quality of financial reporting

The adoption of Ind AS is a welcome change and will play a key role in enhancing the comparability of financial statements of Indian companies with global standards. It will improve the quality of financial reporting and bring financial statements closer to economic reality. For instance, under the revised accounting standards the following changes will have a positive influence in boosting stakeholder confidence.

- Revenue recognition norms for multiple deliverable elements in a sales contract that will ensure judicious allocation of revenues among separate deliverable sales obligations and will prevent up-fronting of revenue.

- Better disclosures in financial statements such as
  - Comprehensive guidelines to be followed on consolidation of companies, joint ventures, etc
  - Details on key operating segments in line with internal reporting practices of a company as against the earlier practice of reporting segmental information on business verticals or geographical segmentation.
  - Information on customer concentration, sensitivity to key risk, expected credit loss etc in the financial statements.

CRISIL believes these changes will provide better insights on companies and will facilitate the benchmarking of the financials of Indian companies with global peers, thereby improving the accessibility of Indian companies to foreign funding.

Impact of Ind AS

The reported financial statements of companies are likely to undergo significant changes. This will make the comparability between financials under revised accounting standards and those under Indian GAAP difficult.

There are a large number of companies which do not come under the purview of Ind AS. Hence comparability of financials of these companies with those that adopt Ind AS will be difficult.

Further the comparability will vary from company to company and depend upon the extent of disclosures provided for reconciliation of financial statements under Ind AS with those under Indian GAAP.

Areas of impact

The Ind AS standards cover all aspects of financial statements. CRISIL believes the financial statements of a majority of companies it rates would be affected because of the following changes:

- Revenue recognition norms
- Changes in networth on account of fair valuation of instruments, property and acquired entities
- Treatment of intangible assets and goodwill
- Guidelines on consolidation of financial statements - *changes from the proportionate consolidation method for joint ventures to the equity method*
- Changes in P&L on account of derivatives as well as foreign currency loan obligations
- Proposed dividend and deferred tax assets
- Employee-based share payments
- Reclassification of actuarial gains and losses

Extent of impact

Though the above-mentioned areas of accounting changes are likely to affect a majority of companies, the extent of impact will largely be driven by differences in reported networth.

A CRISIL study of 80 rated companies that have reported their first-quarter results for the current fiscal as per Ind AS, shows only 8 of them have reported information on changes in networth as on March 31, 2016, under revised accounting standards. In 4 of these companies, the deviation in networth was 5% or more compared with Indian GAAP. Companies that have not provided information on networth will do so as part of their fiscal 2017 financial statements. CRISIL believes that the changes in networth are largely one-time in nature stemming from fair valuation of financial instruments, fixed assets and deferred taxes.

In some cases, the changes in networth were primarily sector-driven because the accounting system shifted from full-cost method to successful efforts method (for oil & gas), or because of hedge accounting done through cash flow hedge reserve.

CRISIL's analysis shows that there is a deviation in profitability by 5% or more for around a third of them versus Indian GAAP.[1]

[1] 15 companies out of 80 have provided reconciliation between Ind AS and Indian GAAP profit on Q1 FY17 financials. The remaining have provided reconciliation profit on Q1 FY 16. Deviations in profitability are compared between reported profit under Indian GAAP and under Ind AS.

These changes in reported profitability were largely on account of lease expenses, changes in consolidation i.e., exclusion or inclusion of entities from consolidated financial statements, recognition of gains/losses for financial instruments designated at fair value through profit and loss (FVTPL), and amortization of goodwill.

Accounting areas impacting networth and profitability

Areas of accounting change	Impact on net worth	Impact on profitability
Fair valuation of land and PPE	Significant	Low
Fair valuation of financial instruments	Significant	Moderate
Deferred taxes	Moderate	Significant
Intangible assets and goodwill	Low	Moderate
Reclassification of actuarial gains and losses	Negligible	Significant
Employee stock options	Moderate	Low
Consolidation of entities	Moderate	Moderate
Foreign currency translation	Moderate	Low

Sector-specific impact

CRISIL has analysed the companies in its portfolio and believes that following accounting changes will have a higher impact on the particular sectors.

Sector-specific impact

Areas of accounting change	Auto	IT	Pharma	Infrastructure & capital goods	Telecom	Retail
Revenue recognition	✓	✓	-	✓	✓	✓
Fair valuation of PPE	✓					✓
Fair valuation of financial instruments (networth)	✓	✓	✓	✓	✓	✓
Fair valuation of gains and losses through FVTPL	✓	✓	✓	-	✓	-
Amortisation of intangibles/ goodwill	-	✓	✓	-	-	-
Consolidation	✓	✓	✓	✓	-	-
Capitalisation of exchange differences on foreign currency loans	✓	✓	-	✓	✓	-
Reclassification of actuarial gains/losses as OCI	-	✓	✓	-	-	-
Employee stock options	✓	✓	✓	-	-	-
Capitalisation of spares/costs as fixed assets	✓	-	-	✓	-	-
Lease accounting	-	-	-	-	✓	✓
Service concession agreement	-	-	-	✓	-	-

Impact on outstanding ratings and criteria

The revised accounting standards and better disclosures will increase information availability on rated companies. The financial statements of companies migrating to the revised accounting standards will undergo significant changes especially the reported net worth and profitability numbers.

However, these will have a minimal impact on overall fundamentals. The underlying cash flows and economic risks of these entities will continue to remain unaffected by the impact of the revision in accounting standards.

CRISIL's rating framework focusses on the cash flow generating ability of companies and its adequacy in timely repayment of outstanding debt obligations. None of these factors are to be impacted due to the application of revised accounting standards.

For instance, when assessing the credit risk profiles of companies in real estate and roads construction, CRISIL uses cash flow-based debt servicing ratio as the primary tool to assess the timely repayment ability. In the construction and capital goods sectors, where working capital cycles are elongated, parameters such as gross current assets, and cash flows from operations assume primacy.

While changes or a revision in accounting standards can improve disclosures of, and information availability on, a company, they cannot alter the cash flows, which are based on the inherent characteristics of a business.

In order to reflect the accurate financial position of an entity, CRISIL, as a part of its analytical approach, has always made adequate analytical adjustments rather than relying on audited financial statements *(please refer to the document titled, '*CRISIL's approach to financial ratios').

The improvement in financial reporting standards through the adoption of Ind AS could mean fewer analytical adjustments to be made. Nevertheless, we will continue to make these adjustments in line with our existing framework to reflect the true and accurate financial position of a company. For example, under the revised accounting guidelines, reported networth is likely to undergo a significant change due to fair valuation of land, financial investments, etc. However, CRISIL will continue to adjust these changes in line with our existing analytical approach and factor the gains in reported net worth due to fair valuation only upon its realisation. Though the impact of fair valuation is not considered as part of overall networth, CRISIL, as part of its ratings approach continues to factor such inputs in the assessment of the overall financial flexibility of the company- a key component of the overall credit profile.

In areas such as consolidation of entities and hybrid instruments, though the revised guidelines are an improvement, CRISIL's criteria framework and analytical treatment remains largely unchanged because of the comprehensiveness of the existing criteria.

For example, under Indian GAAP, the principle of consolidation is driven by the concept of controlling stake, whereas under Ind AS, it is driven by the ability of the investor to direct the activities of the investee company and thus impact its returns. This is a significant improvement.

However, CRISL's existing analytical approach on consolidation is more comprehensive as it involves not only the consolidation of financials, but also of the business risk profile of the consolidated entities. Moreover the rationale for consolidation is based on an analysis of various factors such economic importance of the related entity, fungibility of cash flows, part of homogenous corporate groups, management stance and documentary evidence of support, and shared name, which makes the approach far more comprehensive than the revised accounting standards *(please refer to CRISIL's criteria on consolidation, and on rating entities belonging to homogenous corporate groups).*

Similarly, CRISIL classifies convertible and other hybrid instruments having low, moderate or high equity-like features based on factors such as principle of permanence, committed obligation to service and loss absorption capacity.

Hence, in such cases, CRISIL will continue to the treat the equity portion of hybrid instruments as per its existing criteria *(please refer to CRISIL's criteria for corporate sector hybrids).*

Below is a sample of analytical treatment that CRISIL will continue to adopt as part of its rating framework, compared with what's suggested under Ind AS:

Ind AS vs CRISIL's analytical treatment

Accounting changes under Ind AS	CRISIL's analytical treatment	Relevant CRISIL criteria/*articles*
Segregation of financing income/expenses from revenues	CRISIL will treat any financing income that is not part of core operations as non-operating income. However this would be included in the debt protection indicators such as interest coverage and net cash accrual to total debt.	CRISIL's approach to financial ratios
Revenue recognition under multiple deliverable elements and transfer of risk and rewards	CRISIL will closely monitor up fronting of revenues and make necessary adjustments on case to case basis	Analytical adjustments to financial statements: CRISIL perspective
Non-amortisation of goodwill and testing for impairment	Goodwill generated from arm's length transaction with third parties amortised over 5 years or useful life, whichever is lower. Otherwise tangible net worth is adjusted for goodwill	CRISIL's approach to financial ratios
Intangibles	Acquired tangibles such as trademarks and patents will be amortised over 10 years, or useful life	CRISIL's approach to financial ratios
Increase in networth on account of fair valuation of Assets and Investments	Excludes revaluation reserves and increase in fair valuation of investments from the tangible net worth	CRISIL's approach to financial ratios
Deferred tax liabilities	Excludes deferred tax liabilities from adjusted networth	CRISIL's approach to financial ratios
Consolidation or deconsolidation of entities based on the principle of control. Accounting treatment for joint ventures from proportionate consolidation to equity method	CRISIL's treatment for consolidation of associated entities and joint ventures will be driven by its consolidation criteria based on principles such as such economic importance, fungibility of cash flows, management stance and documentary evidence of support, shared name, etc	CRISIL's criteria on consolidation
Split accounting used for hybrid instruments such as preference shares, perpetual debt and convertible debentures	Capital treatment of the instrument depends upon the equity content assessed through its loss absorption, permanence in capital structure and deferability of servicing requirements	CRISIL's criteria for corporate sector hybrids

Conclusion

CRISIL's rating criteria and outstanding ratings will remain largely unchanged because of the impact of revised accounting standards. The revised standards will improve disclosures and provide additional information about the rated companies. These disclosures and information would be monitored on an ongoing basis and would be factored by CRISIL as a part of its analytical adjustments based on the existing criteria and framework.

About CRISIL Limited

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